# 2012 Q1 IMS

## ANALYSTS PRESENTATION

Held at the offices of the Company

280 Bishopsgate London EC2N 4RB

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**FORWARD-LOOKING STATEMENTS**

This transcript includes certain statements regarding our assumptions, projections, expectations, intentions or beliefs about future events. These statements constitute "forward-looking statements" for purposes of the Private Securities Litigation Reform Act of 1995. We caution that these statements may and often do vary materially from actual results. Accordingly, we cannot assure you that actual results will not differ materially from those expressed or implied by the forward-looking statements. You should read the section entitled "Forward-Looking Statements" in our Q1 Results announcement published on 4th May 2012.

## Presenters

**Stephen Hester**

*The Royal Bank of Scotland – Group Chief Executive Officer*

**Bruce Van Saun**

*The Royal Bank of Scotland – Group Finance Director*

# Presentation

**Operator**

Good morning, ladies and gentlemen.  Today's conference call will be hosted by Stephen Hester, Chief Executive of RBS.

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**Stephen Hester** – The *Royal Bank of Scotland Group - CEO*

Good morning, everyone.  Thank you for joining us for our first quarter review call, Bruce is with me as usual.  We'll canter through the results that we put out this morning and then spend as much time as you would like on trying to answer your questions.

By way of introduction, I would say that I'm happy with progress in the first quarter, although, of course, cognisant that it takes place against a challenging economic backdrop.  I think that, when we analyse the two jobs that we're trying to do, we're showing some good progress in both.  The job of fixing the past is showing really excellent progress any way you care to look at it. Reduction in Non-Core assets, improvement in liquidity stats, improvement in capital ratios, things going absolutely in the right direction.

We've had a couple of milestones, of themselves not economically significant, but I think symbolically significant of our march back to normality.  We've announced the resumption of coupons on our hybrid capital today, and next week we finish paying off all of the central bank liquidity support that we received from whatever resource during the crisis, which was a very large amount of money.  So, I think that's symbolically important, and you know about the share consolidation, which, again, is a symbol of trying to look forward and not backward.  So, we feel pretty good about all of that stuff.  Doesn't mean to say there aren't risks out there, and things that can go wrong.  Which is exactly why we're trying to get into a very conservative position in the face of those challenges externally.

On to our second job of running the bank well, trying to serve customers and then bringing something to the bottom line for shareholders.  Clearly, the macro backdrop of a flat economy makes it very hard to do much on the income line.  So, in many respects, we're treading water, as all of our competitors are also.  It's not such a bad place to be.  Our Retail and Commercial ROE is 13% excluding Ulster Bank.  I think we were really pleased in the quarter that the restructuring in the investment bank is on track.  The results show that it didn't distract us; we were able to deliver a 21% return on equity in our markets business in the first quarter. And, unlike any of our competitors, that's on a balance sheet that's 20% down year-on-year. I don't project that out for the year, but pleased that it didn't knock us off course. And beneath the surface we're doing huge amounts of work trying to make each one of our businesses better. US R&C is still improving on an underlying basis. Ulster's still stuck with past losses, but we're wading through them. So, I think we feel that we've got a solid business, one that we're making better, but some of the visibility of that will have to wait until economies do better.

So that would be my introduction. I do think it's a year where you have to worry about things going wrong that you don't expect in the outside world. And we're braced against that, but we'll make as much progress as we can. And I do think the bank becomes more and more resilient in the face of setbacks like that as we go on. But with that, perhaps I could ask Bruce to go through the financials.

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**Bruce Van Saun** – *The Royal Bank of Scotland Group, FD*

Okay. Thank you, Stephen. The first quarter saw the group take further steps on its path to recovery. Our capital funding and liquidity risk metrics continue to strengthen, while Non-Core saw excellent progress in asset reduction. Quickly running through the financial headlines, the group's first quarter operating profit of £1.4 million was substantially improved from a fourth-quarter loss of £144 million, and it was up slightly on a year ago. Core operating profit was £1.7 billion, and Core ROE stood at 11%. Markets saw a strong rebound at operating performance level, as market sentiment and customer risk appetite improved.

We are pleased with the progress we're making to date in the GBM restructuring. R&C's performance remained resilient against the challenging economic backdrop. Non-Core's operating losses were down sharply for the quarter. At the bottom line, the group showed an attributable loss of £1.5 billion, largely due to a sizeable own credit adjustment as our credit spreads dramatically improved in the quarter.

Looking at our capital position, our Core Tier 1 ratio improved to 10.8% given the underlying profit and further RWA reduction. Our tangible net asset value per share was slightly down at 49p, due to the own credit adjustment.

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Today we announced we'll resume coupon payments on our preferred securities. This is another milestone in returning to standalone strength. Within a couple of weeks - actually, later this week - we'll pay off the last of our CGS debt as it matures, which is still another step.

Looking next at the major group P&L items, group income was up 25%, or £1.4 billion on the prior quarter, but it was down 12% versus a year ago. Markets' revenues saw a strong recovery, up a billion on the prior quarter to £1.7 billion, while lower Non-Core losses drove a £550 million positive revenue swing. Group NIM was up five basis points versus Q4, to 1.89%. R&C's NIM increased a basis point as asset margin improvements in UK corporate and US R&C were partially offset by deposit margin pressure. R&C's first quarter earning assets were broadly stable versus Q4.

Control of underlying expenses remains very good. Group expenses are down 3% year-on-year, but are up 9% sequentially. The sequential increase largely reflects higher incentive compensation accruals tied to higher markets revenues, as well as a litigation settlement at Citizens. The Core cost:income ratio improved 200 basis points on Q4 to 60%.

Group impairments were down £400 million, or 22%, relative to the fourth quarter. Excluding Ulster, impairments were down 41%. Core impairments fell 12% versus prior quarter, with R&C impairments falling 11%. We saw favourable trends across all divisions save Ulster. UK Corporate benefited from non-repeat of some large single-name charges in the fourth quarter.

Looking at Core Ulster impairment trends, impairments rose £70 million on last quarter, due primarily to further softening of residential asset values. This is clearly disappointing. As such, we remain cautious on Irish credit for the near future.

Group provision coverage of REILs continued to improve in the quarter. It's now up to 51%. Group REILs fell 3% in the quarter, a second quarter of decline.

