

BANK OF CHINA (UK) LIMITED

**Annual Report & Financial Statements
for the year ended 31st December**

2011





 中國銀行 BANK OF CHINA

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Business Review

Chairman's Statement

Although China-EU/UK trading relations have moved onto a higher level, 2011 was a year of weak and deteriorating economic conditions worldwide, which resulted in a severe business environment for the banking industry. The UK banking sector was hit by the UK economic downturn, uncertainty of regulation and the Eurozone debt crisis.

Despite this environment, the fourth full financial year of operations for Bank of China (UK) Limited ("BOC UK" or "the bank") has been completed smoothly and the underlying development of some aspects of the bank's business in the UK was satisfactory.

Although financial targets for the year were not fully met, management is to be congratulated on the efforts made throughout the year to streamline the organisational structure of the bank's operations, to enhance business development co-operation with domestic units of the Parent Bank, to develop new delivery channels in the UK and to launch new retail card products. In accordance with the experience of peer group banks in London to meet the increasing challenge of the regulatory environment, management has taken steps to increase both the resources allocated and systems deployed in the bank's Risk Management and Compliance functions. The bank has also been actively involved in the City of London Corporation's initiative to develop London as an Offshore RMB Centre.

Unfortunately, continuing difficulties in the bank's private banking operations in Switzerland which required the establishment of a significant impairment provision and the downgrade of one of the bank's borrowers, together undermined the full year financial performance of the bank, resulting in a substantial loss after corporation tax for the year. The capital resources of the bank were reinforced through a substantial capital injection from the Parent Bank earlier in the year, demonstrating the Group's continuing support for the bank's operations in the UK.

Looking forward to 2012, all the available data indicates that there will be little economic recovery in the UK or in the Eurozone over the next year. However, the improved credit rating of the Parent Bank Group and its classification by the G20 Group as a Globally Significant Financial Institution provides an opportunity for management to raise the bank's profile in the market and to continue the successful development of the bank's business. I am confident that the management team can take advantage of this situation to achieve its financial targets and strategic objectives set by the Board including: further integration with other overseas members of the group and with domestic branches in China, expansion of cross-border products and services and further reinforcement of the bank's position as a leading provider of RMB products and services.

I should also like to take this opportunity to express the bank's appreciation for the contribution made by Dr Kenneth Ge to the successful development of the bank until he left his most recent position as Vice Chairman of the Board in December 2011.



Yi Yue

Chairman of the Board of Directors

Chief Executive Officer's Statement

Notwithstanding the difficult market conditions, the bank's UK businesses, both wholesale and retail, continued to grow throughout the year in order to meet the financial targets set by the Board of Directors.

The expansion in our activities required a further increase in the bank's headcount, continuing a trend from previous years and in marked contrast to the market generally, in which many other financial institutions are scaling back their operations in the UK.

In retail banking, further progress was made in following key marketing strategies around the expansion of the bank's core products for its UK retail customers and equally importantly, encouraging the increasing use of its Renminbi (RMB) denominated products, including Current Accounts, Remittances, Term Deposits and Pre-paid Credit Cards. Supporting the increasing use of RMB products and services outside mainland China is a key strategic objective for the entire Bank of China Group.

In line with improving market standards around governance and risk controls, the bank's management structure was strengthened during the course of the year. The increasing regulatory requirements of the FSA as it prepares for the new "twin peaks" regulatory framework, represent a continuing challenge to management.

Although elements of the bank's corporate and retail banking business improved over the year, deteriorating credit conditions made it necessary to establish a provision of £7,000,000 against the bank's exposure to Yell Group Limited. In addition, adverse market developments at the bank's private banking subsidiary in Geneva, Bank of China (Suisse) S. A. ("BOCS") required the establishment of an impairment provision of £31,432,000 against this investment. These two factors materially contributed to a negative operating result after tax for the year of £26,070,000.

As evidence of strong support from the Parent Bank, Bank of China Limited, the capital resources of the bank were increased by £110,000,000 on 30 March 2012 to cover the cost of the BOCS impairment and to provide additional capital resources for the bank's future business development plans.

Management expects 2012 to be a very challenging year and will continue to follow the strategy set by the Board and make every effort to achieve sustainable and healthy growth.



Wenjian Fang
Chief Executive Officer
Board Director

Report of the Directors

Principal Activities

Bank of China (UK) Ltd (“BOC UK” or the “bank”) is a full service bank offering retail, corporate and trade finance services in the United Kingdom (the “UK”). The bank is a wholly owned subsidiary of Bank of China Limited, Beijing (“BOC”). The bank is authorised and regulated by the Financial Services Authority (the “FSA”).

BOC UK was incorporated in England and Wales as a private company with limited liability on 29 March 2007. The bank’s registration number at Companies House is 6193060.

Our corporate and trade finance business encompasses funding and advisory services for Chinese corporates seeking to expand in the UK and Europe. Syndication plays an important role for the bank in gaining access to European corporate clients. Our retail activities focus on branch banking. The bank offers standard high street retail banking services including current accounts, savings accounts, debit and credit cards, mortgage products and personal and business loans.

Business Review

As at 31 December 2011 the bank had total assets of £777,725,000 (2010: £735,494,000).

The bank’s assets are primarily financed by retail and intra-group deposits. The bank continues to focus its attention on developing the customer deposits base and this reflects our determination to develop our corporate banking services as well as to help in meeting the bank’s funding requirements.

For the year ended 31 December 2011, the bank generated a post-tax loss of £26,070,000 (2010: profit £10,779,000), after an impairment charge of £31,432,000 resulting from an impairment assessment of the bank’s investment in Bank of China (Suisse) S.A. (“BOCS”), see note 34 (b) for further information on the impairment assessment of BOCS, and a £7,000,000 impairment against one loan facility in the Corporate Banking portfolio. Notwithstanding these impairments, the underlying operating result was behind the budget set by the Board of Directors (the “Board”), reflecting the difficulty in identifying

assets that have a risk profile acceptable to the bank, as a result of the continuing difficult market and economic conditions in the UK and the Eurozone.

Retail Banking

The bank continued to build its brand awareness and increase its customer base in the UK retail market. The bank’s buy-to-let mortgage product was selected a Best Buy by Moneyfacts, an independent organisation that monitors financial products. This award contributed towards a steady increase in the mortgage loan book. As at 31 December 2011 there were no non-performing loans and the bank continues to lend prudently in a challenging market.

The bank also achieved a healthy growth in commission business and total commission income for retail banking increased by 23% compared with last year.

In addition to traditional retail products, the bank focused its attention on Renminbi (“RMB”) denominated business, providing a number of RMB services including RMB currency exchange, RMB current account, RMB remittances and a range of RMB accounts. The bank’s Gold Premier service with a dedicated service team has allowed the bank to meet the demands of its High Net Worth customers.

Corporate Banking

Seizing on the opportunity of China’s strong economic growth as well as fast growing Sino-British bilateral trade, the bank continued to develop its relationships with existing and targeted corporate clients by offering a comprehensive range of banking products and services including credit facilities, trade services, cash management, foreign exchange and RMB business. As well as addressing the UK market the bank is also focused on targeting new relationships in Europe, the Middle East and Africa.

A key objective for the corporate banking business is to be a major bank servicing the trade and investment between UK and China and China’s “Going Out” enterprises in the UK, Europe and Africa regions.

Financial Markets

The Financial Markets and Financial Institutions department comprises three divisions: foreign exchange, money market and fixed income investments. During the year, these activities have continued to focus upon efficient liquidity management and the funding requirements of the bank's activities. There was no proprietary trading activity during the year under review.

Dividends

The directors do not recommend the payment of a dividend.

Directors' Interest

The directors of the bank who were in office during the year and up to the date of signing the financial statements were:

Mr. Yi Yue	Chairman
Dr. Kenneth Q. Ge	Vice Chairman (resigned 12 December 2011)
Mr. Wenjian Fang	Chief Executive Officer (appointed 1 March 2011)
Mr. Stephen Hinds	Chief Operating Officer
Mr. Christopher Fitzgibbon	Non-Executive
Mr. Donald Workman	Non-Executive
Ms. Li Ren	Non-Executive (appointed 29 May 2011)

None of the directors who held office at the end of the financial period had any disclosable interest in the shares of the bank at that date.

Directors' Emoluments

Information on emoluments of the directors of BOC UK, in accordance with the Companies Act 2006, is disclosed in Note 15 to the financial statements.

Directors' Indemnities

The BOC UK Board believes that it is in the best interests of the bank to attract and retain the services of the most able and experienced directors by offering competitive terms of engagement, including the granting of indemnities on terms consistent with the applicable statutory provisions. Qualifying third party indemnity provisions (as defined by Section 234 of the Companies Act 2006) were accordingly in force during the course of the financial period ended 31 December 2011 for the benefit of the directors and, at the date of this report, are in force for the benefit of the directors in relation to certain losses and liabilities which they may incur (or have incurred) in connection with their duties, powers or office.

Employees

The average number of employees for the year ended 31 December 2011 was 254 (31 December 2010: 211).

Charitable and Political Contributions

For the year ended 31 December 2011, the bank did not fund any charities nor did it make any donations to political organisations.

Financial Instruments

The bank's principal financial risk management objectives and policies including its exposure to credit risk, market risk and liquidity risk are set out in Note 6, pages 34 to 44, to the financial statements.

Further information regarding the bank's approach to risk management and its capital adequacy are contained in the unaudited disclosures made under the requirements of Basel II Pillar 3 (the Pillar 3 disclosures). These disclosures will be published on the bank's website shortly after the approval of these financial statements at www.bankofchina.com/uk.

Principal Risks and Uncertainties

The bank is subject to a number of risk factors that could cause its future results to differ materially from current expectations. These risk factors are of uncertainties concerning the current and future business climate and risks which are naturally inherent in a banking environment.

The current business climate is subject to significant uncertainties in 2012 and beyond, most notably:

- The rate and sustainability of the recovery of the UK economy;
- The potential impact of increasing inflation on economic growth and corporate profitability;
- The rate and extent of the rise of interest rates in the UK and the Eurozone; and
- The potential fall of residential property prices.

The effect of one or a combination of the above factors could make the business environment a challenging one with regard to possible credit impairments being incurred and difficulty in identifying new assets/business opportunities that meet the bank's risk appetite.

Principal Risks: The bank is exposed to a number of financial and non-financial risks namely credit risk, market risk, liquidity risk and operational risk. Of these risks, credit risk and liquidity risk are deemed to be the principal risks which the bank is exposed to.

Credit risk is the risk of financial loss to the bank if a customer or counterparty to a financial instrument fails to meet its contractual obligations and is considered a principal risk due to the composition of the bank's balance sheet and lending being its primary business.

The bank has established a set of credit risk management policies and procedures, and appropriate credit risk limits to manage and control credit risk that arises through the bank's normal business activities. These policies, procedures and limits are regularly reviewed in light of changes in markets and business strategies.

Further information on the management of credit risk is disclosed in Note 6 (a) of the notes to the financial statements.

Liquidity risk is the risk that the bank is unable to meet its obligations as they fall due resulting in an inability to support normal business activity and/or failing to meet liquidity regulatory requirements.

The bank is exposed to the risk that it will be unable to meet its obligations as they fall due, arising from the differing maturity profiles of its assets and liabilities. To mitigate its exposure the bank places limits on the mismatch of maturity dates, and by holding stock of liquid assets which could be sold at short notice if the need arose. The Board, as part of the going concern assessment, took additional comfort from the Letter of Support from the bank's parent company which, by direct implication, has a significant impact on the bank's assessment of its exposure to liquidity risk. A further mitigating factor is a committed short-term loan facility granted by the bank's parent company which is in support of the Intra Group Liquidity Modification granted to the bank by the FSA.

Further information on the management of liquidity risk is disclosed in Note 6 (b) of the notes to the financial statements.

Key Performance Indicators

The bank's Key Performance Indicator ("KPI") is monitoring the financial performance of the bank against financial targets set at the beginning of the financial year by the Board. The financial targets monitored include the main income streams of the bank by income type and business department, personnel and business expenses and net profit after tax.

Subsequent Events

On the 12 March 2012 Bank of China Limited, the bank's parent company, remitted £110,000,000 for the purpose of subscribing for 110,000,000 £1 ordinary shares in the bank. On the 30 March 2012 the bank issued and allotted 110,000,000 £1 ordinary shares to Bank of China Limited.

The bank entered into and signed a sale and purchase agreement ("SPA") with a Swiss registered bank for the sale of the whole of the issued share capital of BOCS on 20 July 2012. See note 36 for further information on this transaction.

Disclosure of Information to the Auditors

The directors who held office at the date of approval of this Directors' Report confirm that:

- So far as they are each aware, there is no relevant audit information of which the bank's auditors are unaware; and
- Each director has taken all steps that he/she ought to take as a director to make himself/herself aware of any relevant audit information and to establish that the bank's auditors are aware of that information.

This confirmation is given and should be interpreted in accordance with the provisions of Section 418 (2) of the Companies Act 2006.

Pursuant to Section 487 of the Companies Act 2006, the auditors will be deemed to be reappointed and PricewaterhouseCoopers LLP will therefore continue in office.

