The Royal Bank of Scotland Group

H1 2012 Results

ANALYSTS PRESENTATION

Held at the offices of the Company

280 Bishopsgate London EC2N 4RB

on Friday 3rd August 2012

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 H1 Results announcement published on 3rd August 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, Group Chief Executive of RBS.

Stephen Hester – *RBS Group CEO*

Good morning, everyone. Thank you very much for joining us. With me as usual is Bruce Van Saun, our Finance Director; Richard O'Connor, who you also know, Head of Investor Relations. This morning is a slightly different format to other half years, because we're not doing a physical presentation. I hope all of you have seen our presentation via webcast, which was up at seven o'clock this morning, in addition to our releases. In that context, therefore, we're not going to re-go over that ground and we're really going to spend this morning's session answering any questions that you may have, which of course Richard can do afterwards if we don't get to all of them. So let me simply say by way of introduction that I believe RBS is making good progress, albeit clearly we're doing it in the face of a set of challenging conditions in economic and regulatory terms. We have two jobs as you know. The clean-up job I think continues to go well. We're on course for the five-year timetable we set out, and on every measure we're getting stronger and safer, important in these difficult times, and showing how we can ride through some of the current storms that have been going on in financial markets.

Secondly, we do have a good ongoing bank that we're building and that is poised to respond even better when economic times allow. The vast majority of our ongoing businesses are already making double digit ROEs; they're all capable of doing double digit ROEs better than the cost of capital as well, and I believe that we'll see the upturn once our customers see the upturn. In the meantime we're working hard to make them as strong and as resilient as they can be given the top line pressures there are, and I think that in many key areas, we're ahead of the game in terms of our restructuring activity, most notably the change of proportion of our wholesale activities to the total that we have effected. So with those introductions, let me pass straight over to any questions you may have. Operator, perhaps you can take us through that.

Questions and Answers

Operator

Thank you, Stephen. Ladies and gentlemen, if you would like to ask a question, please press the star key followed by the digit one on your telephone keypad. We'll pause for a moment to give everyone an opportunity to signal for questions. We'll take our first question from Andrew Coombs, from Citigroup. Please go ahead.

Andrew Coombs – *Citigroup*

Morning. I have three questions, please: one on the charges you've taken, the technology issues and hedges; one on APS and the B shares; and then finally on provisions. If I start with the first one, it's interesting you've taken the 125 million charge for the June technology issues and the 50 million charge on the interest rate hedge products above the line; whereas you've taken the PPI charge below the line. Is there anything we should read into that in terms of you think the first two potentially are ongoing or recurring costs; whereas the latter is seen to be a non-recurring cost?

Bruce Van Saun – *RBS Group Finance Director*

On the tech incident, that's an operating pitfall of businesses that we operate in. We made a conscious decision not to push those back to the affected businesses, because, in effect, those businesses secure the technology services from our centralised technology group, so we thought it was appropriate to show those in the core performance, but not attribute those back so that you're able to see the underlying trends in the affected businesses.

On the interest rate mis-selling, that's a little bit of a finer call. I think at this point we left it in core and we could reassess that down the road, but PPI to us was something that was really relating to prior periods and so therefore it's exceptional in nature, in size, and time period, and we felt it was appropriate to leave that one in exceptionals.

Andrew Coombs – *Citigroup*

Thanks. And just to move on to the second question, I noticed that you've been more firm in your firm in your dialogue regarding APS. You talk about more of an announcement once you've got formal regulatory clearance, but then you're talking it seems very certain we're going to hear that in the second half. On that front, perhaps you could also update us on the B share, and any renegotiations there are on that front, or do they continue to be viewed as completely separate to the APS exit?

Bruce Van Saun - *RBS Group Finance Director*

Well, I think our focus has been on APS exit for the moment. I think the DAS repurchase and B share simplification is something that's more for down the road, as in over the next 18 months we're very focused on sustaining our capital ratios through the whole period of RWA inflation with CRD4 and some of the local regulator initiatives, and so a dividend is farther out in the future, and since the DAS is related to the dividend, I think that can wait for another day.