Below the line items had a negative impact of £2.6 billion in the quarter, reflecting the large own credit adjustment charge of £2.5 billion. The remaining other items largely cancelled each other out. We benefitted from a roughly £600 million gain from the recent liability management exercise, which offset around £475 million of restructuring costs, and an additional £125 million top-up of the PPI provision. We have seen PPI claims volumes run higher than we had anticipated.

The first quarter APS charge was £43 million. The cumulative charge now stands at £2.5 billion, which is equal to the minimum fee payable to HMT for the programme.

Turning next to the divisional results, you'll notice our new formatting, to account for the GBM restructure and realignment. We also revised our approach to treasury allocations and we increased the allocation of notional equity to 10% of RWAs for all divisions. These changes are described more fully in our release earlier in the week and in the supplemental information which is posted today to our IR website.

Kicking off with UK Retail, it had another solid quarter, delivering an ROE of 24%. Operating profit was up 4% relative to the fourth quarter, as we maintained good cost control and impairment trends continued to be favourable. UK Retail continues to grow deposits, which are up £8 billion on the year and £2 billion on the quarter. UK Retail remains firmly committed to providing helpful banking to its customers. The recently published 2011 customer charter results demonstrate this progress, with 23 out of the 25 goals having been met.

UK Corporate saw a 21% increase in operating profit as income improved 2% on Q4, and costs were kept in check. The main story though, was impairments were down versus Q4 on fewer single-name impairments. ROE reached 16% for the quarter. UK Corporate continues to work to support the UK economy and its customers through a wide array of initiatives, including the ahead for business promise. Q1 saw £14 billion of gross new loans extended to UK business.

Q1 saw further implementation of Wealth's revised strategy, with the announcement of the sale of our Latin American and African business, as well as a restructure of our customer-facing bankers to drive a better client coverage model. While headline profit in Q1 is down versus Q4, this reflects timing issues and one-timers. Underlying operating profit is in line with Q4. Assets under management increased 2% quarter-on-quarter, due to inflows from Asia and higher asset values.

The International Banking division was formed in January to service clients' financing, working capital, and risk management needs internationally. Performance was off in the quarter as portfolio income declined, reflecting balance sheet shrinkage and market-related revenues fell due to subdued corporate hedging activity. A bright spot, though, was good growth in Trade Finance and Cash Management, which were up 7% and 11% respectively on Q4.

Ulster Bank, as mentioned, continues to operate in a difficult economic environment, resulting in persistently high impairments. Core Ulster impairments were up 20% relative to Q4, to £394 million, as the residential mortgage portfolio demonstrated a continued increase in delinquencies, and asset values continued to fall.  We had been hopeful of seeing a turn in this book, but at this point, we remain cautious.

Citizens is driving its back-to-basics strategy forward by developing the customer franchise, managing expenditure, and enhancing credit quality.  In the last quarter, profit was up 7%, excluding a litigation settlement which is tied to legacy overdraft practices.  Underlying costs were broadly flat, and impairments improved further.  On an underlying basis, ROE was 8.4%.

Direct Line Group is delivering its transformation programme to rebuild its competitive position, while also taking important steps in separation from the Group.  Note that Direct Line has been assigned an A credit rating with a stable outlook.  We successfully issued £500 million in term debt in April, which will free capital for dividend to the group.  Operating profit is up 25% relative to a year ago, but down quarter-on-quarter, due to normal seasonal increases in bad weather claims, as well as accelerated marketing costs.

Next, our market franchise rebounded with a strong quarter, capturing the increase in market flows and investor confidence, while managing down to a smaller balance sheet.  Revenues are sharply up from the second half of last year, reflecting strong performances in the Rates, Credit, and Asset-Backed businesses.  Expenses were tightly controlled, producing a first-quarter ROE of 21%.

The restructuring plan is progressing well, with a number of sales of exited businesses announced.  We remain comfortable with our restructuring cost guidance of £550 million, and we're on track with respect to headcount reduction.  In Q1, markets TPA's decreased by £13 billion on the prior quarter to £300 billion, as we track towards our medium-term goal of £250 billion.  We remain focused on RWA mitigation as well.

Lastly, we turn to our Non-Core division.  The first quarter saw good progress in asset reduction, with TPA falling by £11 billion to £83 billion.  Non-Core's operating loss declined by £800 million, due to the non-repeat of Q4 commutation costs, improving credit trends, and the better market environment.

Let's turn next to the balance sheet.  We have had another good quarter of progress across all of our funding, liquidity, and capital metrics.  The Group loan-to-deposit ratio is now 106%, with Core at 93%.  Customer deposits now represent 65% of our funding base.  Our short-term wholesale funding position declined by £23 billion to £80 billion, or 8% of our funded balance sheet.  This is comfortably below our medium-term target of less than 10%.  The liquidity portfolio is prudently set at £153 billion, or 1.9 times our short-term wholesale funding. We compare favourably to our peers across each of these liquidity and funding metrics.

The group capital position remains strong, with a Core Tier 1 ratio increasing to 10.8%, which reflects the quarter's profit and our RWA reduction. Given this continued progress, the board has decided to turn on our dividends on our 'may pay' RBS Group preference shares, which commences this month. The cost of the dividend resumption for the year will be around £350 million, and we will neutralise the impact on Core Tier 1.

So, to sum up, the first quarter was another quarter of good progress in further strengthening the Group's balance sheet and we delivered a solid performance from our Core franchises, in spite of a continued challenging environment. We are particularly pleased with our progress on the restructuring of GBM, and with Non-Core's steady execution. The balance of 2012 continues to hold important milestones for the group, we're very focused on execution, and we expect to make continued progress.

With that, let me turn it back to Stephen.

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**Stephen Hester** – *The Royal Bank of Scotland Group - CEO*

Thank you very much, Bruce. On to the questions.

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# Questions and Answers

**Operator**

Thank you, Stephen.  Ladies and gentlemen, if you would like to ask a question, please press the * key, followed by the digit 1 on your telephone keypad.  We will pause for a moment to give everyone an opportunity to signal for questions.  Your first question comes from the line of Andrew Coombs from Citigroup.  Please go ahead.