1 Lothbury
London
EC2R 7DB

By order of the Board,



Wenjian Fang
Chief Executive Officer
Board Director

17 August 2012



02/ Governance

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Bank of China (UK) Limited (“BOC UK” or the “bank”) is committed to the principles of corporate governance contained in the UK Corporate Governance Code (the “Governance Code”) issued by the Financial Reporting Council on 28 May 2010.

Corporate Governance Framework

The bank’s corporate governance framework centres on the Board of Directors (the “Board”), which provides guidance and effective oversight of the senior management of the bank and of its subsidiaries. In order to run the business effectively, the Board delegates responsibility for the day-to-day management of the bank to the Chief Executive Officer, who is supported by the Executive Management Committee, which he chairs.

Board and Committee meetings are arranged in advance to ensure, as far as possible, that directors can manage their time commitments. All directors are provided with supporting papers and relevant information for each meeting and are expected to attend, unless there are exceptional circumstances that prevent them from doing so.

In the event that a director is unable to attend a meeting, he/she will still receive the papers for the meeting and will normally discuss any matters they wish to raise with the chairman of the meeting, to ensure their views are taken into account. In addition, all directors are able to discuss any issues with the Chairman of the Board and/or the Chief Executive Officer at any time. During the year ended 31 December 2011, it is considered that all directors contributed the time necessary to discharge their responsibilities to the Board.

The Chairman of the Board works closely with the Company Secretary to ensure that accurate, timely and clear information flows to the Board. Supporting papers for scheduled meetings are distributed in advance of each meeting. All directors have access to the services of the Company Secretary.

Following the provisions in the Articles of Association the appointment or removal of a member of the Board requires the approval of the shareholders. Independent non-executive directors are appointed for three-year renewable terms which may, in accordance with the Articles of Association, be terminated without notice or payment of compensation.

Board Effectiveness

Under United Kingdom (the “UK”) Company Law, directors must act in a way they consider, in good faith, would be most likely to promote the success of the bank for the benefit of the shareholders as a whole. In doing so, the directors must have regard (amongst other matters) to the following:

- The likely consequences of any decision in the long-term;
- The interests of the bank’s employees;
- The need to foster the bank’s business relationships with suppliers, customers and others; and
- The impact of the bank’s operations on the community and the environment.

The Board is responsible to shareholders for creating and delivering sustainable shareholder value through the management of the bank’s businesses. It therefore determines the goals and policies of the bank to deliver such long-term value and provides overall strategic direction within a framework of rewards, incentives and controls. The Board aims to ensure that management strikes an appropriate balance between promoting long-term growth and delivering short-term objectives.

The Board is also responsible for ensuring that management maintains a system of internal controls that provide assurance of effective and efficient operations, internal financial controls and compliance with the laws and regulations. In carrying out this responsibility, the Board has regard to what is appropriate for the bank’s business and reputation, the materiality of the financial and other risks inherent in the business, and the relative costs and benefits of implementing specific controls.

The Board is also the decision-making body for all other matters of such importance as to be of significance to the bank as a whole because of their strategic, financial or reputational implications or consequences.

A typical Board meeting receives reports from the Chief Executive Officer and will also be presented with an update on the execution of strategy in the main businesses and functions. It will also receive reports from each of the principal Board Committees and may also receive a report from the Company Secretary on any relevant corporate governance matters.

Chairman and Chief Executive Officer

The roles of the Chairman and the Chief Executive Officer are separate. The Chairman’s main responsibility is to lead and manage the work of the Board to ensure that it operates effectively and fully discharges its legal and regulatory responsibilities. The Board has delegated the responsibility for the day-to-day management of the bank to the Chief Executive Officer, who is responsible for recommending strategy to the Board, leading the executive directors and for making and implementing operational decisions.

Board Balance and Independence

The Board has collective responsibility for the success of the bank, however, executive directors have direct responsibility for business operations, whereas non-executive directors are responsible for bringing independent judgement and scrutiny to decisions taken by the Board, providing objective challenge to management. The Board can draw on the wide range of skills, knowledge and experience they have built up as directors of other companies and as business leaders.

The Governance Code sets out circumstances that the Board may find relevant when determining the independence of a non-executive director. The Board considers that the following behaviours are essential in order for the Board to conclude that an individual is independent:

- Provides objective challenge to management
- Is prepared to challenge others' assumptions, beliefs or viewpoints as necessary for the good of the bank;
- Questions intelligently, debates constructively, challenges rigorously and makes decisions dispassionately;
- Is willing to stand up and defend their own beliefs and viewpoints in order to support the ultimate good of the bank; and
- Understands the bank's business and affairs, to enable them properly to evaluate the information and responses provided by management.

All directors must report any changes in their circumstances to the Board and the shareholders reserve the right to terminate the appointment of a director if there are any material changes in their circumstances that may conflict with their commitments as a director of the bank, or that may impact on their independence.

Information and Professional Development

A three-part training programme is in place for Directors. This comprises:

- Induction training, when they join the Board;
- Training and awareness of the business of the bank; and
- Training and awareness of external technical matters.

A presentation is given to all new directors, which outlines their responsibilities as a director of a UK limited company and provides an overview of the bank and its businesses. Each new director then has a tailored induction programme to further familiarise themselves with the bank and its businesses. This takes the form of sessions with each of the executive directors and the heads of the main bank functions and includes opportunities to visit operational sites to meet with senior management and employees. Once they have completed the first part of their induction, and have a good overview of the bank, they then have further sessions with the executive directors and senior managers from each of the principal business units to gain a detailed and in-depth understanding of their business, which includes the challenges, opportunities and risks that are faced by each.

During 2011, the Board was provided with material on Corporate Governance and Regulatory Responsibilities providing updates on the previous training they attended in 2010 on these subjects.

Performance Review

As with the previous year, annual performance contracts were established for the executive directors for 2011 to assess their performance across five key performance areas aligned to the bank's 'balanced scorecard' approach to performance management, being:

- Financial
- Business Processes and Technical Skills
- Customer Focus
- Leadership
- Team

The performance contracts provide an overall summary of their achievements throughout the year in their roles as directors of the bank.

Internal Control

The Board is responsible for the bank's system of internal control. It is designed to facilitate effective and efficient operations and to ensure the quality of internal and external reporting and compliance with applicable laws and regulations. In devising internal controls, the Board considers the nature and extent of the risk, the likelihood of it crystallising and the cost of controls.

The Board receives regular reports and updates from the Executive Management and the Audit Committee on the effectiveness of the bank's internal control system. The system of internal controls is also subject to regulatory oversight and periodic FSA ARROW2 assessment, the most recent of which was in October/November 2011.

Remuneration Committee Report

The functions of the Remuneration Committee (the "Committee") are fulfilled. The Committee met on three occasions in 2011 and considered and approved the following:

• Corporate Governance

The Committee members considered how other global banks with overseas subsidiaries operate their Remuneration Committees specifically in relation to corporate governance structures i.e. global Head Office versus local requirement and agreed that alignment to global policies and procedures was a priority where practical but local regulations and legislation would always prevail.

• Management Information

The Committee members reviewed the headcount information/staff turnover throughout 2011 and confirmed that nothing adverse was noticed. The Committee will continue to monitor staff turnover regularly and if anything adverse is noted, appropriate actions will be taken accordingly.

• Training and Development

In conjunction with staff development strategies, the Committee approved the Training and Development plan for 2011 to primarily focus on:

- Internal regulatory training;
- IT skills training;
- Language/cultural awareness training;
- Management Development Programmes for staff across different levels of management grades;
- Client relationship/customer services training;
- Project management workshops;
- Performance management workshops, and
- Implementation of a professional banking qualification provided by CIOBS (Chartered Institute of Bankers in Scotland).

• Performance Management

In alignment with Performance Management strategies, the Committee approved the continual review of the Performance Management process to streamline and clarify measurement/target application, weighting application and moderation of performance ratings and ensure it achieves the bank's and the employees' objectives. The Committee approved the year-end performance management process which was also aligned to annual salary and discretionary bonus scheme allocation.

• Flexible Benefits Scheme

The Committee approved the implementation of a Flexible Benefits Scheme (including salary exchange components) to enhance the current benefits package to ensure the appropriateness/competitiveness for individuals considering that the diverse range of staff may have different needs/lifestyles. The Scheme was implemented in July 2011 and was well received within the bank. An employee survey will be undertaken in 2012 to collect employees' opinions in preparation for Year 2.

• FSA Code of Practice on Remuneration

Following the implementation of the revised FSA Remuneration Code of Practice on 1 January 2011, extensive work has been completed to comply with the code for example identifying code staff and taking consideration of risk implications. The following documents are also being revised and completed:

- Remuneration Policy;
- Remuneration Policy Statement; and
- Tier 2 Pillar 3 remuneration disclosure.

Audit Committee Report

The Audit Committee (the "Committee") currently comprises of two non-executive directors who are voting members: Mr Chris Fitzgibbon (Chairman) and Mr Donald Workman; and two non-voting members: Mr Stephen Hinds, Chief Operating Officer and Mr Long Yue, Head of Internal Audit. The Committee meets at least quarterly and four meetings were held in 2011: the external auditors were in attendance at each meeting. During the course of the year, the Committee considered the effectiveness of the bank's systems for internal control, risk management and compliance with financial services legislation and regulations. In addition the following key activities were undertaken:

- The Committee approved the scope of the external auditors' work and separately assessed their effectiveness;
- The Committee reviewed the financial statements presented to the Board and the quality and acceptability of the related accounting policies, practices and financial reporting disclosures;
- The Internal Audit Department Plan was considered and approved. The effectiveness of the department and the adequacy of its resources were also considered and its ongoing performance monitored;
- Regular reports and updates from the Internal Audit Department were received and considered; and
- Reports were received from the Risk Management and Legal and Compliance Departments and these were reviewed and discussed.

Board Risk Committee Report

Following the Walker Report recommendations to reinforce Enterprise-wide Risk Management (“ERM”) and in line with FSA guidelines, the Board approved the establishment of a Board Risk Committee (“BRC”) on 23rd March 2011. This Committee succeeds the Board Credit Committee (“BCC”).

BRC comprises three directors who are voting members: Mr Donald Workman (non-executive director and BRC Chairman), Dr Kenneth Q. Ge (Vice Chairman – resigned 9/12/2011) and Mr Wenjian Fang (Chief Executive Officer).

The Committee is responsible for the oversight and implementation of risk strategy and risk appetite within the bank, oversight of risk management performance and the Executive Committees including Compliance Committee, Operational Risk Committee, Assets and Liabilities Management Committee, Credit Risk Policy Committee and Credit Committee. BRC also approves all credit limits, provisions (and/or write-offs) above the delegated limits of the CEO.

The BRC meets at least quarterly. Four BRC meetings and two BCC meetings were held during 2011.

Of the four BRC meetings held during the year two were held specifically to review, discuss and challenge the bank’s Individual Capital Adequacy Assessment (“ICAAP”) and Individual Liquidity Adequacy Assessment (“ILAA”) documents prior to them being presented to the Board for approval.

Statement of Directors' Responsibilities in Respect of the Directors' Report and the Financial Statements

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

Company law requires the directors to prepare financial statements for each financial period. Under that law the directors have prepared the financial statements in accordance with International Financial Reporting Standards (the "IFRSs") as adopted by the European Union. Under company law the directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the company and of the profit or loss of the bank for that period. In preparing these financial statements the directors are required to:

- Select suitable accounting policies and apply them consistently;
- Make judgements and estimates that are reasonable and prudent;
- State that the financial statements comply with IFRSs as adopted by the European Union; and
- Prepare the financial statements on a going concern basis unless it is inappropriate to presume that the bank will continue in business.

The directors are responsible for keeping adequate accounting records that are sufficient to show and explain the company's transactions and disclose with reasonable accuracy at any time the financial position of the company and enable them to ensure that the financial statements comply with the Companies Act 2006. They are also responsible for safeguarding the assets of the company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

Going Concern

The directors have assessed, in the light of current and ongoing uncertain economic conditions, the bank's ability to continue as a going concern. The directors confirm they are satisfied that the bank has adequate resources, together with parental support, to continue in business for the foreseeable future and continue to adopt the "going concern" basis for preparing the financial statements.

The directors are responsible for the maintenance and integrity of the company's website. Legislation in the United Kingdom governing the preparation and disseminating of financial statements may differ from legislation in other jurisdictions.

Directors' Responsibility Statement

On behalf of the directors of BOC UK, I confirm that to the best of my knowledge the following statements are true:

1. The financial statements, prepared in accordance with International Financial Reporting Standards, as adopted by the European Union, give a true and fair view of the assets, liabilities, financial position and profit of the bank; and
2. The Directors' Report includes a fair review of the development and performance of the business and the position of the bank.



Wenjian Fang
Chief Executive Officer
Board Director

17 August 2012

Independent Auditors' Report to the Members of Bank of China (UK) Limited

We have audited the financial statements of Bank of China (UK) Limited ("the company") for the year ended 31 December 2011 which comprise Income Statement, Statement of Comprehensive Income, Statement of Financial Position, Statement of Changes in Equity, Statement of Cash Flows, the Accounting Policies and the related notes. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union.

Respective Responsibilities of Directors and Auditors

As explained more fully in the Directors' Responsibilities Statement, 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 Ethical Standards for Auditors.