Andrew Coombs – *Citigroup*

Okay. The final question was on provisions, and I just wanted to highlight the non-core provisions. You talk about a large one-off provision there in portfolio finance. How big is that one-off provision as a function of the 607 million non-core provisions you've taken during the quarter?

Bruce Van Saun - *RBS Group Finance Director*

It's about 125 million, so it related to an asset in the project finance portfolio, and it was something that we thought could go some time this year, and it happened that we assessed it to take the impairment in Q2.

Andrew Coombs – *Citigroup*

Thank you very much.

Bruce Van Saun – *RBS Group Finance Director*

Sure.

Operator

Thank you. Your next question comes from Chira Barua, from Sanford Bernstein. Please go ahead.

Chira Barua – *Sanford Bernstein*

Morning, guys. Quick three questions. One on non-core: great progress there. What do we see as the block at the end of 2013? Round it, it will be great if you can give us some colour and round the credit risk and market risk that'll remain out there. The second one is on technology. Are you foreseeing increasing spend in technology, given the outage going forward? And third is on the Dutch entity. Are there any implications for capital tax charges and funding if that collapses? Thank you.

Stephen Hester – *RBS Group CEO*

Let me take the first one; Bruce the second two. I think at the end of 2013 we've given our balance sheet target for non-core, ie we think it'll be at the point where it is, you know, close to irrelevant in balance sheet and funding balance terms, and therefore that the priority for reduction falls. I don't think we will have substantive market risk left at that stage. Obviously we will have credit risk in the rump of assets that are there. We give very high disclosure on what's in there, and clearly the stickiest bit will be real estate, especially Irish real estate positions. I hope they will be substantially provided by that stage, although obviously we have to see. So I expect non-core will make losses beyond 2013, but they should fall sharply. We shouldn't be needing to take big disposal losses post that point, and the rest should be left to run off over whatever period is relevant.

Bruce Van Saun – *RBS Group Finance Director*

On your second question about tech spend, I should be clear that over the first three and a half years of the recovery plan, we've increased the tech spend quite dramatically, and so we're doing lots of things to both address the infrastructure system and resilience, as well as the new products in terms of how you communicate with the bank and mobile apps, and things like that. This tech incident was a very specific matter in upgrading a piece of software that runs batch running overnight. We are going through a full investigative review to get to root cause, and then look at our response, and look at what we need to do to make sure that doesn't happen again. I do think that the preliminary findings there are that it will not cost a meaningful amount of money to actually make this right and make this more resilient going forward. So we have to do some things to simplify the batches and to tighten our processes and procedures a bit, but in terms of having a meaningful impact on future spend, I don't think you'll see it.

Your last question was on the Dutch entity, and I think again here we've been doing this in waves. We've moved over a big slug of assets last year in the Fall. This is the last big slug to move across. We had it all teed up for July, but that was right in the midst of the tech incident, and we wanted to keep our focus on that first. We pushed it back out to the September 10th, that week-end. All systems are go and we think that'll go off without incident and then we'll really have fairly much of a rump left in that NV entity that will just run down over time.

Chira Barua – *Sanford Bernstein*

Thank you.

Bruce Van Saun - *RBS Group Finance Director*

Okay. Next question, please.

Operator

Thank you. Your next question comes Jason Napier, from Deutsche Bank. Please ask your question.

Jason Napier – *Deutsche Bank*

Good morning. Three fairly straightforward ones, I think. Just in terms of the wealth division in core. There's reference made to a gain on disposal, as well as redressed cost on the ALICO Enhanced Variable Rate Fund. Would you be able to give us sort of a sense of what the net impact of what those is, if you could?

Bruce Van Saun – *RBS Group Finance Director*

For the quarter, those are about a wash, so we had a kind of mid-teen positive impact from the gain on disposal, and the same as the terms of the redress on the regulatory matter.

Jason Napier – *Deutsche bank*

Okay. And from a principal perspective, the reason those don't go in strategic disposal gains below the line is because it wasn't in non-core, or…?