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**Andrew Coombs** - *Citigroup*

Morning.  I have two questions, please, one on the Non-Core rundown, and then one on the margin.  The Non-Core one comes in two parts.  Could you perhaps elaborate on the positions that were reduced during the first quarter, because I noticed that you've had an £11 billion reduction in Non-Core assets to £83 billion, but only a £3 billion reduction in RWAs to £90 billion.  I would be interested to know if it's a case of selling or disposing of lower risk-weighted assets there.  And also, in terms of Aviation Capital, and it's statement on page 11, the £5 billion is not incorporated in the £11 billion that has been achieved.  Maybe I'm misunderstanding that.  But I'd be interested to know what your thoughts are on the full-year target, because you have got a target of £65 to £75 billion.  If you look at the £83 billion where you already are today, take off another £5 billion, you're already at £78 billion.  So some might argue that that's not that ambitious, and might be achieved already.  So just wanted to understand if that's conservatism on your behalf, or perhaps a reflection of the assets remaining.  That's my first large question.

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**Bruce** - *Royal Bank of Scotland*

Okay, want to stop there, and I'll come back to you for your next question.

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**Andrew Coombs** - *Citigroup*

Yes, let's do that.

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**Bruce** - *Royal Bank of Scotland*

I think the reduction in Non-Core assets was pretty much across the board. There's a couple other little regulatory things that went as offsets to the RWA reduction. It is true, though, that some of the assets are market assets that came out through the commutation of our monoline exposures. We were in good markets, and we were able to liquidate some of those positions. So I think that's probably why we ran a little bit ahead. But, again, roughly half of the run-down was through natural run-off, and the other half was through asset disposals. You're correct that the £5 billion from Aviation Capital is still in the signed but not completed category, and we have, a fairly good pipeline of transactions that we're working on. We don't really have anything that big left, and so, if you actually look at how we're going to proceed from here, we probably have in excess of 80 data rooms open, and we're talking about lots of individual assets or small portfolios. But when we look at the stage of completion that those are in, we feel quite confident of our ability to hit that target. We're managing to a loss budget. So, provided that Core continues to deliver, we'd like to spend that full amount. And if that means that we can end up below that targeted range for the year that would be a good outcome.

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**Andrew Coombs** - *Citigroup*

Thank you. The second question I had was on your liquidity buffer that you flag on slide 19 and 20. You're now at 191% of short-term wholesale funding, and if I look at the NSFR, it's 109% as well. I know you don't disclose the LCR, but just interested to know, is there any ability to deploy some of that £154 billion of liquidity buffer, perhaps post the Moody's review? And also, what's baked into your new margin guidance of 189 basis points on that front as well?

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**Bruce** - *Royal Bank of Scotland*

Well, obviously, it is expensive to maintain liquidity at that level. And I think the 1.9 measure is a little simplistic, because we run scenarios and stress tests that look at deposit outflows in addition to short-term funding outflows. So, as that short-term wholesale funding number comes down, you kind of move out of the range. We had set a target of 1.5x to 1x. I think you'd naturally move a little bit over that. Having said that, I think one of the reasons to keep the liquidity buffer where it is, you mention Moody's, but also looking at the geopolitical environment that we face, the Eurozone's still in some distress. I think the number one priority here is to make the bank safer and keep it safe through a still rocky period. We brought down the average liquidity in the quarter by about £8 billion.  That's helping to improve the NIM.  I do think there will be opportunities as the year goes on to continue to do more of that.  But we're going to be cautious until we see the environment improve.

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**Andrew Coombs** - *Citigroup*

Thank you.

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**Bruce Van Saun** – *The Royal Bank of Scotland Group - FD*

Okay.

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**Operator**

Thank you.  Your next question comes from the line of Jason Napier from Deutsche Bank. Please go ahead.

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**Jason Napier** – *Deutsche Bank*

Good morning.  I had some questions around the disclosures on page 104, if I may, focusing on Ulster in the Core bank first of all.  Commentary in your Core so far concerns collateral values and an increase in REILs.  I just wonder, when write-off amounts are so small, whether you could give some colour on what level of realisations are taking place, and perhaps what the inventory of repossessed properties looks like.  It just strikes me that the market's so illiquid that figuring out what the right coverage level is has got to be a real challenge.  So I wonder whether you could just talk about properties in possession, noting that I think, you said that half of the properties taken were voluntary surrenders or abandonments.  I just wonder whether you could just talk about how you figure out the right coverage ratio there.  And I have another question after that.

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**Stephen Hester** – *The Royal Bank of Scotland Group - CEO*

Yes, I don't have at my fingertips the actual number, I'm afraid. But, having just been over there last week, I'll try and give you a bit more colour, I think the reality is, there is currently no material market in real estate in Ireland in terms of investment transactions. And it's for that reason that it's sort of a pointless exercise to use the provisions and write things down formally, because you're not going to do anything different with them for the time being in any event. And so that's why you have low levels of write-off. It doesn't mean that they're not going to get written off. And because there is so little evidence, you're absolutely right to say it's kind of meaningless to set a value. So the way we try and approach it is to take some through the cycle long-term average estimate of what things might be in the absence of any meaningful short-term market. And, frankly I completely accept, it's a little bit like sticking a finger in the air. And our attempt will be to keep our provisions broadly in the pack. But in the end, it will be what it will be, and we'll only know in ten years what the losses are. I think that the key indicators to look at, apart from REILs, is what's going on in the Irish economy, and then what's going on in real estate prices. The slightly disappointingly residential house prices have continued to come down this year, albeit March was the first month that they didn't. Whether that's a blip or a trend, is too early to tell. On the other hand, you know, the government seems to be doing the right things. The economy seems to be flat as opposed to going down. Exports are still positive. So, I think we're still feeling it's more likely than not that provisions start coming down this year, and the economy gets better. Obviously, mathematically, our provision coverage gets to a point where you're caught up in any event. But clearly, that's still a reasonable bid offer spread for exactly where this thing ends.

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**Jason Napier** – *Deutsche Bank*

Thank you. And on that, what sort of actions the government are taking or looking at taking, the three near misses of engaging in a non-judicial way on debt resolution and management. Have you seen any behavioural change ahead of that?