This report, including the opinions, has been prepared for and only for the company's members as a body in accordance with Chapter 3 of Part 16 of the Companies Act 2006 and for no other purpose. We do not, in giving these opinions, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

Scope of the Audit of the Financial Statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the company's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the directors; and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the company's Annual Report to identify material inconsistencies with the

audited financial statements. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

Opinion on Financial Statements

In our opinion the financial statements:

- give a true and fair view of the state of the company's affairs as at 31 December 2011 and of its loss and cash flows for the year then ended;
- have been properly prepared in accordance with IFRSs as adopted by the European Union; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

Opinion on Other Matter Prescribed by the Companies Act 2006

In our opinion 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 matters where the Companies Act 2006 requires us to report to you if, in our opinion:

- adequate accounting records have not been kept, or returns adequate for our audit have not been received from branches not visited by us; or
- the financial statements are not in agreement with the accounting records and returns; or
- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.



Nicholas Morrison (Senior Statutory Auditor)
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
London

17 August 2012



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Financial Statements

Income Statement

£000	Note	12 months to 31 December 2011	12 months to 31 December 2010
Interest income from financial investments		3,425	6,117
Other interest income		9,531	10,065
Interest expense		(2,828)	(3,858)
Net interest income	9	10,128	12,324
Fee and commission income		6,353	6,317
Fee and commission expense		(507)	(170)
Net fee and commission income	10	5,846	6,147
Net loss on derivative financial instruments	11	(927)	(2,312)
Foreign exchange (loss)/gain		(2,080)	262
Other operating income	12	25,698	30,331
Loss on sale of debt securities		(1,298)	(190)
Non-interest income		21,393	28,091
Total income		37,367	46,562
Staff costs	13	(16,203)	(13,759)
Other expenses	14	(4,657)	(4,044)
Depreciation of plant and equipment	23	(507)	(516)
Amortisation of intangible assets	24	(160)	(161)
Impairment charges	21 (c)	(8,272)	(35)
Impairment of investment in subsidiary	34	(31,432)	(8,432)
(Loss) / profit before income tax		(23,864)	19,615
Income tax expense	16	(2,206)	(8,836)
(Loss) / profit for the year		(26,070)	10,779

Statement of Comprehensive Income

£000	Note	12 months to 31 December 2011	12 months to 31 December 2010
(Loss) / profit for the year		(26,070)	10,779
Other comprehensive income			
Net change in fair value of available for sale financial assets	21	(1,141)	4,329
Net change in fair value of available for sale financial assets transferred to profit or loss	21	1,105	150
Net (loss)/gain on available for sale financial assets		(36)	4,479
Income tax income/(expense) relating to components of other comprehensive income	16	10	(1,254)
Other comprehensive (expense) / income for the year, net of income tax		(26)	3,225
Total comprehensive (expense) / income for the year		(26,096)	14,004

Statement of Financial Position

£000	Note	31 December 2011	31 December 2010
Assets			
Cash and cash equivalents	17	275,821	215,155
Loans and advances to banks	19	12,865	12,817
Loans and advances to customers	20	290,752	214,623
Derivative financial instruments	18	72	505
Prepayments, accrued income and other assets	26	37,692	46,427
Available for sale investments	22	95,671	149,677
Deferred tax assets	25	30	4
Tangible fixed assets	23	1,374	1,612
Intangible assets	24	163	317
Investment in subsidiary companies	34	63,285	94,357
Total assets		777,725	735,494
Liabilities			
Deposits from banks	27	202,684	176,070
Deposits from customers	28	352,176	296,289
Derivative financial instruments	18	4,416	5,956
Other liabilities	30	15,290	14,205
Accruals and deferred income	31	3,602	3,137
Current tax liabilities		–	14,184
Subordinated liabilities	29	60,000	60,000
Total liabilities		638,168	569,841
Equity			
	32		
Authorised and called up share capital		140,000	140,000
Retained earnings		528	26,598
Available for sale reserve		(971)	(945)
Total shareholders' equity		139,557	165,653
Total shareholders' equity and liabilities		777,725	735,494

The financial statements were approved by the Board of Directors of Bank of China (UK) Limited and authorised for issue on 17 August 2012. They were signed on its behalf by:



Wenjian Fang
Chief Executive Officer
Board Director

Statement of Changes in Equity

£000	Issued share capital	Retained earnings	Available for sale reserve	Total
As of 1 January 2011	140,000	26,598	(945)	165,653
Unrealised losses on available for sale investments net of income tax	-	-	(26)	(26)
Loss for the financial year	-	(26,070)	-	(26,070)
Total comprehensive expense	-	(26,070)	(26)	(26,096)
As at 31 December 2011	140,000	528	(971)	139,557
As of 1 January 2010	140,000	15,819	(4,170)	151,649
Unrealised profit on available for sale investments net of income tax	-	-	3,225	3,225
Profit for the financial year	-	10,779	-	10,779
Total comprehensive income	-	10,779	3,225	14,004
As at 31 December 2010	140,000	26,598	(945)	165,653

Statement of Cash Flows

£000	Note	12 months to 31 December 2011	12 months to 31 December 2010
Cash flows from operating activities			
(Loss) / profit on ordinary activities before taxation		(23,864)	19,615
Adjustments for non cash items			
Depreciation and amortisation of plant and equipment and intangible assets		667	677
Net impairment loss on investment securities		1,105	150
Net impairment loss/(profit) on loans and advances		7,167	(115)
Impairment of investment in subsidiary		31,432	8,432
Interest receivable from financial investments		(3,425)	(6,117)
Other interest receivable		(9,531)	(10,065)
Interest payable		2,828	3,858
Loss on the sale of debt securities		1,298	190
Loss on disposal of tangible fixed assets		6	–
Exchange-rate movements on available for sale investments		489	797
Changes in operating assets and liabilities			
Change in derivatives held for risk management		(1,107)	1,060
Change in loans and advances to banks		(48)	24,116
Change in loans and advances to customers		(83,295)	290,235
Change in other assets		792	(9,397)
Change in deposits from banks		26,254	(201,627)
Change in deposits from customers		55,887	(81,930)
Change in other liabilities and provisions		1,174	1,724
Adjustment for cash items			
Interest and coupon received		16,421	15,426
Interest paid		(2,451)	(3,810)
Income tax paid		(11,131)	(5,059)
Net cash generated from operating activities		10,668	48,160
Cash flows from investing activities			
Proceeds from sale of investment securities		50,279	101,235
Acquisition of property and equipment		(275)	(102)
Acquisition of intangible assets		(6)	(39)
Investment in subsidiaries		–	(61,911)
Net cash from investing activities		49,998	39,183
Net increase in cash and cash equivalents			
		60,666	87,343
Cash and cash equivalents at beginning of period		215,155	127,812
Cash and cash equivalents at period end	17	275,821	215,155

The statement of cash flows has been prepared under the indirect method.

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Financial Statements

Notes to the Financial Statements *continued*

1. Reporting entity

Bank of China (UK) Limited (“BOC UK” or “the bank”) is a company domiciled in the United Kingdom (the “UK”) with its registered office at 1 Lothbury, London, EC2R 7DB. The separate financial statements of the bank as at and for the year ended 31 December 2011 are presented below. The bank is primarily involved in retail and corporate banking.

Accounting policies for the year ended 31 December 2011

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

2. Basis of preparation

(a) Statement of compliance

These financial statements have been prepared in accordance with International Financial Reporting Standards (the “IFRSs”) as adopted by the European Union (the “EU”), IFRIC interpretations and the Companies Act 2006.

The bank has availed itself of the exemption election in IAS 27 Consolidated and Separate Financial Statements that permits an entity to prepare separate financial statements. The bank is a wholly-owned subsidiary of Bank of China Limited (“BOC”), which produces consolidated financial statements available for public use that comply with IFRSs. BOC is domiciled in the People’s Republic of China (the “PRC”), with its head office located at 1 Fuxingmen Nei Dajie, Beijing, 100818, PRC. The consolidated financial statements of the BOC Group are publicly available from this address.

The financial statements were authorised for issue by the Board of Directors (the “Board”) on 17 August 2012.

(b) Basis of measurement

The financial statements have been prepared under the historical cost basis modified to include the fair valuation of certain financial instruments and contracts to buy or sell non-financial items to the extent required or permitted under accounting standards and as set out in the relevant accounting policies.

The following items are measured at fair value:

- Derivative financial instruments
- Available for sale financial assets

(c) Functional and presentational currency

These financial statements are presented in Sterling (£), which is the bank’s functional currency. Except as indicated, financial information presented in Sterling has been rounded to the nearest thousand.

(d) Use of estimates and judgements

The preparation of financial statements requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expense. Actual results may differ from these estimates.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised and in any future periods affected.

Information about significant areas of estimation uncertainty and critical judgements in applying accounting policies that have the most significant effect on the amounts recognised in the financial statements are described in Note 4.

3. Significant accounting policies

The accounting policies set out below have been applied consistently to all periods presented in these financial statements, and have been applied consistently by the bank.

(a) Revenue recognition

Interest income and expense are recognised in the income statement for all interest-bearing financial instruments, except for those classified at fair value through profit or loss, using the effective interest method. The effective interest method is a method of calculating the amortised cost of a financial asset or liability and of allocating the interest income or interest expense. The effective interest rate is the rate that exactly discounts the estimated future cash payments or receipts over the expected life of the instrument or, when appropriate, a shorter period, to the net carrying amount of the financial asset or financial liability. The effective interest rate is calculated on initial recognition of the financial asset or liability, estimating the future cash flows after considering all the contractual terms of the instrument but not future credit losses. The calculation includes all amounts paid or received by the bank including expected early redemptions and related penalties and premiums and discounts that are an integral

part of the overall return as well as direct incremental transaction costs related to the acquisition, issue or disposal of a financial instrument. 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 (see Note 3 (g)).

Fees and commissions which are not an integral part of the effective interest rate are generally recognised when the service has been provided. Loan commitment fees for loans that are likely to be drawn down are deferred (together with related direct costs) and recognised as an adjustment to the effective interest rate on the loan.

Dividend income is recognised when the right to receive payment is established.

Other operating income is recognised when the bank is entitled to receive that income.

(b) Available for sale financial assets

Debt securities are classified as available for sale and recognised in the statement of financial position at their fair value. Available for sale investments are those intended to be held for an indeterminate period of time and may be sold in response to need for liquidity or changes in interest rates, exchange rates or equity prices. Gains and losses arising from changes in the fair value of investments classified as available for sale are recognised directly in equity, until the financial asset is either sold, becomes impaired or matures, at which time the cumulative gain or loss previously recognised in equity is recognised in the income statement. Interest calculated using the effective interest method is recognised in the income statement.

The fair values of assets and liabilities traded in active markets are based on current bid and offer prices respectively. If the market is not active the bank establishes a fair value by using valuation techniques. These include the use of recent arm's length transactions, reference to other instruments that are substantially the same, discounted cash flow analysis and other valuation techniques commonly used by market participants.

Purchases and sales of securities and other financial assets and liabilities are recognised on trade date, being the date that the bank is committed to purchase or sell an asset. Available for sale financial assets are initially recognised at fair value inclusive of transaction costs.

These financial assets are derecognised when the rights to receive cash flows from the financial assets have expired or where the bank has transferred substantially all risks and rewards of ownership.

(c) Derivative financial instruments

All derivative instruments are held for risk management purposes and do not qualify for hedge accounting according to IAS 39. All derivatives are recognised at their fair value. Fair values are obtained from quoted market prices in active markets, including recent market transactions, and using valuation techniques, including discounted cash flow, as appropriate. Derivatives are carried in the statement of financial position as assets when their fair value is positive and as liabilities when their fair value is negative. All changes in the fair value of the derivative are recognised immediately in the income statement as a component of net loss on derivative financial instruments.

(d) Foreign currencies

Foreign currency transactions are translated into the functional currency using the exchange rates prevailing at the dates of the transactions. Foreign exchange gains and losses resulting from the settlement of such transactions are recognised in the income statement. Non-monetary assets that are measured at fair value are translated using the exchange rate at the date that the fair value was determined. Translation differences on monetary items, including available for sale investments, measured at fair value are recognised in the income statement.

Financial Statements

Notes to the Financial Statements *continued*

3. Significant accounting policies *continued*

(e) Loans and advances to banks and customers

Loans and advances to banks and customers are initially recognised at fair value and subsequently accounted for at amortised cost using the effective interest method less accumulated impairment losses. Loans and advances are initially recognised when cash is advanced to the borrowers at fair value inclusive of transaction costs. Loans and advances are derecognised when the rights to receive cash flows from them have expired or where the bank has transferred substantially all risks and rewards of ownership.

Loans and advances to banks and customers include residential and commercial mortgages, originated and syndicated loans. The bank does not originate loans to syndicate, rather it purchases syndicated loans from third party banks.

(f) Loan commitments, guarantees and other financial facilities

Provision is made for undrawn loan commitments, guarantees and other financial facilities if it is probable that the facility will be drawn and result in the recognition of an asset as an amount less than the amount advanced.

(g) Impairment of financial assets

At each reporting date the bank assesses whether, as a result of one or more events occurring after initial recognition, there is objective evidence that a financial asset or group of financial assets has become impaired.

The criteria that the bank uses to determine that there is objective evidence of an impairment loss may include:

- Delinquency in contractual payments of principal and/or interest.
- Indications that the borrower or group of borrowers is experiencing significant financial difficulty.
- Significant legal or regulatory disputes.
- Breach of loan covenants or conditions.
- Initiation of bankruptcy proceedings.
- Other objective evidence indicating impairment of the financial asset.