Bruce Van Saun – *RBS Group Finance Director*

It wasn't a separate business. It wasn't a discrete business that we would carve out and sell. It was simply the client relationship, so it was actually a booker business.

Jason Napier – *Deutsche Bank*

Got it. Okay, thank you. Secondly, the AFS disclosure seems to suggest a sort of a better quarter for realisations there. Maybe 150 million more than last quarter. I was just wondering whether you'd sort of think there was anything unusual in sort of run rate of realisations there; whether, you know, that's a repeatable kind of contribution?

Bruce Van Saun – *RBS Group Finance Director*

Actually that's not accurate, Jason. I could see why you could draw that supposition. But there was actually a few things going on in central items, probably the biggest of which was a swing in IFRS volatility, so there's a risk management P&L in Treasury that bounces around based on it's effectively a hedge portfolio. We don't want to burden the businesses with that, so we keep it in central items, and it had flipped from a negative last quarter to a positive this quarter, and that flip was quite significant: over 150 million. So the actual incremental swing in the AFS gains from quarter to quarter was, I'd say, circa 50 million. It wasn't that big.

Jason Napier – *Deutsche Bank*

Okay. So the Note 14 sort of 160 million is something else going on elsewhere that brings it down to about 50. Is that right?

Bruce Van Saun – *RBS Group Finance Director*

Yes. I think the Visa gain is probably in there as well, so that was reported in the US results.

Jason Napier – *Deutsche Bank*

Got it. Okay, then lastly, potentially a question for Stephen. The commentary around the funding for Lending Scheme is extremely clear and the sentiments around passing on the funding going to customers is one that we've heard from Barclays Retail already. I just wonder whether you'd sort of confirm the lending will, you know, obviously be profitable from a shareholder ROE perspective, and also you know how it is you think about passing this on. Is this a cost-plus kind of thought process? It's generally not the way that we sort of understand product pricing to work. I'm just interested in how you've thought about the waiving of fees on SME and the like. Thank you.

Stephen Hester - *RBS Group CEO*

Yes. Well, all of our ROE disciplines in our affected business divisions are intact. So, in other words, the instructions of our management is to target ROEs better than the cost of capital in the things that they do, but simply what I did was to say that to the extent that funding cost fell as a result of this government scheme, that we shouldn't treat that as a windfall profit, but that we should use that to pass it on to customers, so that's all that's going on now. You know obviously every individual pricing decision has got all sorts of different dynamics in it, in front book, and back book, impacts, and so on, but the business targets are unchanged, but there is… you know I think it would be inappropriate and undesirable to take any windfall gains from this and it's our job to pass it on to customers.

Jason Napier – *Deutsch Bank*

Very clear. Thank you.

Operator

Thank you. Your next question comes from Rohith Chandra Rajan, from Barclays. Please go ahead.

Rohith Chandra Rajan – *Barclays*

Morning. Thank you. A couple on capital, please. Firstly, on Basel III. Just wondering if you could give us a bit more clarity around the 9.0-9.5% fully-loaded 2013 ratio, if you could just reiterate your capital and RWA adjustments, and then also just describe what you're thinking in terms of the underlying balance sheet and earnings through to 2013 that drives that 9.0-9.5% ratio.

Bruce Van Saun – *RBS Group Finance Director*

Okay. So effectively we've given you most of the numbers previously in terms of the RWA uplift that come from the CRD4, and then also from some of the FSA local initiatives, like CRE slotting, so we continue to track towards those numbers, and as I said, our objective is to manage above 10% at year ends on a transitional basis, both at the end of 2012 and then at the end of 2013. That 9 to 9.5, the fully-loaded deducts would principally relate to three things. So DTAs is one; the EL in excess of provisions is the other; and then some for Direct Line Group. And so I think at this point you have to recall we're in transition, so we're a recovering bank, we're running down non-core. There's a bunch of moving parts here as we project outwards. We're using our own balance sheets projections; we're using consensus earnings; and then we're giving you the uplift that we have for RWAs. So I think all the bread crumbs are there for you to do the maths. You can call Richard later in the day and he can walk you through that.