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**Stephen Hester** – *The Royal Bank of Scotland Group - CEO*

Well, I think there is… yes, there has been some evidence of behavioural changes, as some people speculated that it might be easier to get out of their debts in the light of legislative change. And so, I think there's some evidence of that. That said, I had a number of contacts with the government of Ireland when I was over there and received pretty strong assurances that the regime that is due to go through Parliament in the next three or four months will not be an unduly anti-business regime.  For example, personal insolvency periods will be three years, against one year in the UK.  So, at the moment, it feels like the legislative process is not going to lead to a chaotic situation for banks, although there's some uncertainty until it's complete.

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**Jason Napier** – *Deutsche Bank*

Great, thank you.  And then, if I may, just on that same table, is there something in particular going on in the international banking numbers?  I noticed your REILs have halved, and coverage is nearly 100%.  Was that a specific instance and is there room for write-backs there at all?

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**Bruce Van Saun** – *The Royal Bank of Scotland Group - FD*

No, I think that's the old GBM portfolio, which is now the main asset portfolio in the group.  And that's going to move around a bit, because those are large single-name exposures in that.  So, I think that portfolio has been performing reasonably well.  We've had reasonably good credit performance and good coverage levels in that portfolio.  But whether we have any near-term recovery opportunities, I think is too early to tell.  They kind of hit you, good or bad, often in a big lump.

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**Jason Napier** – *Deutsche Bank*

Thank you.

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**Bruce Van Saun** – *The Royal Bank of Scotland Group - FD*
Next question?

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**Operator**

Your next question comes from the line of Chris Manners from Morgan Stanley.  Please go ahead.

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**Chris Manners** – *Morgan Stanley*

Good morning to everyone.

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**Bruce Van Saun** – *The Royal Bank of Scotland Group - FD*

Hi.

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**Chris Manners** – *Morgan Stanley*

I just had one question, which was about the Core loan growth for the bank.  The Core loan book has shrunk a little bit on the quarter.  I was just trying to work out what was driving that.  Is that a demand issue?  Is it the funding cost?

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**Stephen Hester** – *The Royal Bank of Scotland Group - CEO*

It's demand.  I mean, you know, we're frustrated.  We've got a 93% loan to deposit ratio.  So, quite unlike, I don't know, Lloyds or Santander, we have no desire to get our core loan to deposit ratio other than up, and we'd like to be making more loans.  But right at this stage of the economy, if our customers don't see their top line going up, they don't want to borrow more.  So we're running as hard as we can, frankly, to stand still.  That will change, obviously, when the economy changes, but that's where we are.

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**Chris Manners** – *Morgan Stanley*

Thanks. And, if you were to be able to raise the loan book, which parts are you seeing the best demand in?

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**Bruce Van Saun** – *The Royal Bank of Scotland Group - FD*

At this point, we're seeing some good demand in the US on the commercial book. And so, that's been one area of emphasis for us. Also in UK retail, we continue to see opportunities in the mortgage side, where our flow of mortgages is above our stock position. Also, in UK corporate, we're seeing, in the smaller business segment, lots of asset finance opportunities, so that's also been a good area of growth for us. I'd really highlight those three.

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**Chris Manners** – *Morgan Stanley*

Thanks guys.

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**Bruce Van Saun** – *The Royal Bank of Scotland Group - FD*

Okay.

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**Operator**

Thank you. Your next question comes from the line of Manus Costello from Autonomous Research. Please go ahead.

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**Manus Costello** – *Autonomous Research*

Morning, everybody. I just wanted to go back to slide 20 in the liquid assets, please. I just wanted to clarify what you were saying earlier, Bruce. Because it looks, from your guidance for 2012, as if you're expecting the liquidity buffer to fault perhaps £100 billion at the end of this year. Is that correct, or should I just take it that it's going to be definitely in excess of £100 billion?

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**Bruce Van Saun** – *The Royal Bank of Scotland Group - FD*

No, I don't, why would you…?

**Manus Costello** – *Autonomous Research*

Just taking the £65 billion times by 1.5x your short-term margin point.

**Bruce Van Saun** – *The Royal Bank of Scotland Group - FD*

No, what I was saying is that that's our medium-term target, and we've been working hard to get the STWF numbers down. I think the liquidity buffer will still be quite a bit higher than the 1.5x. Again, we're managing the size of that buffer in a linear programme, with different stress metrics that we've created here at the bank, and then the FSA runs a bunch of different stress metrics. And so, basically, we need to optimise within those constraints. Having said that, I think there still is a bit of extra prudence built into that based on today's numbers, which, as the year goes by, and if some of the weakness in the economy or Euro concerns lessen, and the STWF keeps going down, we'll be able to release. Again, and that could be positive to the margin. It's one of the reasons we feel that the NIM could continue to be stable as the year goes on.

**Manus Costello** – *Autonomous Research*

Okay, so it's somewhere between 1.5 and 1.9 is what you're saying.

**Bruce Van Saun** – *The Royal Bank of Scotland Group - FD*

Yes, I'd say that's probably closer to the 1.9.

**Manus Costello** – *Autonomous Research*

And in terms of the mix of that, primary versus secondary liquidity, will that remain broadly as it is?  Or, as you bring it down, will you be bringing down the primary?

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**Bruce Van Saun** – *The Royal Bank of Scotland Group - FD*

Yes, I think there's clearly a desire to keep a lot of that in, at central banks, or in near-cash, so it's highly liquid.  The other wild card out there, Manus, is the Moody's review.  And they're going through all the banks, and I think the UK banks decision will be taken sometime in June at this point.  And so we have to keep our eye on that as well.

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**Manus Costello** – *Autonomous Research*

Does your £65 billion of short-term wholesale funding assume that that downgrade happens, or not?

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**Bruce Van Saun** – *The Royal Bank of Scotland Group - FD*

I think it will probably work out the same either way.

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**Manus Costello** – *Autonomous Research*

Okay.  Thank you.

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**Operator**

Thank you.  Your next question comes from the line of Tom Rayner from Exane.  Please go ahead.

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**Tom Rayner** - *Exane*

Yes, good morning, everybody. Can I have a couple of questions maybe, for Bruce, and then one for Stephen, please? Just on the Non-Core guidance, I think you were indicating last time we spoke that the full-year losses would be around the £3 billion mark in Non-core. And, obviously, you're much below that in Q1, despite a faster run-off. So I wonder if you could just update us on your thoughts on that. And the second one for Bruce is, I don't know if you can comment at this stage about the proposed changes in holding capital against trading exposures, the move from VaR to an expected loss approach, how that might help capital, and whether there's any material cost of moving to that type of system. And then I have a final question for Stephen, please.