The estimated period between a loss occurring and its identification is determined by local management for each identified financial asset. In general, the periods used vary between one month and three months.

(i) Assets accounted for at amortised cost

If there is objective evidence that an impairment loss has been incurred, an allowance is established which is calculated as the difference between the carrying amount of the asset and the present value of estimated future cash flows discounted at that asset's original effective interest rate. Allowances are established on a case-by-case basis for all of the bank's lending activities which include residential mortgage, personal lending, credit cards and corporate lending. If an asset has a variable interest rate, the discount rate used for measuring the impairment loss is the current effective interest rate. The calculation of the present value of the estimated future cash flows of a collateralised asset reflects the cash flows that may result from foreclosure less the costs of obtaining and selling the collateral, whether or not foreclosure is probable.

For credit card lending where there is no objective evidence of individual impairment the portfolio is collectively assessed for impairment based on historical loss experience and adjusted for current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently.

If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, such as an improvement in the borrower's credit rating, the allowance is adjusted and the amount of the reversal is recognised in the income statement.

A loan or advance is normally written off, either partially or in full, against the related allowance when the proceeds from realising any available security have been received or there is no realistic prospect of recovery (as a result of the customer's insolvency, ceasing to trade or other reason) and the amount of the loss has been determined. Subsequent recoveries of amounts previously written off decrease the amount of impairment losses recorded in the income statement.

(ii) Available for sale financial assets

If there is objective evidence that an impairment loss has been incurred, the cumulative loss measured as the difference between the acquisition cost (net of any principal repayment and amortisation) and the current fair value, less any impairment loss on that asset previously recognised, is removed from equity and recognised in the income statement.

If, in a subsequent period, the fair value of a debt instrument classified as available for sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognised, the impairment loss is reversed through the income statement.

(h) Hedge accounting

Hedge accounting is applied to derivative and other instruments designated as hedges in hedging relationships provided certain criteria are met.

The bank documents, at the inception of the hedging relationship, the relationship between hedged items and hedging instruments, as well as the risk management objective and strategy for undertaking the hedge transaction. The bank also documents its assessment, both at inception and on an ongoing basis, of whether the instruments that are used in the hedging transaction are highly effective in offsetting changes in the fair values or cash flows of the hedged items.

(i) Fair value hedge

When considered appropriate the bank hedges the foreign exchange risk arising from its investment in foreign subsidiaries using either derivative or other financial instruments. For such hedges, the foreign exchange difference arising on both the hedging instrument and the hedged item is recognised directly in the income statement. The hedged risk is adjusted for against the carrying amount of the investment in subsidiaries.

(ii) Derivatives that do not qualify for hedge accounting

All gains or losses from the changes in fair value of derivatives that do not qualify for hedge accounting are recognised immediately in the income statement.

(i) Derecognition of financial liabilities

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

(j) Subsidiaries

Subsidiaries are entities controlled by the bank. Control exists when the bank has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. In assessing control, potential voting rights that presently are exercisable are taken into account.

The investment in subsidiaries is accounted for at cost less impairment adjusted for any foreign exchange risk that has been hedged.

(k) Tangible fixed assets

Tangible fixed assets are included at cost less accumulated depreciation and accumulated impairment losses. The value of land (included in premises) is not depreciated. Depreciation on other assets is calculated using the straight-line method to allocate the difference between the cost and the residual value over their estimated useful lives, as follows:

Property (excluding land):

- Freehold/long and short leasehold premises: shorter of 50 years or the remaining period of the lease
- Leasehold improvements: shorter of 10 years or the remaining period of the lease

Equipment:

- Furniture and equipment: 4 – 5 years
- Computer equipment: 4 years
- Motor vehicles: 4 years

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each reporting date.

Assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. In the event that an asset's carrying amount is determined to be greater than its recoverable amount it is written down immediately. The recoverable amount is the higher of the asset's fair value less costs to sell and its value in use.

The cost of replacing a part of an item of property or equipment is recognised in the carrying amount of the item if it is probable that the future economic benefits embodied within the part will flow to the bank and its cost can be measured reliably. The carrying amount of the replaced part is derecognised. The costs of the day-to-day servicing of property and equipment are recognised in the income statement as incurred.

Financial Statements

Notes to the Financial Statements *continued*

3. Significant accounting policies *continued*

(l) Intangible assets

Software acquired by the bank is stated at cost less accumulated amortisation and accumulated impairment losses.

Amortisation is recognised in the income statement on a straight-line basis over the estimated useful life of the software, from the date that it is available for use. The estimated useful life of software is three to five years.

Intangible assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. In the event that an asset's carrying amount is determined to be greater than its recoverable amount it is written down immediately. The recoverable amount is the higher of the asset's fair value less costs to sell and its value in use.

(m) Leases

The bank enters into leases as the lessee. All of the leases are operating leases. Operating lease rentals are charged to the income statement on a straight-line basis over the period of the lease.

When an operating lease is terminated before the end of the lease period, any payment made to the lessor by way of penalty is recognised as an expense in the period of termination.

(n) Offset

Financial assets and liabilities are offset and the net amount reported in the statement of financial position when there is a legally enforceable right of set-off and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously.

(o) Cash and cash equivalent

For the purposes of preparing these financial statements, cash and cash equivalents comprise cash and non-mandatory balances with central banks and amounts due from banks with an original maturity of less than three months.

(p) Borrowings

Borrowings (which include deposits from banks, customer accounts and subordinated liabilities) are recognised initially at fair value, being their issue proceeds net of transaction costs incurred. Borrowings are subsequently stated at amortised cost using the effective interest method.

(q) Employee benefits

(i) Defined contribution plans

Obligations for contributions to defined contribution pension plans are recognised as an expense in income statement when they are due.

(ii) Defined benefit plans

The bank is a participant of the Bank of China Pension and Life Assurance scheme offered by Bank of China Limited, London Branch (the "London Branch"). The London Branch is the sponsoring employer. There are no contractual arrangements for charging the net defined benefit cost for this plan. Contributions to the fund are recognised as an expense in the income statement in the accounting period to which they relate. Any unpaid contributions are recognised in the statement of financial position as a liability.

(r) Short-term benefits

Short-term employee benefit obligations are measured on an undiscounted basis and are expensed as the related service is provided.

A provision is recognised for the amount expected to be paid under short-term cash bonus or profit-sharing plans if the bank has a present legal or constructive obligation to pay this amount as a result of past service provided by the employee and the obligation can be estimated reliably.

(s) Taxation

Income tax on the profit for the year comprises current tax and deferred tax. Income tax is recognised in the income statement except to the extent that it relates to items recognised directly in other comprehensive income or directly in equity, in which case it is recognised in other comprehensive income or equity.

Current tax is the tax expected to be payable on the taxable profit for the year, calculated using tax rates enacted or substantially enacted at the reporting date.

Deferred income tax is provided in full, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the financial statements. Deferred income tax is determined using tax rates (and laws) that have been enacted or substantially enacted by the reporting date and are expected to apply when the related deferred income tax asset is realised or the deferred income tax liability is settled.

The tax effects of losses available for carry forward are recognised as a deferred tax asset when it is probable that future taxable profits will be available against which these losses can be utilised.

The carrying amount of deferred tax assets is reviewed at each reporting date and reduced to the extent that it is no longer probable that sufficient taxable profits will be available to allow all or part of the asset to be recovered.

(t) Provisions

Provisions are recognised in respect of present obligations arising from past events where it is probable that outflows of resources will be required to settle the obligations and they can be reliably estimated.

Contingent liabilities are possible obligations whose existence depends on the outcome of uncertain future events or those present obligations where the outflows of resources are uncertain or cannot be measured reliably. Contingent liabilities are not recognised in the financial statements but are disclosed unless they are remote.

(u) Share capital and reserves

Ordinary shares are classified as equity. Incremental costs directly attributable to the issue of an equity instrument are deducted from the initial measurement of the equity instrument.

4. Critical estimates and judgements

The bank makes estimates and assumptions concerning the future. The estimates and assumptions that could have significant risk of causing material adjustment to the carrying amounts of assets within the next financial year are highlighted below.

(i) Impairment of loans and advances

The bank reviews its loans and advances on an individual basis to assess impairment on a periodic basis unless a known circumstance occurs at or before the scheduled review date. In determining whether an impairment loss should be recorded in the income statement, the bank makes a judgement as to whether there is any observable data indicating that there is a measurable decrease in the estimated future cash flow of a loan or advance. This evidence may include observable data indicating that there has been an adverse change in the payment status of the borrower

e.g. payment delinquency, or default. Additional observable data that would be considered is set out in Note 3(g).

(ii) Impairment of available for sale investments

The bank follows the guidance of IAS 39 to determine when available for sale investment securities are impaired. This determination requires significant judgement. In making this judgement, the bank evaluates, among other factors, the duration and extent to which the fair value of an investment is less than its cost, the extent to which changes in fair value relate to credit events; and the financial health of and near-term business outlook for the investee/ underlying portfolio, including factors such as industry and sector performance, credit ratings, and counterparty risk.

The methodology and assumptions used for impairment assessments are reviewed regularly. In evaluating impairment of asset backed securities ("ABS") and mortgage backed securities ("MBS") during the year, the bank continued to use a significant decline in market price to be a key indicator of impairment. The bank also considered other objective evidence of impairment, taking into account that during the year market prices continued to be impacted by liquidity and indicative prices were obtained for certain ABS and MBS held by the bank.

(iii) Impairment of investment in subsidiaries

For non financial assets the bank follows the guidance of IAS 36 – Impairment of Assets. The bank assesses at the end of each reporting period whether there is an indication that an asset may be impaired. If any indication exists, the bank estimates the recoverable amount of the asset concerned. The recoverable amount is the higher of the asset's fair value less cost to sell and the value in use. Where an assets carrying amount is higher than its estimated recoverable amount it is written down immediately to its recoverable amount.

Details about the use of estimates and judgements are presented in Note 3.

Financial Statements

Notes to the Financial Statements *continued*

5. New pronouncements

New and amended standards and interpretations:

- (i) *Mandatory for the first time for the financial year beginning 1 January 2011 but not currently relevant to the bank although they may affect the accounting of future transactions and events.*

Following the Financial Reporting Council's report "Cutting clutter" the aim of the disclosures, required by IAS 8 "Accounting policies, changes in accounting estimates and errors" is to enable the users to assess the possible impact of the new standard or interpretation on the bank's financial statements and not to provide a general update on accounting developments.

A number of new standards became effective from 1 January 2011. The directors have reviewed and considered the effect of these new standards on the financial statements of the bank and have concluded that they are either not applicable or do not have a material effect.

- (ii) *Issued but not effective for the financial year beginning 1 January 2011 and not early adopted.*

The bank has assessed the impact of these new standards and interpretations and concluded that they are either not material or are not expected to have a material effect, except for:

- IFRS9, "Financial instruments", issued in November 2008. This standard is the first step in the process to replace IAS 39, "Financial instruments: recognition and measurement". IFRS 9 introduces new requirements for the classifying and measuring of financial assets and is likely to affect the bank's accounting for financial assets. The standard is not applicable until 1 January 2013 but is available for early adoption. However, the standard has not yet been endorsed by the EU.

The bank is yet to assess IFRS 9's full impact. However, initial indications are that it may affect the bank's accounting for its debt available for sale financial assets, as IFRS 9 only permits the recognition of fair value gains and losses in other comprehensive income if they relate to equity investments that are not held for trading. Fair value gains and losses on available for sale debt investments will therefore have to be

recognised directly in profit and loss. In the current reporting period the bank recognised £36,000 of such losses in other comprehensive income.

6. Financial risk management

Introduction and overview

The bank has exposure to the following risks from financial instruments:

- Credit risk
- Liquidity risk
- Market risk

This Note presents information about the bank's exposure to each of the above risks, the bank's objectives, policies and procedures for measuring and managing risk and the bank's management of capital.

Risk management framework

The Board has overall responsibility for the establishment and oversight of the bank's risk management framework. The Board has established the bank's Board Risk Committee ("BRC") which is responsible for the oversight and implementation of risk strategy and risk appetite within the bank, oversight of risk management performance and the executive committees including, Asset and Liability ("ALCO"), Credit Risk Policy, Credit and Operational Risk Committees. These committees are responsible for developing and monitoring the bank's risk management policies in their specified areas. The bank's risk management policies are established to identify and analyse the risks faced by the bank, to set appropriate risk limits and controls, and to monitor risks and adherence to limits. Risk management policies and systems are reviewed regularly to reflect changes in market conditions, products and services offered. Internal Audit department undertakes both regular and ad-hoc reviews of the risk management controls and procedures, the results of which are reported to the Audit Committee.

The bank, through its training and management standards and procedures, aims to develop a disciplined and constructive control environment, in which all employees understand their roles and responsibilities.

(a) Credit risk

Financial risk management

Credit risk is the risk of financial loss to the bank if a customer or counterparty to a financial instrument fails to meet its contractual

obligations, and arises principally from the bank's loans and advances to customers and available for sale financial investments.

Credit risk management framework

The bank has established a set of credit risk management policies and procedures, and appropriate credit risk limits to manage and control credit risk that arises through the bank's normal business activities. These policies, procedures and limits are regularly reviewed in light of changes in markets and business strategies.