Rohith Chandra Rajan – *Barclays*

Okay. Thanks. Just wondered why is there a direct line deduction still at the end of 2013?

Bruce Van Saun – *RBS Group Finance Director*

Well, we still have an inflation to RWAs related to the piece that we hold, so I guess it would be more of an RWA impact than a deduct impact. You're right.

Rohith Chandra Rajan – *Barclays*

Okay, thank you. And then secondly, just on non-core. The 7 to 12 billion asset reductions for the second half, I'm just wondering about the risk weighting in there, the capital impact of that. So risk weighting on the book overall's about 100%, looks like the reduction in the first half if you exclude the operational risk RWA inflation was mid-60s. So in terms of what you got targeted for the second half of the year, I was wondering what the average risk weighting which you think about would be. And then also total non-core, again excluding the operational risk looks pretty much capital neutral in the first half, and again, so just wondering if that was something we should extrapolate for the full year.

Bruce Van Saun

Well, in Q2 aviation capital was a big driver in terms of the types of assets that went out. I think adjusting for that I'd say closer to one-to-one would probably be the risk weights that go out over the rest of the year. Your second question was on ops risk?

Rohith Chandra Rajan – *Barclays*

No, no, sorry. The second question was just in terms of overall capital impact, so first half looked pretty much capital neutral if you look at the RWA reduction and the losses in non-core; whether that would also be the expectation for the end of the year.

Bruce Van Saun - *RBS Group Finance Director*

No, I think that's safe. When we look out over a longer period of time, it's neutral to slightly accretive. That's still our call on it.

Stephen Hester *RBS Group CEO*

We're still working through regulatory increases in risk weighting which are broadly offsetting the asset reduction, at least this year and the beginning of next year.

Bruce Van Saun – *RBS Group CEO*

Yes, so there are some headwinds in terms of you won't be able to do the quick math, we'll probably have to clarify that for you, but there's things like CRE slotting that are going to affect the non-core RWAs, so there'll be a little bit of gapping there relative to what the underlying trend is.

Rohith Chandra Rajan – *Barclays*

Okay, that's great. Thanks very much for that.

Bruce Van Saun – *RBS Group Finance Director*

Yes.

Operator

Your next question comes from Chintan Joshi, from Nomura. Please go ahead.

Chintan Joshi – *Nomura*

Good morning. Three questions from me, please, and the first one is in your prepared comments you mentioned growth in the UK R&C divisions. How has the pace of growth for aggregate UK lending as the BOE sees it been over the past six to 12 months? Do you believe you can grow aggregate lending in the next 18 months, including non-core deleveraging?

Stephen *Hester* – *RBS Group CEO*

Well, I think that it is safest to assume that lending doesn't expand until economic growth takes place. That would be the pattern of past recessions, speaking of the industry as a whole, and of course any bank with a non-core will then see if core lending isn't expanding there will then be a reduction in respect of those non-core assets. Now obviously if we are able to take market share, then that would be an offset, in mortgages in the UK we have been able to take market share; that's why our mortgage book has been rising. In corporates we haven't taken much market share, which is why the corporate has been stable to slightly down in terms of drawn lending, even though gross lending has been quite active. So you know I think that the... since you're probably working through to net interest income trends, we've made some comments on NIM, but in terms of, if you like interest-earning balances, I don't think that we should assume favourable trends yet awhile.

Bruce Van Saun – *RBS Group Finance Director*

I would say to Stephen's point, in terms of once you see some recovery, I think that a number like 4% to 5% loan growth is something that we could see, but of course the path from here to then and how quickly that materialises is a hard call at this point.

Chintan Joshi – *Nomura*

Is that 4 to 5 in core?

Bruce Van Saun - *RBS Group Finance Director*

Yes.