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**Bruce Van Saun** – *The Royal Bank of Scotland Group - FD*

Okay. On your first question, I guess, the market and credit markets and credit environment were both favourable in Q1. So I think we probably performed a bit better than we would have expected in Non-Core. There's a lot of moving parts that, in some quarters, you'll have some fair value movements or trading movements that go for you, and others that go against you. So, you know, I'd say that we would, at some point during the year, revert back towards kind of that trend level. Having said that, we have banked some versus anticipated run rate in the first quarter, and that does give us some flexibility later in the year to either capture that if we need it or use it and spend it to get further asset reduction, and so I think we'll just see how that goes as the year goes along. Your second question again? Could you just repeat it briefly, Tom?

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**Tom Rayner** - *Exane*

Yes, just the story that Basel's looking to shift from a VaR approach of allocating capital to trading books toward expected loss. I wondered if you could comment on how that could affect the business, whether there be any cost of implementation.

**Stephen Hester** – *The Royal Bank of Scotland Group - CEO*

Short answer is that we don't know. The announcement came out overnight.

**Tom Rayner** - *Exane*

Yes. Thought it might have been a bit much to ask you to answer that one. Sorry. Finally Stephen, it's a year to worry about things going wrong that you don't expect. I just wondered if you could comment on something that might go right that people weren't expecting. The CRD 4 discussions; it sounds as if the compromise document has qualified majority support, it's heading toward the European Parliament and the UK might not be able to do anything about it and it makes life harder for the UK regulator to be super-equivalent. Maybe extend that even to whether it makes it harder to put a ring fence type of structure in place. I just wondered if you could comment on all of these discussions, and how you see that panning out, and how you think it might affect yourselves and the industry.

**Stephen Hester** – *The Royal Bank of Scotland Group - CEO*

Well, obviously, I wasn't an insider at the discussions the last day, so I don't know any more than I've read in the newspapers about it. My understanding had been that the main things that the Europeans were trying to wriggle out of from Basel was on some of the tough definitions of equity capital, some of the insurance capitalisation rules, and some of the leverage or LCR rules, and none of those are issues for us, so they don't help us if they get wriggled out of, although they obviously would help European banks on one level. In terms of the FSA's ability to be super-equivalent, in my experience, they will find lots of creative ways to be super-equivalent in the detail, even if they can't in the big picture. So I'm afraid I feel jaundiced about that in terms of whether you should project some easier regulatory regime in the UK. I think UK banks will continue to have to be strong husbanders of capital ratios. It's my hope that at some point, the markets also give us a dividend from that, although, obviously, it's not very visible in CDS spreads and so on at the moment.

**Tom Rayner** - *Exane*

Okay.  Thanks very much for your answers.  Thanks.

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**Operator**

Thank you.  Your next question comes from the line of Peter Towman from HSBC.  Please go ahead.

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**Peter Toeman** - *HSBC*

Morning.  I just wanted to ask you about GBM because I see that revenues have held up reasonably well in the quarter, but actually the amount of RWAs reduction from the end of 2011 is only about £5 billion.  I think you were talking about a £70 billion reduction in WRAs.  So, should we still be concerned about the sort of curtailment of inventories, and what that might do for GBM revenues as you continue to push down RWAs by a very significant margin?

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**Stephen Hester** – *The Royal Bank of Scotland Group - CEO*

I think the balance sheet you're seeing is going down nicely.  The RWA decline was really about Basel III coming in and taking that off.  So part of the decline I think we'll see as the year goes on, is the avoidance of increases and part of it we'll see once increases have come in next year and in the year after.  At the same time, going back to my previous comment, the FSA continues to try to put in extra pieces of conservatism and other models around it, which are a continuing headwind below the big Basel figures.  So, we're working hard on this and I think it could be quite a noisy time series up and down, sometimes delivering some unexpected things over the next two years.  My real focus is where are we in two years time, not what is each quarter going to be in the meantime.  But on an underlying basis, the business is absolutely doing at least as well, and maybe better, at this stage in what we expected to be doing in terms of lightening up resources.

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**Peter Toeman** - *HSBC*

Yes, well, you've got to give us a comment on what you expect for two years time, then.

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**Stephen Hester** – *The Royal Bank of Scotland Group - CEO*

Well, we've given our medium-term RWA targets for the business, which I think I described as two to three years time, i.e. 2013, 14, plus or minus. So I don't think we have particular changes to make from that. But with a very big health warning that the regulatory picture and the model interpretations that lie beneath it have significant volatility still in them everywhere.

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**Peter Toeman** - *HSBC*

Yes, I was thinking more in terms of revenues, and whether the sort of £6 billion of annual revenue…

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**Stephen Hester** – *The Royal Bank of Scotland Group - CEO*

Well again, to be honest, our strong attempt will be to manage the business so that it covers its cost of capital in a normal market once the things we've done have worked through. So, to my mind, all of the other variables should be managed to that end, whether that be expenses, revenues or RWA and balance sheet consumption and that's still an industry where quarterly projections, or even annual projections, or revenues in terms of what the market is going to deliver seems to me to be almost futile. But, you'll all have as good an idea as I will and that's what we have to try and do, to produce something equal to cost of capital, and I also happen to believe that the sort of 20/80 split of Retail and Commercial versus more volatile business is a shareholder friendly place to be relative to some other business models out there.

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**Peter Toeman** - *HSBC*

Thank you.

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**Operator**

Thank you. Your next question comes from the line of Rahul Sinha from JP Morgan. Please go ahead.

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**Raul Sinha** - *JP Morgan*

Hi. Good morning. Can I have two questions please? One is just a follow-up on a previous one about the Core loan growth. If I could just clarify what you were saying. It looks like Core loans were down 2% in the quarter. Would you encourage us to expect a slow down from this rate of shrinkage if the economy improves from what looks like a recession in Q1, or do you think that that kind of number should be what we should expect going forward?