The bank's organisation structure establishes a clear set of authority and responsibilities for monitoring compliance with policies, procedures and limits, based on the principle of 'Three Lines of Defence'.

The business units are responsible for the day-to-day management of credit risk with the Risk Management department being responsible for risk oversight and ensuring procedural compliance as well as the drafting, reviewing and updating of credit risk management policies and procedures. The Internal Audit function represents the third line of defence.

The Board has the highest credit approval authority for BOC UK. The Board has delegated its authority to the Board Risk Committee, and the Chief Executive Officer (the "CEO") of the bank. The CEO of the bank has delegated credit approval authority to Branch Managers, subject to Board approval.

Credit risk measurement and control

Loans and advances

The approval of an individual credit risk proposition requires assessment of the customer, any existing credit exposure to the customer and the credit risks associated with the transaction, at the same time taking into account the reward being offered for the risk and the extent of risk mitigation available to offset the potential loss in the event of default. The Credit Risk department is responsible for making an independent assessment of all credit facilities.

There are three main areas of concentration risk that are monitored, reported and managed by the bank, single customer (group), industrial sector and country risk. The bank monitors changes to counterparties' credit risk, quality of the credit portfolio and risk concentrations, and reports regularly to the bank's Executive Management Committee and the Board Risk

Committee. Consideration must be taken and compliance must be adhered to these three concentration risk management areas either during initiating a transaction or maintaining and managing the portfolio quality.

The bank's internal loan grading system divides loans into five categories as follows:

- Category 1: "Performing" represents loans where the borrower is currently meeting their repayment obligations and full repayment of interest and principal is not in doubt.
- Category 2: "Special Mention" represents loans where the borrower is experiencing difficulties which may threaten the bank's position. Ultimate loss is not expected at this stage but could occur if adverse conditions persist.
- Category 3: "Sub-standard" represents loans where the borrower displays a definable weakness that is likely to jeopardise repayment.
- Category 4: "Doubtful" represents loans where collection in full is improbable and the bank expects to sustain a loss of principal and/or interest, taking into account the net realisable value of any collateral held.
- Category 5: "Loss" represents loans which are considered un-collectible after all collection options (such as the realisation of collateral or the initiation of legal proceedings) have been exhausted.

Debt securities and derivatives

For investment in debt securities and securitisation-backed assets, the external credit rating and assessment on the credit quality of the underlying asset are used for managing the credit risk involved. Credit limits are established on a counterparty and security issuer basis. For derivatives, the bank sets customer limits to manage the credit risk involved and follows the same approval process as loans and advances. Ongoing monitoring of stop-loss limits is established.

Collateral held as security

The bank has established a mechanism to update the value of its main type of collateral, residential properties, with the use of a publicly available index on a portfolio basis.

For loans guaranteed by a third party guarantor, the bank assesses the guarantor's financial condition, credit history and ability to meet their obligations if called to do so.

Financial Statements

Notes to the Financial Statements *continued*

6. Financial risk management *continued*

Exposure to credit risk

The carrying amount of financial assets represents the maximum credit exposure without taking account of any collateral held or other credit enhancements. The maximum exposure to credit risk at the reporting date was:

£000	31 December 2011	31 December 2010
On balance sheet		
Cash and cash equivalents	274,203	214,065
Loans and advances to banks	12,865	12,817
Loans and advances to customers	290,752	214,623
Derivative financial instruments	72	505
Available for sale financial investments	95,671	149,677
Total on balance sheet	673,563	591,687
Off balance sheet		
Loan commitments	254,967	253,856
Guarantees	10,394	21,450
Total off balance sheet	265,361	275,306
Total exposure	938,924	866,993

The fair value of collateral held at 31 December 2011 against amounts due from customers was £283,140,000 (31 December 2010: £164,459,000). The collateral is in the form of real estate properties and this collateral reduces the maximum amount of credit risk by £144,632,000 (31 December 2010: £78,690,000).

Cash and cash equivalents include exposures to the parent company of £269,743,000 (31 December 2010: £140,788,000) which are supported by a legal netting agreement. No other significant concentration of credit risk exposure exists.

Cash and cash equivalents exclude cash in hand for the purposes of the assessment of credit risk.

Credit risk exposure

The tables below present further detail on the bank's exposure to credit risk.

(a) Based on external credit rating system

£000	31 December 2011		31 December 2010	
	Cash and cash equivalents	Available for sale investments	Cash and cash equivalents	Available for sale investments
Gross exposure	274,203	99,601	214,065	155,426
Individually impaired	-	7,182	-	17,139
Allowance for impairment	-	(3,930)	-	(5,749)
Carrying amount	-	3,252	-	11,390
Past due but not impaired	-	-	-	-
<i>Ageing profile:</i>				
0-3 months	-	-	-	-
4-6 months	-	-	-	-
7-9 months	-	-	-	-
10-12 months	-	-	-	-
Neither past due nor impaired	274,203	92,419	214,065	138,287
<i>Credit rating:</i>				
AAA	-	14,765	-	44,824
Aa1 – Aa3	3,398	16,860	73,176	31,599
A1 – A3	270,805	41,365	140,889	59,125
Baa1 – Baa3	-	19,429	-	2,739
Ba1 – Ba3	-	-	-	-
Unrated	-	-	-	-
Total carrying amount	274,203	95,671	214,065	149,677

(b) Based on internal loan grading system mapped against external credit ratings

Loans and advances to banks

£000	31 December 2011	31 December 2010
Gross exposure	12,865	12,817
Neither past due nor impaired	12,865	12,817
Performing		
A1 – A3	-	-
Baa1 – Baa3	12,865	12,817
Unrated	-	-
Total carrying amount	12,865	12,817

Financial Statements

Notes to the Financial Statements *continued*

6. Financial risk management *continued*

Loans and advances to customers

£000	31 December 2011	31 December 2010
Gross exposure	297,880	215,031
Individually impaired	13,683	417
Allowance for impairment	(7,128)	(408)
Carrying amount	6,555	9
Past due but not impaired	2,728	2,427
<i>Ageing profile:</i>		
0-3 months	2,728	2,404
4-6 months	-	3
7-9 months	-	1
10-12 months	-	19
Neither past due nor impaired	281,469	212,187
Performing	280,412	192,293
Aa1 – Aa3	3,853	4,524
A1 – A3	22,809	27,765
Baa1 – Baa3	22,393	-
Ba1 – Ba3	5,392	-
Unrated	225,965	160,004
Special mention	1,053	19,894
Baa1 – Baa3	-	-
Ba1 – Ba3	-	14,149
B1 – B3	-	-
Unrated	1,053	5,745
Substandard	-	-
Unrated	-	-
Doubtful	4	-
Unrated	4	-
Loss	-	-
Unrated	-	-
Total carrying amount	290,752	214,623

(b) Liquidity risk

Liquidity risk is the risk that the bank will not be able to meet its financial obligations as they fall due.

The bank is exposed to the risk that it will be unable to meet its obligations as they fall due, arising from the differing maturity profiles of its assets and liabilities. To mitigate its exposure the bank places limits on the mismatch of maturity dates, and by holding stock of liquid assets which could be sold at short notice if the need arose.

The Board is the ultimate decision-making body and is responsible for compliance with the regulatory requirements. Formulation of the risk management procedures, implementation mechanism and monitoring of the compliance is the main responsibility of the ALCO. Daily management of liquidity is carried out by the Treasury function assisted by the Finance department who monitor the liquidity risk and provide regular reports to management and the Financial Services Authority (the “FSA”).

The following are the contractual (undiscounted) maturities of financial liabilities, including estimated interest payments and excluding the effect of any netting agreements if they were in place:

£000	Carrying amount	Contractual cash flows	Less than 1 month	1-3 months	3 months to 1 year	More than 1 year
31 December 2011						
Non-derivative financial liabilities						
Deposits from banks	202,684	(203,957)	(53,252)	(59,278)	(91,427)	-
Customer accounts	352,176	(352,477)	(300,724)	(38,638)	(13,115)	-
Subordinated liabilities	60,000	(60,206)	-	(206)	-	(60,000)
Derivative financial instruments	4,416	-	-	-	-	-
Cash outflows	-	(167,515)	(162,855)	(201)	(1,317)	(3,142)
Cash inflows	-	162,206	162,206	-	-	-
	619,276	(621,949)	(354,625)	(98,323)	(105,859)	(63,142)
Loan commitments	254,967	(254,967)	(254,967)	-	-	-
	874,243	(876,916)	(609,592)	(98,323)	(105,859)	(63,142)
31 December 2010						
Non-derivative financial liabilities						
Deposits from banks	176,070	(176,956)	(25,151)	(82,857)	(68,948)	-
Customer accounts	296,289	(296,346)	(268,317)	(17,063)	(10,953)	(13)
Subordinated liabilities	60,000	(60,156)	-	(156)	-	(60,000)
Derivative financial instruments	5,956	-	-	-	-	-
Cash outflows	-	(127,884)	(120,449)	(231)	(1,576)	(5,628)
Cash inflows	-	119,226	119,226	-	-	-
	538,315	(542,116)	(294,691)	(100,307)	(81,477)	(65,641)
Loan commitments	253,856	(253,856)	(253,856)	-	-	-
	792,171	(795,972)	(548,547)	(100,307)	(81,477)	(65,641)

The previous table shows the undiscounted cash flows on the bank’s financial liabilities and unrecognised loan commitments on the basis of their earliest possible contractual maturity. The bank’s expected cash flows on these instruments to vary significantly from this analysis and hence this table shows a worst case scenario. For example, current accounts and demand deposits from customers are expected to maintain a stable or increasing balance and unrecognised loan commitments are not all expected to be drawn down immediately but to be drawn over a period of time.

The contractual cash flow disclosed in the previous table represents the contractual undiscounted cash flows relating to the principal and interest on the financial liability or commitment. The disclosure for derivatives shows a net amount for derivatives that are settled on a net basis, (e.g. interest rate swaps) but on a gross outflow and inflow basis for derivatives that have simultaneous gross settlement (e.g. forward foreign exchange contracts and currency swaps).

Financial Statements

Notes to the Financial Statements *continued*

6. Financial risk management *continued*

(c) Market risk

Foreign exchange risk

Foreign exchange risk is the risk that movements in the various currencies could materially impact the financial statements. To manage its exposure to foreign exchange risk the bank enters into derivative transactions.

The following table shows the foreign exchange positions as at 31 December 2011 and 2010.

£000

31 December 2011	Sterling	US Dollar	EURO	Other	Total
Cash and cash equivalents	86,204	94,096	64,335	31,186	275,821
Loans and advances to banks	-	12,865	-	-	12,865
Loans and advances to customers	205,201	38,595	46,956	-	290,752
Derivative financial instruments (asset)	14	-	58	-	72
Available for sale financial investments	349	6,261	69,347	19,714	95,671
Other assets	37,975	1,002	243	63,324	102,544
Deposits from banks	(1,319)	(81,450)	-	(119,915)	(202,684)
Customer accounts	(242,132)	(68,829)	(19,630)	(21,585)	(352,176)
Derivative financial instruments (liability)	(285)	(663)	(3,468)	-	(4,416)
Other liabilities	(16,074)	(1,641)	(409)	(768)	(18,892)
Subordinated liabilities	(60,000)	-	-	-	(60,000)
Total shareholder equity	(172,307)	(184)	1,114	31,820	(139,557)
Net on balance sheet exposure	(162,374)	52	158,546	3,776	-
Net off balance sheet exposure	160,224	-	(157,074)	(3,420)	(270)
Loan commitments	119,530	86,076	49,361	-	254,967

£000

31 December 2010	Sterling	US Dollar	EURO	Other	Total
Cash and cash equivalents	138,817	47,520	22,675	6,143	215,155
Loans and advances to banks	-	12,817	-	-	12,817
Loans and advances to customers	136,261	39,371	35,066	3,925	214,623
Derivative financial instruments (asset)	28	-	477	-	505
Available for sale financial investments	412	6,323	123,329	19,613	149,677
Other assets	46,787	1,211	217	94,502	142,717
Deposits from banks	-	(21,684)	(35,673)	(118,713)	(176,070)
Customer accounts	(180,020)	(78,778)	(29,259)	(8,232)	(296,289)
Derivative financial instruments (liability)	(581)	(1,282)	(4,093)	-	(5,956)
Other liabilities	(28,416)	(1,815)	(933)	(362)	(31,526)
Subordinated liabilities	(60,000)	-	-	-	(60,000)
Total shareholder equity	(166,926)	(313)	1,030	556	(165,653)
Net on balance sheet exposure	(113,638)	3,370	112,836	(2,568)	-
Net off balance sheet exposure	119,226	-	(111,748)	(8,294)	(816)
Loan commitments	119,971	56,665	77,220	-	253,856

Sensitivity analysis

A 1% percent weakening of the following currencies against Sterling at 31 December 2011 would have increased (decreased) equity and the income statement by the amounts shown below. This calculation assumes that the change occurred at the reporting date and had been applied to risk exposures existing at that date.

This analysis assumes that all other variables, in particular other exchange rates and interest rates, remain constant.

£000	Equity		Income statement	
	31 December 2011	31 December 2010	31 December 2011	31 December 2010
Sterling	(41)	(59)	-	-
US Dollars	(28)	3	(50)	(18)
EURO	(21)	(10)	(5)	(18)
Other	82	(6)	(14)	(24)

A 1% percent strengthening of the above currencies against Sterling at 31 December 2011 would have had the equal but opposite effect on the above currencies to the amounts shown above, on the basis that all other variables remain constant.