Chintan Joshi – *Nomura*

In recovery, yes. Just following on from that. I mean the Bank of England clearly wants to see growth of lending in the UK over the next 18 months. Growth isn't likely to be recovering substantially over the next 18 months. I mean do you think you would face pressure from the regulator if net lending in the UK didn't expand because two big banks are reducing lending in non-core?

Stephen Hester – *RBS Group CEO*

I think that the regulator is in fact is insistent that the two banks in question do reduce their non-core for risk reasons, and because of course amount of that non-core is commercial real estate which the regulator wants to have reduced and is putting regulatory penalties on holding through slotting, so I don't think there's any dissonance with the regulators in terms of non-core. I mean the authorities want the economy to grow and want lending to be available if it is needed for that. I think that the Bank of England understands that in recessions lots of companies and individuals are trying to manage their balance sheet downwards. So what they're mostly focused on is that if lending doesn't grow it should be because there isn't creditworthy demand, not because there are supply constraints, and also they're now trying to discover whether there is any price elasticity and the funding for lending is all about whether there's price elasticity at low interest rates or not, and of course we'll see that.

Chintan Joshi – *Nomura*

Thank you. My second question was on Citizens. You've obviously seen the New York Post article. I'm wondering how core is Citizens?

Stephen Hester – *RBS Group CEO*

Citizens is core. It was loss-making three years ago, and every single year that we've been managing it we've improved its performance, so it is much more valuable to our shareholders today than it was three years ago, and I expect it to be more valuable again in three years from now. Now obviously we're a shareholder-owned company. We will always try to behave in the interests of shareholders on any of our businesses, but our view is that the most valuable thing we can do for shareholders is to keep the trajectory of Citizens moving upwards as a core part of the group.

Bruce Van Saun - *RBS Group Finance Director*

And I should just add it is a very valuable franchise, so it's not surprising if people think that it is so. But as Stephen said, we're continuing to improve it, and it fits well inside our portfolio.

Chintan Joshi – *Nomura*

So if the article indicates that you're looking for 14 to 16 billion…?

Stephen Hester – *RBS Group CEO*

The article is inaccurate. We have not received an offer, and we haven't put a price on it.

Bruce Van Saun – *RBS Group Finance Director*

And no discussions.

Stephen Hester – *RBS Group CEO*

You don't have to look very far to see the sorts of prices that banks are getting in disposal today. We don't think that would be optimising to sell any banking asset other than our non-core ones in the current environment, and we think we can improve Citizens' performance further.

Chintan Joshi – *Nomura*

Thanks. And third and last question, a very quick one. Where do you see the Basel III CT1 fully loaded today?

Bruce Van Saun – *RBS Group Finance Director*

Yes, I guess that's ex APS, did you say?

Chintan Joshi – *Nomura*

Yes, ex APS.

Bruce Van Saun – *RBS Group Finance Director*

Yes. Look, that's not a number that we published, because again as I said in response to an earlier question, we're in transition and so we're targeted to where the future numbers are that we're going to have to print down the road when it really matters. If you look at where we are today, I think we're roughly in a pack with the UK peers, so it would be mid-sevens, but again that's not a number that we're very much focused on or concerned about.

Stephen Hester – *RBS Group CEO*

Obviously not least we've got Direct Line which is about to be sold, which is one of the type of calculations in this thing, and indeed our Santander branches etc.

Bruce Van Saun – *RBS Group Finance Director*

And non-core is not run down to where the point it'll matter, so there's a bunch that I think, you know, show a clear path to the range that we indicated of 9.0 to 9.5 by the end of '13.

Chintan Joshi – *Nomura*

So that mid-seven number is ex APS?

Bruce Van Saun – *RBS Group Finance Director*

Yes, it is.

Chintan *Joshi* –

Okay. Thank you very much.

Bruce Van Saun – *RBS Group Finance Director*

Yes.

Operator

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

Raul Sinha – *JP Morgan*

Hi. Good morning, gentlemen. Bruce, in the prepared comments and on the Libor issue, I think you mentioned that there are some meaningful security schemes positioned available to the group to offset any negative capital impact. I mean could you elaborate on that statement and maybe give us some idea of where these schemes are coming from?