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**Stephen Hester** – *The Royal Bank of Scotland Group - CEO*

It will map on lags to the economy. Look you know, a few basis points up or down in the GDP numbers are just statistical noise, so I wouldn't get excited about that. But I think the economy will deleverage until we see growth and when we see growth on a lag basis, then we'll be able to grow some loans. I think an optimistic view would be flattish this year. On the other hand as you can see the deleveraging is now modest or at least we're being helped because some other banks are being forced to deleverage for funding reasons. So that is at the margin, allowing us to pick up market share, as Bruce indicated in mortgages as an example. But not enough, still, to grow the loan book.

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**Bruce Van Saun** – *The Royal Bank of Scotland Group - FD*

I think, also, if you look at UK Corporate, the headline number was down 1%, but underneath that, we're actually still working to contract our commercial real estate exposure. But we are growing the loans away from that modestly. So you still have some of those underlying dynamics, where we're making strategic shifts in how we deploy capital.

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**Raul Sinha** - *JP Morgan*

Okay. My second question is on Citizens. Obviously, a very strong performance in the US on impairments. Would you be able to comment on the performance of the division in the FED stress test? You know, how it did? What were its capital ratios? Because it looks like they're well capitalised. And can I just check if you have been allowed to pay a dividend from Citizens back to the parent?

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**Bruce Van Saun** – *The Royal Bank of Scotland Group - FD*

Yes, Citizens legal entity starts with a very high capital ratio above is peer group and given the risk improvements we've made on the balance sheet, it certainly fared rather well through the stress test. We did apply to reinstate a dividend, and then also to pay back some preferred stock that the group holds, which was approved and so that is factored into our legal entity planning for the year.

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**Rahul Sinha** - *JP Morgan*

Would you be able to quantify the dividend for us? Or is it too early?

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**Bruce Van Saun** – *The Royal Bank of Scotland Group - FD*

It's probably going to be circa £300 million.

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**Rahul Sinha** - *JP Morgan*

Okay. Thanks very much.

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**Operator**

Thank you. Your next question comes from the line of Rohith Chandra-Rajan from Barclays. Please go ahead.

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**Rohith Chandra-Rajan** – *Barclays*

Hi. Thanks. Just very quick question to confirm on Non-Core. The RWA reductions for the rest of the year; do you expect that to be more in line with the remaining asset reduction?

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**Bruce Van Saun** – *The Royal Bank of Scotland Group - FD*

It may be although I would be cautioned, given some of the changes coming on the regulatory front. We have CRE slotting coming in place, and we'll try and be transparent and show you what the plusses and minuses are. So, I would say yes on a kind of underlying reduction, but slight headwind coming in CRE slotting, because a lot of our real estate exposures that we're working down are sitting in Non-Core

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**Rohith Chandra-Rajan** – *Barclays*

Do you expect CRE slotting to be phased over the next couple of years, or all to come in this year? How would you…?

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**Bruce Van Saun** – *The Royal Bank of Scotland Group - FD*

Well, we said that it's £20 billion, and my guess is that we pick up at least 60% of that this year and the remainder probably in the first half of next year.

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**Rohith Chandra-Rajan** – *Barclays*

Okay. Thank you, and then just very briefly on the branch disposals. I was wondering if there is any update on timing of those.

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**Bruce Van Saun** – *The Royal Bank of Scotland Group - FD*

No, I think, it's a very complex project, to actually carve out the whole asset and branch system that we're required to dispose. So first it has to be separated and then that information has to be moved over to Santander and mapped to their product set, so we have over 1,000 people working on this project. I think they probably have a comparable number. We're making steady progress, we have hedged a little bit that the closing is likely later this year or through the first quarter of next year. If I were a betting person, I'd probably say into early next year at this point.

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**Rohith Chandra-Rajan** – *Barclays*

Okay. Thank you very much.

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**Operator**

Thank you. Your next question comes from the line of Michael Helsby from Merrill Lynch. Please go ahead.

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**Michael Helsby** - *Merrill Lynch*

Morning, everyone. Just a question on bad debts. Clearly, US impairments were just ten bps and the UK Retail and Commercial charge was quite a lot lower again. Are they clean numbers, or are there any releases of provisions depressing that? And I was wondering if you could just talk briefly on what you're seeing in terms of forward-looking indicators at the moment.

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**Bruce Van Saun** – *The Royal Bank of Scotland Group - FD*

The UK Retail number is a pretty clean number. We've taken a certain risk posture towards our personal unsecured book and we've improved our collections effort there. So we continue to see more favourable credit trends on that side of the assets in UK Retail and levels like this probably, touch wood, we could see continue. On the US, there was a bit of a release from the general reserve, and so we've had a cautious position in our reserving and we released a little bit of that. But I still think given the trends we see in the US, it's likely to be a very favourable year on credit there as well.

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**Michael Helsby** - *Merrill Lynch*

And just a second question on the markets. I see comp ratio is just 29%, which is, clearly very market-leading. I was wondering if you've got a target comp ratio for that business, given that it's relatively new for us.

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**Stephen Hester** – *The Royal Bank of Scotland Group - CEO*

We have to see how the year goes. Because of the extensive use of deferrals, which are now fully through a three-year cycle, the variability in comp is dramatically less than it once was from an accounting perspective, even though there remains a variability from a gross grant perspective so, I think you will see the ratio being very volatile quarter to quarter, in response to revenue volatility. You know, the industry is still broadly in the 40-50% comp to income ratio, with some banks even worse than that. I think our view is that if we can keep it in the high 30s, that would be terrific, but it's not going to be in the 20s.

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**Michael Helsby** - *Merrill Lynch*

No. Okay. Thanks a lot.

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**Operator**

Your next question comes from the line of Arturo de Frias from Santander. Please go ahead.

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**Arturo de Frias** - *Santander*

Good morning. Two questions, please. Firstly on the US, you've had a couple of questions already on the impairments, but I would ask with the performance of this division, both the return on equity and the cost income, etc., remain quite low, and pretty much unchanged since last year. I would like to know your views in terms, are you happy with the speed of the turnaround? Do you think you need to do more on the cost side? When do you expect some revenue improvement, if it's only interest rates driven? So, in one word, when do you think we're going to see the US generating ROEs that might meet the cost of equity, at least? And then, the second question is on Non-Core. Talking just about losses on disposals, not RWA reductions or losses in the divisions, what is your feeling? What do you see in the marketplace regarding losses on disposals? On the one hand, I see some of the investment banks saying that the environment is really tough. On the other hand, I see other participants saying that the liquidity after the LTRO has improved, and there is more risk appetite. So it's quite confusing, whether it's easier now or not to sell Non-Core assets at a loss, at a small loss. What is your feeling there? Thank you.