Exposure to interest rate risk

The bank does not operate a trading book.

The principal exposure to which the banking book portfolios are exposed is the risk of loss from fluctuations in the future cash flows or fair values of financial instruments because of a change in market interest rates. Interest rate risk is managed principally through monitoring the cumulative interest rate gap position and by having pre-approved limits for the time bands. The ALCO is the monitoring body for compliance with these limits and is assisted by the Treasury department in its day-to-day monitoring activities. A summary of the bank's interest rate gap position in the banking books is as follows:

£000	Carrying amount	Less than 1 month	1-3 months	3 months to 1 year	1-5 years	Over 5 years	Non interest bearing
31 December 2011							
Assets							
Cash	275,821	237,032	-	-	-	-	38,789
Loans and advances to banks	12,865	-	12,865	-	-	-	-
Loans and advances to customers	290,752	259,045	25,421	6,059	-	-	227
Derivative financial instruments	72	-	-	-	-	-	72
Available for sale financial investments	95,671	12,639	30,657	-	41,356	10,175	844
Other assets	102,544	-	-	-	-	-	102,544
Total assets	777,725	508,716	68,943	6,059	41,356	10,175	142,476
Liability and equity							
Liabilities							
Deposits from banks	202,684	51,783	59,114	90,337	-	-	1,450
Customer accounts	352,176	288,586	38,473	13,016	-	-	12,101
Derivative financial instruments	4,416	-	-	-	-	-	4,416
Other liabilities	18,892	-	-	-	-	-	18,892
Subordinated liabilities	60,000	-	60,000	-	-	-	-
Equity							
Shareholders' equity	139,557	-	-	-	-	-	139,557
Total equity and liabilities	777,725	340,369	157,587	103,353	-	-	176,416
Effect of derivatives held for risk management	-	31,069	16,552	(13,381)	(34,240)	-	-
Interest rate sensitivity gap	-	199,416	(72,092)	(110,675)	7,116	10,175	(33,940)
Cumulative gap	-	199,416	127,324	16,649	23,765	33,940	-

Financial Statements

Notes to the Financial Statements *continued*

6. Financial risk management *continued*

£000	Carrying amount	Less than 1 month	1-3 months	3 months to 1 year	1-5 years	Over 5 years	Non interest bearing
31 December 2010							
Assets							
Cash	215,155	178,364	–	–	–	–	36,791
Loans and advances to banks	12,817	–	12,817	–	–	–	–
Loans and advances to customers	214,623	154,160	50,620	9,766	–	–	77
Derivative financial instruments	505	–	–	–	–	–	505
Available for sale financial investments	149,677	25,865	37,229	3,966	71,230	10,594	793
Other assets	142,717	–	–	–	–	–	142,717
Total assets	735,494	358,389	100,666	13,732	71,230	10,594	180,883
Liability and equity							
Liabilities							
Deposits from banks	176,070	24,890	82,502	68,526	–	–	152
Customer accounts	296,289	141,102	17,052	10,924	13	–	127,198
Derivative financial instruments	5,956	–	–	–	–	–	5,956
Other liabilities	31,526	–	–	–	–	–	31,526
Subordinated liabilities	60,000	–	60,000	–	–	–	–
Equity							
Shareholders' equity	165,653	–	–	–	–	–	165,653
Total equity and liabilities	735,494	165,992	159,554	79,450	13	–	330,485
Effect of derivatives held for risk management	–	36,784	23,374	–	(48,124)	(12,034)	–
Interest rate sensitivity gap	–	229,181	(35,514)	(65,718)	23,093	(1,440)	(149,602)
Cumulative gap	–	229,181	193,667	127,949	151,042	149,602	–

The table below indicates the sensitivity to a reasonable possible change in interest rates, with all other variables held constant, of the bank's income statement.

At the reporting date the exposure to interest rate risk was projected to be:

£000	100bps parallel increase	100bps parallel decrease
Sensitivity of projected net interest income at		
31 December 2011	978	(978)
31 December 2010	1,750	(1,750)
Sensitivity of reported equity to interest rate movements at		
31 December 2011	1,020	(1,020)
31 December 2010	1,891	1,891

Interest rate movements affect reported equity in the following ways: (i) retained earnings; arising from increases or decreases in net interest income and the fair value changes reported in profit or loss and (ii) fair value reserves; arising from increases or decreases in fair values of available for sale financial instruments reported directly in equity.

(d) Capital management

Regulatory capital

The bank's lead regulator the FSA sets and monitors capital requirements for the bank. The parent company and individual banking operations are directly supervised by their local regulators.

With effect from 1 January 2008 the bank is required to comply with the provisions of the Basel II framework in respect of regulatory capital. The bank has adopted the standardised approach for credit and operational risk in the calculation of the bank's capital requirement as prescribed under the Basel II framework. As the bank does not have a trading book the capital requirement for the foreign exchange risk inherent in the banking book is the bank's only market risk, which is also calculated on the standardised approach.

The bank's regulatory capital comprises of tier 1 and tier 2 capital:

- Tier 1 capital, which includes ordinary share capital, retained earnings, translation reserve and other regulatory adjustments relating to items that are included in equity but are treated differently for capital adequacy purposes
- Tier 2 capital, which includes qualifying subordinated liabilities, collective impairment allowances (limited to those credit portfolios where the standardised approach is used under Basel II) and the element of the fair value reserve relating to unrealised gains / losses on equity instruments classified as available for sale.

Various limits are applied to elements of the capital base. The amount of innovative tier 1 securities cannot exceed 15 percent of total tier 1 capital; qualifying tier 2 capital cannot exceed tier 1 capital; and qualifying term subordinated loan capital may not exceed 50 percent of tier 1 capital. There also are restrictions on the amount of collective impairment allowances that may be included as part of tier 2 capital. Other deductions from capital include the carrying amounts of investments in subsidiaries as these are not included in the regulatory consolidation, investments in the capital of banks and certain other regulatory items.

Banking operations are categorised as banking book, and risk-weighted assets are determined according to specified requirements that seek to reflect the varying levels of risk attached to assets and off-balance sheet exposures. As noted above, Basel II introduced a risk-weighted asset requirement in respect of operational risk.

The bank's policy is to maintain a strong capital base so as to maintain investor, creditor and market confidence and to sustain future development of the business. The impact of the level of capital on shareholders' return is also recognised and the bank recognises the need to maintain a balance between the higher returns that might be possible with greater gearing and the advantages and security afforded by a sound capital position.

The bank has complied with all externally imposed capital requirements throughout the period.

Financial Statements

Notes to the Financial Statements *continued*

6. Financial risk management *continued*

The bank's regulatory capital position at 31 December 2011 was as follows:

£000	2011 Basel II Actual	2010 Basel II Actual
Tier 1 capital		
Ordinary share capital	140,000	140,000
Retained earnings	528	26,598
Tier 2 capital		
Qualifying subordinated liabilities	60,000	60,000
Other regulatory adjustments	(63,285)	(94,357)
Total regulatory capital	137,243	132,241

Management uses regulatory capital ratios in order to monitor its capital base, and these capital ratios remain the international standards for measuring capital adequacy. The FSA's approach to such measurement based upon Basel II is now primarily based on monitoring the relationship of the Capital Resources Requirement (measured as 8 percent of risk-weighted assets) to available capital resources. The FSA also sets individual capital guidance ("ICG") for any bank that sets capital requirements in excess of the minimum Capital Resources Requirement. A key input to the ICG setting process is the bank's Internal Capital Adequacy Assessment Process ("ICAAP"). The bank submitted its ICAAP document to the FSA in October 2011 and the ICG was agreed with the FSA in March 2012. The agreed ICG remains confidential between each bank and the FSA in accordance with accepted practice.

7. Pillar III disclosures

The European Union Capital Requirements Directive (the "Directive") came into effect on 1 January 2007. It introduced consistent capital adequacy standards and an associated supervisory framework in the EU based on the Basel II rules agreed by the G-10.

Implementation of the Directive in the UK was by way of rules introduced by the FSA. Among them are disclosure requirements applicable to banks and building societies, which are known as Pillar III. These are designed to promote market discipline by providing market participants with key information on a firm's risk exposures and risk management processes. Pillar III also aims to complement the minimum capital requirements described under Pillar 1 of Basel II, as well as the supervisory review processes of Pillar 2 and aims to encourage market discipline by allowing market participants to assess key pieces of information on risk exposures and the risk assessment processes of the firm.

The bank adopted the Pillar 1 Standardised Approach to credit risk, market risk and operational risk from 1 January 2008, it also became subject to Pillar II & III from that date.

8. Financial assets and financial liabilities

Fair values of financial instruments

The bank's valuation methodology is detailed in Note 3.

Fair values

The fair values for each class of financial assets and financial liabilities together with their carrying amounts shown in the reporting date are as follows:

£000	Financial instruments at fair value through profit and loss	Loans and receivables	Available for sale	Other amortised cost	Total carrying amount	Fair value
31 December 2011						
Assets						
Cash and cash equivalents	–	275,821	–	–	275,821	275,821
Cash and balances with banks	–	274,203	–	–	274,203	274,203
Cash in hand	–	1,618	–	–	1,618	1,618
Loans and advances to banks	–	12,865	–	–	12,865	12,865
Loans and advances to customers	–	290,752	–	–	290,752	290,752
Corporate loans and advances	–	143,606	–	–	143,606	143,606
Retail loans and advances	–	147,146	–	–	147,146	147,146
Derivative financial instruments	72	–	–	–	72	72
Interest rate swaps	58	–	–	–	58	58
Cross currency swaps	–	–	–	–	–	–
Foreign exchange forwards	14	–	–	–	14	14
Available for sale investments	–	–	95,671	–	95,671	95,671
Debt securities	–	–	77,243	–	77,243	77,243
Asset backed securities	–	–	18,428	–	18,428	18,428
Total financial assets	72	579,438	95,671	–	675,181	675,181
Liabilities						
Deposits from banks	–	–	–	202,684	202,684	202,684
From subsidiaries	–	–	–	47,602	47,602	47,602
Other deposits from banks	–	–	–	155,082	155,082	155,082
Deposits from customers	–	–	–	352,176	352,176	352,176
Retail customers	–	–	–	345,300	345,300	345,300
Corporate customers	–	–	–	6,876	6,876	6,876
Derivative financial instruments	4,416	–	–	–	4,416	4,416
Interest rate swaps	4,131	–	–	–	4,131	4,131
Cross currency swaps	285	–	–	–	285	285
Subordinated liabilities	–	–	–	60,000	60,000	60,000
Total financial liabilities	4,416	–	–	614,860	619,276	619,276

The fair value of financial assets and liabilities that are not accounted for at fair value are deemed to be equal to their carrying value. The interest rates on these financial assets and liabilities re-price on a regular and short term basis resulting in the fair value calculation being not materially different from the carrying value.

Financial Statements

Notes to the Financial Statements *continued*

8. Financial assets and financial liabilities *continued*

£000	Financial instruments at fair value through profit and loss	Loans and receivables	Available for sale	Other amortised cost	Total carrying amount	Fair value
31 December 2010						
Assets						
Cash and cash equivalents						
Cash and balances with banks	–	215,155	–	–	215,155	215,155
Cash in hand	–	1,090	–	–	1,090	1,090
Loans and advances to banks						
	–	12,817	–	–	12,817	12,817
Loans and advances to customers						
Corporate loans and advances	–	214,623	–	–	214,623	214,623
Retail loans and advances	–	129,384	–	–	129,384	129,384
	–	85,239	–	–	85,239	85,239
Derivative financial instruments						
Interest rate swaps	505	–	–	–	505	505
Cross currency swaps	477	–	–	–	477	477
Foreign exchange forwards	28	–	–	–	28	28
	–	–	–	–	–	–
Available for sale investments						
Debt securities	–	–	149,677	–	149,677	149,677
Asset backed securities	–	–	107,553	–	107,553	107,553
	–	–	42,124	–	42,124	42,124
Total financial assets	505	442,595	149,677	–	592,777	592,777
Liabilities						
Deposits from banks						
From subsidiaries	–	–	–	176,070	176,070	176,070
Other deposits from banks	–	–	–	9,885	9,885	9,885
	–	–	–	166,185	166,185	166,185
Deposits from customers						
Retail customers	–	–	–	296,289	296,289	296,289
Corporate customers	–	–	–	290,768	290,768	290,768
	–	–	–	5,521	5,521	5,521
Derivative financial instruments						
Interest rate swaps	5,956	–	–	–	5,956	5,956
Cross currency swaps	5,375	–	–	–	5,375	5,375
	581	–	–	–	581	581
Subordinated liabilities						
	–	–	–	60,000	60,000	60,000
Total financial liabilities	5,956	–	–	532,359	538,315	538,315

The table opposite analyses financial assets and liabilities measured at fair value, by valuation method:

- Level 1: quoted prices (unadjusted) 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).

Fair value hierarchy

During the financial year ended 31 December 2011 no financial assets or liabilities were transferred between Level 1, Level 2 or Level 3.