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**Bruce Van Saun** – *The Royal Bank of Scotland Group - FD*

I guess, on the US, we have seen steady and consistent progress. So, the business was in loss in 09 and it had a 4% ROE, using a 9% capitalisation of RWAs in 2010. That was up to about seven last year. We have flipped to 10% capitalisation of RWAs, and they put up an 8.5% ROE in the first quarter if you strike out the litigation settlement. So you can just see from that historical time series that the business is improving. And frankly, it's doing that in a less-than-hospitable environment. So we've been mired in a low interest rate environment, sluggish economic recovery, falling asset values in residential and commercial real estate and so I think the management team is doing a good job of just grinding out improvements to the franchise in terms of how we interact with our customers and cross-cell and manage the expense base. So I guess we expect that to continue. We said at the annual results meeting, that they could get to a 9%+ ROE this year on that higher capitalisation. I think they're on track to deliver that, and they're certainly closing the performance gap with peers. We still do have a very asset-sensitive profile on the balance sheet and so when rates start to move higher in the US, I think you will see even better revenue growth, and then we'll have the business where we want it. So I think it's steady as she goes. We have to have patience, given the environment, but we are making progress. On Non-Core, again the LTRO has put a little more liquidity into the environment, and there certainly, I think, low rates combined with more liquidity means there's more people looking to put assets on the books. That's one of the factors that meant we were able to sell some markets assets and had reasonably good bids on those. I think the broader equation is that, through the first three years of the run-down, we've basically incurred what we refer to as friction costs of about three points on the assets that we've disposed of. We've disposed of about £75 billion of assets. We probably have £25 billion to go over the next two years. We did five of that this quarter, so there's probably £20 billion to go. I think if you look at the big picture, what we're now going to sell from here is going to be less liquid asset classes and so we would expect the friction on that to be higher. I think it's really a reflection of what assets you're trying to offer to the marketplace that will determine what your friction costs will be.

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**Arturo de Frias** - *Santander*

Yes. Can I ask a quick follow-up on that? Going forward, do you expect to release capital from Non-Core, i.e. with respect to losing less money than the capital you recover via RWA reductions? Or do you expect it to be probably neutral? What is your feeling?

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**Bruce Van Saun** – *The Royal Bank of Scotland Group - FD*

I think, in forward look, 2012, 13, and 14, we would expect it to be modestly accretive.

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**Arturo de Frias** - *Santander*

Okay. Thank you.

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**Bruce Van Saun** – *The Royal Bank of Scotland Group - FD*

Yes.

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**Operator**

Thank you. Your next question comes from the line of Edward Firth from Macquarie. Please go ahead.

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**Edward Firth** - *Macquarie*

Yes, good morning. Just two questions. First on the GBM restructuring. I wondered if you could just update us on how many risk-weighted assets are still to go from the £70 billion you said. And then, I guess the second question is somewhat related. In the markets division, on the risk-weighted assets, you mentioned that some of that was getting ahead with Basel III implications, and trying to avoid some of the Basel III uplifts. Does that mean that the mitigation figures are already in the numbers, or that's still to come?

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**Stephen Hester** – *The Royal Bank of Scotland Group - CEO*

It's both. I mean, I don't think we have any more guidance. As I say, we're going to try and hit the two- to three-year from now target. There will be all sorts of volatility quarter to quarter in the meantime. At the moment we're indifferent when we're trying to reduce capital consumption as to whether it's currently measured capital or futurely measured capital on Basel III and it's a matter of coincidence what the market's offer as to which one we're reducing, but we're focused on the endpoint in doing it.

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**Edward Firth** - *Macquarie*

Okay and in terms of the GBM restructuring, risk-weighted assets? Are we on that?

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**Stephen Hester** – *The Royal Bank of Scotland Group - CEO*

Sorry, do you mean GBM restructuring?

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**Edward Firth** - *Macquarie*

I mean the, sort of the… yes, the closures, and the bits that you're selling off or closing.

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**Stephen Hester** – *The Royal Bank of Scotland Group - CEO*

Okay.  Not the risk-weighted assets.  We're not, we're not closing and selling anything meaningful in risk-weighted assets, other than the, you know, the closure and sales are to remove loss-making business and expenses.

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**Bruce Van Saun** – *The Royal Bank of Scotland Group - FD*

We've got a little improvement.  The equities, cash equities positions might have been £10 or £15 billion in TPAs.  Not very heavy in terms of risk-weighted content.  But in terms of the restructuring costs, we gave a number for both markets and IBD that we thought we'd run into about £550 million of restructuring costs.  Probably spent maybe two and a quarter of that so far, and it's on schedule.  So the heads are coming out as planned, and we're tracking still to that number, and we're confident that that still remains the number.

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**Edward Firth** - *Macquarie*

The risk-weighted asset implications of those ongoing business and restructurings are going to be reasonably modest.

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**Bruce Van Saun** – *The Royal Bank of Scotland Group - FD*

Reasonably modest.  The real work is going to be on the continuing businesses, and using the balance sheet smarter.

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**Edward Firth** - *Macquarie*

Okay.  Thanks so much.

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**Bruce Van Saun** – *The Royal Bank of Scotland Group - FD*

Sure.

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**Operator**

Thank you. Your next question comes from the line of Chintan Joshi from Nomura. Please go ahead.

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**Chintan Joshi** - *Nomura*

Good morning. Two questions from me, please. Firstly, on the APS, can you update us on that process and how much of these fees can you save? Do you have any visibility on that?

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**Bruce Van Saun** – *The Royal Bank of Scotland Group - FD*

Okay, from an accounting standpoint, we've expensed the £2.5 billion. We won't actually pay it until September/October time frame, at which point we will request that we exit the APS. So it's our intention to exit later this year. That's obviously subject to FSA approval. Were we to stay in the programme, we must pay HMT £500 million per annum. So, exiting the programme, keeps £500 million in our pocket.

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**Chintan Joshi** - *Nomura*

Would you expect to save all of that? Do you have any judgement on whether there might be any mitigating actions that FSA might require out of you?

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**Bruce Van Saun** – *The Royal Bank of Scotland Group - FD*

Well, I think that's a separate question. So, is there anything the FSA would look to with respect to our capital position if we say the APS is no longer required? I think we're just going to have to wait and see. We're going to go through the stress test, as all UK banks are doing now, in the second quarter, and we'll be having a conversation with the FSA and HMT probably in a June/July time frame.

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**Chintan Joshi** - *Nomura*

On the same topic, once you make the requests in October, how soon should we expect to hear back on that from the FSA?

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**Bruce Van Saun** – *The Royal Bank of Scotland Group - FD*

Well, I would hope maybe by the half-year results in August we could say more, but that may be optimistic. We'll have to see how detailed those discussions are.

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**Chintan Joshi** - *Nomura*

Okay, and the second question, just a quick update on the SME swap miss selling issue, if you've seen any more claims or customers complaining, and any more payouts that would cause concern.

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**Stephen Hester** – *The Royal Bank of Scotland Group - CEO*

So far, there have been, over the last three years, 67 cases that went to the ombudsman for RBS, and 66 were ruled in our favour.

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**Chintan Joshi** - *Nomura*

Thank you.

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**Operator**

Thank you.  Your next question comes from the line of Gary Greenwood from Shore Capital. Please go ahead.

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**Gary Greenwood** - *Shore Capital*

Oh, hi, morning, it's Gary at Shore.  I've got three questions, if that's okay.  The first one is just on the NAV of Direct Line, which I think fell from £4.4 billion to £4.1 billion since year end – I was just wondering why.

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**Bruce Van Saun** – *The Royal Bank of Scotland Group - FD*

Allow me to just take that one quickly.

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**Gary Greenwood** - *Shore Capital*

Yes, sure.

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**Bruce Van Saun** – *The Royal Bank of Scotland Group - FD*

They paid a dividend to us as part of the separation plan to get them to the right capital structure; at this point our view is that they hold more capital than they need as a standalone company.  So they paid a divided, they've issued £500 million of debt, we've also requested a dividend which the regulator has approved, and so there will be a second dividend coming in the second quarter. And then, I think, prior to the IPO separation, we'd probably get another dividend.  So we're basically working the capital structure to be in line with peer group and consistent with the single A rating that we've achieved from the rating agencies.

**Gary Greenwood** - *Shore Capital*

So it's just taking that Q2 dividend and the final one into account. Roughly how much would that be?

**Bruce Van Saun** – *The Royal Bank of Scotland Group - FD*

I think the total amount would be about £1 billion across all three by the time we're done.

**Gary Greenwood** - *Shore Capital*

And the amount, sorry, you took in, at the year end, that's since the year end that was how much?

**Bruce Van Saun** – *The Royal Bank of Scotland Group – FD*

It's £200 to £300 million.

**Gary Greenwood** - *Shore Capital*

Okay. Second question was just on the mortgages in Ulster Bank. I think your NPLs there are 12.4%, but you've got quite a big proportion of the book over 90% LTV. I think it's about 60% of the book is over 90% LTV, and about a third is over 130%. So, in terms of those NPLs, I was just trying to understand where they sit within the LTV structure. Do they relate to the high LTV mortgages, or have those not been impaired yet?

**Stephen Hester** – *The Royal Bank of Scotland Group - CEO*

The NPLs are where people are not paying us. That's the definition of it. So it's got nothing to do with loan to value. Now, there's some correlation, but it's frankly a very imperfect one, not just in Ireland, anywhere, people pay their mortgages when they can, and that tends to be when they're employed and they've got money coming in. If they're unemployed and don't have money coming in, they tend to not be able to do it. So, as I say, the loan to value exposure has got much more to do with how much money we lose if we repossess a house than who defaults on their payments.

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**Gary Greenwood** - *Shore Capital*

Okay. Sorry, just, the last question was on the dividend. I think, on the wires, there's a comment from you saying that you'd not be in a position to consider dividends for at least another year. I think Lloyds, on their conference call, were talking about having greater clarity on dividends or the interim results. I was just wondering if you could expand on your comments.

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**Stephen Hester** – *The Royal Bank of Scotland Group - CEO*

Well, what I said was that, from our point of view, we obviously won't consider our job at RBS to be successful until we're finally paying dividends again and making good profits and so on, so forth, although there are many milestones of success before we get there. So we're very focused on that. But, aside from our own ability to A, generate profits, and B, stop spending them on the clean-up, there's a time period involved in that. But over and above that, what I said was my guess, and it's a guess because there's no formal policy, is that the FSA is likely to be cautious in permitting dividends from banks that are not paying dividends, until Basel III is in and until people post Basel III adjustments are above 10% Core Tier 1. You see a similar pattern in the United States. So, they're being cautious about dividends from a regulation perspective. I think there's a regulatory hurdle, which my guess is, doesn't get jumped this year for anyone, but that's a guess. Then, obviously, we have the additional hurdle, which Lloyds doesn't have, of the DAS and, again, in theory, the DAS could get solved any time, but my guess is that minds won't concentrate in HMT and Europe until we get nearer the point when it's relevant, i.e., when we're wanting to pay a dividend.

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**Bruce Van Saun** – *The Royal Bank of Scotland Group - FD*

And there's a last, other technical matter, which is, the dividend stoppers, we have another year to go until we've paid all those preferred securities. So today's step to actually turn back on those preference shares does pave the way for us to be able to do that, but that's kind of a backdrop to the points that Stephen has mentioned.

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**Gary Greenwood** - *Shore Capital*

Okay and, sorry, just the discussions on the, on the DAS. Are they likely to form part of the discussions on the APS as well, or is that, be a separate process?

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**Stephen Hester** – *The Royal Bank of Scotland Group - CEO*

I don't think they're connected.

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**Gary Greenwood** - *Shore Capital*

Okay. Okay, thanks very much.

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**Operator**

Thank you. I would now like to hand the call back to Stephen for any closing comments. Thank you.

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**Stephen Hester** – *The Royal Bank of Scotland Group - CEO*

Very good. Well, thank you again for your time. Obviously, Richard is available, should any of you have follow up questions. We look forward to talking to you again in three months time. I hope we can continue to produce progress. Thanks a lot.