£000

31 December 2011	Level 1	Level 2	Level 3	Total
Financial assets				
Derivative financial instruments:				
Interest rate swap	–	58	–	58
Cross currency swap	–	–	–	–
Foreign exchange forward	–	14	–	14
	–	72	–	72
Financial investments available for sale:				
Debt securities	77,243	–	–	77,243
Asset backed securities	18,428	–	–	18,428
	95,671	–	–	95,671
Total assets	95,671	72	–	95,743
Financial liabilities				
Derivative financial instruments:				
Interest rate swap	–	4,131	–	4,131
Cross currency swap	–	280	–	280
Foreign exchange forward	–	5	–	5
Total liabilities	–	4,416	–	4,416

£000

31 December 2010	Level 1	Level 2	Level 3	Total
Financial assets				
Derivative financial instruments:				
Interest rate swap	–	477	–	477
Cross currency swap	–	28	–	28
	–	505	–	505
Financial investments available for sale:				
Debt securities	107,553	–	–	107,553
Asset backed securities	42,124	–	–	42,124
	149,677	–	–	149,677
Total assets	149,677	505	–	150,182
Financial liabilities				
Derivative financial instruments:				
Interest rate swap	–	5,375	–	5,375
Cross currency swap	–	581	–	581
Total liabilities	–	5,956	–	5,956

Financial Statements

Notes to the Financial Statements *continued*

9. Net interest income

£000	31 December 2011	31 December 2010
Interest income from financial investments	3,425	6,117
Other interest income:		
Cash and cash equivalents	8	745
Loans and advances to banks	1,347	162
Loans and advances to customers	8,176	9,158
Total other interest income	9,531	10,065
Total interest income	12,956	16,182
Interest expense:		
Deposits from banks	1,789	2,922
Customers accounts	358	348
Subordinated liabilities	681	588
Total interest expense	(2,828)	(3,858)
Net interest income	10,128	12,324

Included within various line items under interest income for the year ended 31 December 2011 is a total of £175,000 (31 December 2010: £85,000) accrued for non performing impaired financial assets.

10. Net fee and commission income

£000	31 December 2011	31 December 2010
Fee and commission income:		
Retail Banking customer fees	3,966	3,218
Corporate Banking credit-related fees	2,319	2,894
Other	68	205
Total fee and commission income	6,353	6,317
Inter-bank transaction fees	21	22
Other	486	148
Total fee and commission expense	(507)	(170)
Net fee and commission income	5,846	6,147

11. Net loss from derivative financial instruments

£000	31 December 2011	31 December 2010
Net loss from derivative financial instruments held for risk management purposes:		
Interest rate swaps	(936)	(2,311)
Foreign currency forwards	9	(1)
	(927)	(2,312)

There are no financial derivative instruments that qualify for hedge accounting in accordance with IAS39.

At 31 December 2011 net gains of £272,000 (31 December 2010: net losses £1,076,000), on currency swap derivative instruments, have been recorded against foreign exchange gains and losses in the income statement, reflecting the effects of these derivative instruments in mitigating the foreign exchange gains and losses on the net non Sterling assets of the bank held at these dates.

12. Other operating income

£000	31 December 2011	31 December 2010
Related party service charges	25,690	30,326
Other	8	5
	25,698	30,331

The related party service charges represents the net amount receivable by the bank for services provided and received under service level agreements with related parties as disclosed in note 34.

13. Staff costs

£000	31 December 2011	31 December 2010
Wages and salaries	12,580	11,027
Contributions to defined contribution plans	1,143	986
Social security costs	1,313	1,153
Other	1,167	593
	16,203	13,759

14. Other expenses

£000	31 December 2011	31 December 2010
Administrative	4,100	3,464
Software licensing and other IT costs	153	110
Other	404	470
	4,657	4,044

Auditor's remuneration:

£000	31 December 2011	31 December 2010
Fees payable to the Company's auditors for the audit of the company's financial statements		
Current year	125	98
Prior years	14	–
Fees payable to the company's auditor and its associates for other services		
The audits of the company's subsidiaries, pursuant to legislation	70	101
Other services pursuant to legislation	169	220
Other services	45	27

15. Directors' emoluments

£000	31 December 2011	31 December 2010
Emoluments of directors in respect of services rendered		
Emoluments	956	894
Pension contributions	70	63
Highest paid director		
Emoluments	470	498
Pension contributions	54	47

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Notes to the Financial Statements *continued*

16. Income tax expense

£000	31 December 2011	31 December 2010
Current tax expense		
Current period	2,173	8,144
Adjustments for prior years	59	1,497
Total current tax	2,232	9,641
Deferred tax expense		
Origination and reversal of temporary differences	(19)	(129)
Adjustments for prior years	(7)	(676)
Total deferred tax	(26)	(805)
Total income tax expense	2,206	8,836

The tax on the bank's profit before tax differs from the theoretical amount that would arise using the weighted average tax rate applicable to profits of the bank as follows:

Reconciliation of effective tax rate

£000	31 December 2011	31 December 2010
(Loss) / profit before income tax	(23,864)	19,615
Income tax using the standard rate of corporation tax in the UK 26.5% (2010: 28%)	(6,324)	5,492
Non-deductible expenses	130	162
Impairment of investment in subsidiary	8,329	2,361
Under provided in prior years	53	821
Other – tax rate adjustment	2	–
Foreign tax not fully creditable	16	–
Total income tax expense in income statement	2,206	8,836

Income tax recognised in other comprehensive income

£000	31 December 2011	31 December 2010
Current tax		
UK current tax expense	(10)	1,135
Adjustments for prior years	–	(699)
Total current tax	(10)	436
Deferred tax		
Current year deferred tax expense	–	119
Adjustments for prior years	–	699
Total deferred tax	–	818
Total income tax expense	(10)	1,254

During the year, as a result of the changes in the UK main corporation tax rate to 26% that was substantively enacted on 29 March 2011 and that was effective from 1 April 2011, and to 25% that was substantively enacted on 5 July 2011 and that was effective from 1 April 2012, the relevant deferred tax balances have been re-measured. Further reductions to the UK corporation tax rate were announced in the March 2011 Budget. The changes, which are expected to be enacted separately each year, propose to reduce the rate by 1% per annum to 23% by 1 April 2016. The changes had not been substantively enacted at the balance sheet date and, therefore, are not recognised in these financial statements.

17. Cash and cash equivalents

£000	31 December 2011	31 December 2010
Cash and cash equivalents with banks	274,203	214,065
Cash in hand	1,618	1,090
	275,821	215,155

18. Derivative financial instruments

The bank holds derivative instruments for risk management and cross currency funding purposes.

£000	31 December 2011		31 December 2010	
	Assets	Liabilities	Assets	Liabilities
Instrument type:				
Interest rate swap	58	4,131	477	5,375
Cross currency swap	-	280	28	581
Foreign exchange forward	14	5	-	-
	72	4,416	505	5,956

The bank did not designate any derivative financial instruments for hedging purposes during either period presented.

19. Loans and advances to banks

£000	31 December 2011	31 December 2010
Loans and advances to banks	12,865	12,817

At 31 December 2011 £Nil (31 December 2010: £12,817,000) of loans and advances to banks are expected to be recovered more than twelve months after the reporting date.

20. Loans and advances to customers

£000	31 December 2011	31 December 2010
Corporate loans and advances	150,606	129,385
Retail loans and advances	147,274	85,646
Gross loans and advances	297,880	215,031
Less: allowance for impairments		
Specific	(7,128)	(408)
Collective	-	-
Total allowance for impairment	(7,128)	(408)
Loans and advances to customers net	290,752	214,623

At 31 December 2011 £242,694,000 (31 December 2010: £196,642,000) of loans and advances to customers are expected to be recovered more than twelve months after the reporting date.

Loans and advances to customers at amortised cost

£000	31 December 2011			31 December 2010		
	Gross amount	Impairment allowance	Carrying amount	Gross amount	Impairment allowance	Carrying amount
Corporate loans and advances	150,606	(7,000)	143,606	129,385	-	129,385
Retail loans and advances	147,274	(128)	147,146	85,646	(408)	85,238
	297,880	(7,128)	290,752	215,031	(408)	214,623

Financial Statements

Notes to the Financial Statements *continued*

21. Allowances for impairment

(a) Loans and advances to banks and customers

£000	Specific		Collective	
	Loans and advances to banks	Loans and advances to customers	Loans and advances to banks	Loans and advances to customers
Balance at 1 January 2011	-	408	-	-
Increase in impairment	-	7,167	-	-
Reversal of impairment	-	-	-	-
Charge in income statement	-	7,167	-	-
Amounts written off	-	(447)	-	-
Balance at 31 December 2011	-	7,128	-	-
Balance at 1 January 2010	-	531	-	-
Increase in impairment	-	37	-	-
Reversal of impairment	-	(152)	-	-
(Credit) in income statement	-	(115)	-	-
Amounts written off	-	(8)	-	-
Balance at 31 December 2010	-	408	-	-

(b) Available for sale financial investments

£000	Note	Movement in fair value recognised in equity	Impairment
Balance at 1 January 2011		1,340	5,749
Changes in fair values	22	1,141	-
Increase in impairment	22	(1,105)	1,105
Amounts written off		-	(2,934)
Exchange-rate movements		-	10
Balance at 31 December 2011		1,376	3,930
Balance at 1 January 2010		5,819	5,584
Changes in fair values	22	(4,329)	-
Increase in impairment	22	(150)	150
Amounts written off		-	-
Exchange-rate movements		-	15
Balance at 31 December 2010		1,340	5,749

(c) Impairment charges

£000	31 December 2011	31 December 2010
Loans and advances to customers		
Specific	7,167	(115)
Collective	-	-
Available for sale financial investments	1,105	150
Total impairment charges in income statement	8,272	35

22. Available for sale investments

At 31 December 2011 there were £51,695,000 of available for sale investments (31 December 2010: £149,677,000) which are expected to be recovered more than twelve months after the reporting date. The available for sale investments balance is comprised of fixed and floating interest rate bonds.

£000	Note	31 December 2011	31 December 2010
Debt securities		77,243	107,610
Asset backed securities		18,428	42,067
		95,671	149,677
Balance at 1 January		149,677	249,004
Accrued interest		(799)	(1,434)
Disposals through sale and redemptions		(54,463)	(101,385)
Gains from changes in fair value recognised in equity	21 (b)	(36)	4,479
Movements in impairment amounts	21 (b)	1,829	(150)
Amortisation of premium		(48)	(40)
Exchange-rate movement		(489)	(797)
Balance at 31 December		95,671	149,677

23. Tangible fixed assets (Property, plant and equipment)

£000	Property, plant and fixtures	Furniture and equipment	Computer equipment	Motor vehicles	Total
Cost					
Balance at 1 January 2011	4,909	616	443	67	6,035
Additions	-	141	101	33	275
Disposals	-	(13)	(5)	-	(18)
Balance at 31 December 2011	4,909	744	539	100	6,292
Balance at 1 January 2010	4,900	593	372	67	5,932
Additions	9	23	71	-	103
Disposals	-	-	-	-	-
Balance at 31 December 2010	4,909	616	443	67	6,035
Depreciation					
Balance at 1 January 2011	3,585	533	267	38	4,423
Depreciation for the year	379	30	81	17	507
Disposals	-	(8)	(4)	-	(12)
Balance at 31 December 2011	3,964	555	344	55	4,918
Balance at 1 January 2010	3,172	507	207	21	3,907
Depreciation for the year	413	26	60	17	516
Disposals	-	-	-	-	-
Balance at 31 December 2010	3,585	533	267	38	4,423
Net carrying values at					
31 December 2011	945	189	195	45	1,374
31 December 2010	1,324	83	176	29	1,612

As at 31 December 2011 and 31 December 2010 the bank identified no events or circumstances that would indicate that the bank's tangible fixed assets might be impaired.

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Notes to the Financial Statements *continued*

24. Intangible assets

£000	IT Software	Total
Cost		
Balance at 1 January 2011	671	671
Additions	6	6
Balance at 31 December 2011	677	677
Balance at 1 January 2010	633	633
Additions	38	38
Balance at 31 December 2010	671	671
Depreciation and Impairment loss		
Balance at 1 January 2011	354	354
Depreciation for the year	160	160
Balance at 31 December 2011	514	514
Balance at 1 January 2010	193	193
Depreciation for the year	161	161
Balance at 31 December 2010	354	354
Net carrying value at		
31 December 2011	163	163
31 December 2010	317	317

As at 31 December 2011 and 31 December 2010 the bank identified no events or circumstances that would indicate that the bank's intangible assets might be impaired.

25. Deferred tax assets and liabilities

Recognised deferred tax assets and liabilities

Deferred tax assets and liabilities are attributable to the following:

£000	31 December 2011			31 December 2010		
	Assets	Liabilities	Net	Assets	Liabilities	Net
Property and equipment, and software	30	-	30	4	-	4
Net tax assets	30	-	30	4	-	4

Unrecognised deferred tax assets

There were no unrecognised deferred tax assets as at 31 December 2011 and 31 December 2010.

Movements in temporary differences during the year

£000	Opening balance 1 January 2011	Recognised in profit or loss	Recognised in equity	Closing balance 31 December 2011
Property and equipment, and software	4	26	-	30
Available for sale investments	-	-	-	-
	4	26	-	30

£000	Opening balance 1 January 2010	Recognised in profit or loss	Recognised in equity	Closing balance 31 December 2010
Property and equipment, and software	16	(12)	-	4
Available for sale investments	-	817	(817)	-
	16	805	(817)	4

26. Prepayments, accrued income and other assets

£000	31 December 2011	31 December 2010
Accrued income	901	961
Prepaid expenses	295	330
Prepaid tax	1,599	6,874
Receivable from related party	33,588	36,983
Other	1,309	1,279
	37,692	46,427

27. Deposits from banks

£000	31 December 2011	31 December 2010
From subsidiaries	47,602	9,885
Other deposits from banks	155,082	166,185
	202,684	176,070

At 31 December 2011 £nil (31 December 2010: £nil) of deposits from banks are expected to be settled more than twelve months after the reporting date.

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Notes to the Financial Statements *continued*

28. Deposits from customers

£000	31 December 2011	31 December 2010
Retail customers:		
Term deposits	95,498	83,916
Notice deposits	60,237	64,329
Current deposits	189,131	142,270
Other	434	253
	345,300	290,768
Corporate customers:		
Current deposits	6,583	3,723
Other	293	1,798
	6,876	5,521
	352,176	296,289

At 31 December 2011 £nil (31 December 2010: £13,000) of deposits from customers are expected to be settled more than twelve months after the reporting date.

29. Subordinated liabilities

£000	31 December 2011	31 December 2010
Subordinated note issued	60,000	60,000
	60,000	60,000

The subordinated note issued is expected to settle more than twelve months after the reporting date (31 December 2010: £60,000,000).

On 20 September 2007 the bank issued a £60,000,000 subordinated loan. Interest is payable on 31 March, 30 June, 30 September and 31 December at the three-month London Interbank Bank Offered Rate plus 30 basis points. The rate applicable to the loan as at the reporting date was 1.38% (31 December 2010: 1.06%). The loan is repayable upon giving 5 years and one day's notice.

The above liabilities will, in the event of the winding-up of the bank, be subordinated to the claims of depositors and all other creditors of the bank.

The bank has not had any defaults of principal, interest or other breaches with respect to its subordinated liabilities during the periods ended 31 December 2011 and 31 December 2010.

30. Other liabilities

(a) Other liabilities

£000	31 December 2011	31 December 2010
Creditors and accruals	13,415	12,656
Other	1,875	1,549
	15,290	14,205

(b) Defined benefit obligations

The bank makes contributions to a group defined benefit scheme, the Bank of China Pension & Life Assurance Scheme (the "Scheme"), that provides pension benefits for employees upon retirement. The Scheme entitles a retired employee to receive an annual payment equal to 1/60th of final salary for each year of service the employee provided. The Scheme is sponsored by Bank of China Limited, London Branch and was closed to new employees on 31 December 2004.

The following tables set out details of the Scheme as at 31 December 2011 and 2010. This disclosure is for the scheme as a whole and does not represent the bank's allocation of the Scheme's assets and liabilities due to its participation in the Scheme. The Scheme prepares its financial statements as at 31 December annually.

Changes in the present value of the Scheme's liabilities

£000	31 December 2011	31 December 2010
Benefit obligations at beginning of year	36,468	33,644
Interest costs	2,023	1,902
Current service costs	858	900
Members' contributions	126	124
Actuarial gains	427	272
Effects of curtailments or settlements	(67)	(68)
Benefits paid	(286)	(306)
Benefit obligations at the end of the year	39,549	36,468

The benefit obligations arising from the Scheme that are wholly un-funded and wholly or partly funded are as follows:

£000	31 December 2011	31 December 2010
Un-funded obligations	-	-
Wholly or partly funded obligations	(4,578)	(3,937)
Total	(4,578)	(3,937)

Financial Statements

Notes to the Financial Statements *continued*

30. Other liabilities *continued*

Changes in Scheme assets

£000	31 December 2011	31 December 2010
Market value of assets at beginning of year	32,531	30,158
Expected return on Scheme assets	1,667	1,548
Actuarial gain/(loss)	(79)	262
Members' contributions	126	124
Employer's contributions	1,079	813
Effects of settlements	(67)	(68)
Benefits paid	(286)	(306)
Market value of assets at end of year	34,971	32,531

Scheme assets as a percentage of total assets

£000	31 December 2011	31 December 2010
Equities	24.90%	26.70%
Bonds	26.10%	24.00%
Property	4.10%	4.00%
Cash	44.90%	45.30%

Principal actuarial assumptions

The overall expected return on assets has been derived by considering the long-term expected rate of return for each asset class and taking the average rates weighted by the proportion invested in each asset class at the year end.

£000	31 December 2011	31 December 2010
Discount rate	4.70%	5.50%
Price inflation	2.80%	3.40%
Rate of increase in salaries	4.30%	4.90%
Rate of increase for pensions in payment (LPI)	2.80%	3.20%
Post retirement mortality table	PM/FA 92 YOB	PM/FA 92 YOB
	(Long Cohort)	(Long Cohort)
Expected return on assets	5.06%	5.60%

The bank expects to pay £754,000 (2010: £631,000) in contributions to defined benefit plans in 2012.

31. Accruals and deferred income

£000	31 December 2011	31 December 2010
Deferred income	2,759	2,669
Accrued interest	843	468
	3,602	3,137

32. Equity

(a) Capital

At 31 December 2011 the authorised share capital comprised 140,000,000 ordinary shares (31 December 2010:140,000,000). These instruments have a par value of £1 and are all issued shares and fully paid.

The holders of ordinary shares are entitled to receive dividends as declared from time to time and are entitled to one vote per share at meetings of the bank. All shares rank equally subordinated to the bank's assets.

(b) Available for sale reserve

The available for sale reserve includes the cumulative net change in the fair value of available for sale investments, excluding impairment losses, until the investment is derecognised or impaired.

(c) Dividends

There were no dividends declared for the years ended 31 December 2011 or 31 December 2010.

33. Provisions

There were no provisions or contingencies at the years ended 31 December 2011 or 31 December 2010.

34. Related parties

(a) Parent and ultimate controlling party

The immediate parent company of the bank is Bank of China Limited (a company incorporated in the People's Republic of China). The ultimate holding company is China Investment Corporation Limited.

The largest and smallest group which includes the bank and which prepares publicly available consolidated financial statements is the Bank of China Limited. Copies of its consolidated financial statements are publicly available from the Head Office of the Bank of China Limited, 1 Fuxingmen Nei Dajie, Beijing, 100818, People's Republic of China.

During the year ended 31 December 2011 there were no transactions which resulted in there being a change in the ultimate controlling party of the bank.

The bank regards the following as being related parties that exercise significant influence:

- Bank of China Limited
- China Investment Corporation Limited

Related party transactions occurred between the bank and the London Branch of Bank of China Limited. At 31 December 2011 the bank received £155,082,000 (31 December 2010: £163,085,000) which is 28% (31 December 2010: 35%) of its funding from Bank of China Limited, London Branch in the form of short-term funding. The funding is interest-bearing at market rate for the term and currency borrowed, and is repayable in accordance with the contractual maturity date of the deposit.

Financial Statements

Notes to the Financial Statements *continued*

34. Related parties *continued*

£000	Nature of related party	
	Significant influence	Significant company
Balance at 31 December 2011		
Cash and cash equivalents	269,743	–
Loans and advances to customers	–	3
Derivative financial instruments	72	–
Prepayments, accrued income and other assets	33,476	112
Deposits from banks	155,082	47,602
Deposits from customers	–	2,482
Derivative financial instruments	4,416	–
Other liabilities	8,525	–
Subordinated liabilities	60,000	–
Included in the income statement for the period		
Interest receivable	442	–
Interest payable	(2,133)	(199)
Other operating income	25,381	309
Pension contributions	(692)	–
Net loss on derivative financial instruments	(1,648)	–
Balance at 31 December 2010		
Cash and cash equivalents	140,788	–
Loans and advances to customers	–	3
Derivative financial instruments	505	–
Prepayments, accrued income and other assets	36,983	–
Deposits from banks	163,085	9,885
Deposits from customers	–	1,763
Derivative financial instruments	5,956	–
Other liabilities	6,756	–
Subordinated liabilities	60,000	–
Included in the income statement for the period		
Interest receivable	724	–
Interest payable	(3,455)	–
Other operating income	30,152	173
Pension contributions	(655)	–
Net loss on derivative financial instruments	(2,249)	–

(b) Investment in non-consolidated subsidiaries

	Country of incorporation	Ownership interest	
		31 December 2011	31 December 2010
Bank of China (Suisse) S.A.	Switzerland	100%	100%
China Bridge Group (UK) Limited ²	United Kingdom	100%	100%
China Visa Services Italy SRL ¹	Italy	100%	100%
PT. China Visa Services Indonesia ¹	Indonesia	99%	99%

1. Indirect holding via China Bridge Group (UK) Limited

2. Name changed on 18 November 2011 from China Visa Services Limited

At 31 December 2011, the bank holds an investment of £89,229,000 (CHF 150,000,000) (31 December 2010: £89,229,000 (CHF 150,000,000)) in Bank of China (Suisse) S.A. (“BOCS”) and £1 in China Bridge Group (UK) Ltd. (31 December 2010: £1). These entities are wholly-owned, with head quarters at rue du General-Dufour 3, 1204 Geneva, Switzerland and Morley House, London, United Kingdom respectively.

As required by IAS 36 – Impairment of assets, the bank shall assess at the end of each reporting period whether there is any indication that an asset may be impaired. If any such indication exists, the bank shall estimate the recoverable amount of the assets. Due to the adverse business performance of BOCS against the approved 5-year business plan resulting in BOCS having negative reserves, the recoverable amount is less than the book value of the investment of BOCS in the bank’s balance sheet, hence an impairment assessment was required.

Subsequent to the year end, the bank entered into a sale and purchase agreement (“SPA”) with a Swiss registered bank to dispose of the whole issued share capital of BOCS (the “sale”), (Please see Note 36). Therefore, the recoverable amount of the investment in BOCS for the impairment assessment was estimated using the fair value less cost to sell approach in accordance with paragraph 25 of IAS 36.

Based on the above, the fair value of the investment in BOCS was determined to be £63,285,000 (calculated based on the terms in the SPA), which results in an impairment charge of £31,432,000 recognised in the income statement.

In performing this assessment, management has made some key assumptions in estimating the probability of certain monetary items, contained in the SPA being received and paid. The monetary items concerned are the receipt of funds in relation to the usage of the tax losses by the purchaser (subject to tax rulings being granted by the tax administration at a cantonal and federal level) and net future revenues generated from clients transferring to the purchaser and payment of expenses relating to the re-structuring of the business.

These adjustments represent management’s best estimates after taking into consideration advice from its advisors as to the probability of receiving/paying certain variable elements contained in the SPA from experience of similar transactions and Swiss tax regulations.

The bank has availed itself of the consolidation exemption (refer to Note 2) and therefore does not consolidate these subsidiaries.

(c) Key management compensation

Key management is comprised of directors and the members of the Executive Management Committee of the bank.

Key management personnel compensation for the period ended 31 December 2011 comprised of salaries and other short term benefits in the amount of £1,358,000 (31 December 2010 £1,488,000).

The bank does not provide non-cash benefits to any of the key management personnel.

(d) Transactions with key management

£000	31 December 2011	31 December 2010
Loans and advances	14	218

35. Contingent liabilities and commitments

(a) Loan commitments, guarantees and other financial facilities

At 31 December 2011, the bank had off-balance sheet financial instruments that commit it to extend credit to customers, guarantees and other facilities as follows:

£000	31 December 2011	31 December 2010
Loan commitments	254,967	253,856
Guarantees	10,394	21,450
Total	265,361	275,306

(b) Operating lease commitments

Where the bank is the lessee, the future aggregate minimum lease payments under non-cancellable operating leases are as follows:

£000	31 December 2011	31 December 2010
Less than one year	158	427
Between one and five years	209	270
More than five years	–	–
Total	367	697

36. Subsequent events

On the 12 March 2012 Bank of China Limited, the bank's parent company, remitted £110,000,000 for the purpose of subscribing for 110,000,000 £1 ordinary shares in the bank. On the 30 March 2012 the bank issued and allotted 110,000,000 £1 ordinary shares to Bank of China Limited.

On the 20 July 2012 the bank entered into and signed a sale and purchase agreement ("SPA") with a Swiss registered bank for the sale of the whole of the issued share capital of BOCS.

The consideration receivable under the SPA is for the net asset value of the bank at the closing day, as defined in the SPA, a premium above the net asset value, compensation for the use of the accumulated tax losses and a percentage of net future revenues generated from clients transferring to the purchaser. The consideration receivable is offset by a contribution, which is capped, to any restructuring costs incurred integrating the existing operations of BOCS into the purchaser's operations. At the date of signing the SPA there were unsettled litigation actions against BOCS. The SPA provides that to the extent a settlement is made or defended any amount payable by the purchaser which is less than the provision amount booked for the settled/defended litigation and used in the calculation of the net asset value shall be returned to the bank. Where the payment by the purchaser is greater than the provision amount booked for the settled litigation and used in the calculation of the net asset value shall be payable by the bank.

37. Going concern assessment

The Board has given its consideration to the going concern status of the bank as at the reporting date. After due consideration the Board is of the opinion that the bank will continue as a going concern for the foreseeable future, generating cash flows from its continuing operations, but taking additional comfort from the Letter of Support from the parent company.



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