Bruce Van Saun

Well, sure. In our liquidity buffer, we have various holdings that we have in cash in central banks. We have a bond portfolio. We have other eligible collateral that's posted at the discount window. So that number's GBP155 billion. Within the government bond element of that, we have in fact tried to stay very high quality. So we have a big portfolio of treasuries, gilts and bunds that, as the world has seemed riskier, those assets have become safe havens and have rallied in price. So we have, I think, a meaningful gain that has increased over the half-year, and so all we're pointing out is, again, mission-critical over the next 18 months is to absorb these regulatory impacts on capital and continue to deliver according to our operating plan. If things hit us that weren't expected, we have some balance sheet actions, including realizing securities gains that could generate core Tier 1 capital and provide some offset. So that's there.

Raul Sinha - *JPMorgan*

Okay. Obviously, it doesn't look like you want to quantify it for us right now, but if I put the question differently, the Bank of England has said... or the regulators are quite happy for banks to run down their liquidity buffers. Would this be something that you might consider doing more immediately in the next few quarters if you don't think that you require the liquidity buffer to be as high?

Bruce Van Saun

I do think there's potential to take down the liquidity buffer, but it would be across the different elements. The things that we hold, the cash at central banks and the government bond holdings are things that we could adjust down in response to the FSA and the FPC saying that banks have built buffers upon buffers and probably have more liquidity than is appropriate on the balance sheet, and we can work that down.

So we'll be doing that with an eye though towards still some of the challenges in the environment, the Eurozone situation. I think we'll be reasonably cautious in terms of the pace.

Raul Sinha - *JPMorgan*

Okay. Well, that leads me to my next question on the margin. Obviously, you're indicating the R&C is likely to be up slightly in the second half. But then when we look at the quarter-on-quarter progression in the R&C margin, it looks like Q2 is...

Bruce Van Saun

Well, I think that's really a Group NIM statement, so the juxtapositioning may not be the best, but I think we're satisfied with how we've been managing the overall NIM. I think the retail NIM is likely to be stable, and I think we can improve the NIM a bit from here, largely around some of these liquidity and funding initiatives that we have centrally.

So we've been driving off some higher cost funding as we reduce liquidity, and I think there's more of that to come in the second half which can certainly solidify and grow slightly the Group NIM.

Raul Sinha*, JPMorgan*

Okay. And just lastly, a quick follow-up on the NIM again. The interest rate hedge impact that you indicated as being on the UK retail margin, what should we expect that in the second half or going forward?

Bruce Van Saun

I guess it continues to tractor through. We have a five-year hedge in place, and so every month, we drop something and we pick up something new. So it's a gradual impact which is probably going to be similar to what we saw in the first half.

And I think the challenge for the business is to look at how they're pricing deposits. We've got this surplus of liquidity; we can drive off some of the higher cost deposits potentially, and also look for asset pricing opportunities to offset some of that headwind.

Raul Sinha - *JPMorgan*

Thanks very much.

Operator

Thank you. Your next question comes from Ian Gordon from Investec. Please go ahead.

Ian Gordon, Investec

Actually, apologies, mine have already been done. Thanks.

Operator

Thank you. Your next question comes from Manus Costello from Autonomous. Please go ahead.

Manus Costello - *Autonomous*

Morning everyone. A couple of questions on your capital structure please. You're confident of leaving the APS in the second half of this year, but the quid pro quo for that is likely to be some kind of change in the trigger point for your outstanding CoCos. So I wondered if we should be modelling for any kind of charge for that, because the way you booked the original CoCo line was against equity. I wondered if we should be putting anything in for the second half, or any change of trigger in Q3 or Q4.

Bruce Van Saun

Manus, on that point, that's been speculated in the press but we have nothing to comment on there, and so there's no guidance in terms of modelling any change at this point.

Manus Costello - *Autonomous*

So your 9.0-9.5% for example of Basel 3 in 2013 would not include any impact of change?

Bruce Van Saun

That is correct.

Manus Costello - *Autonomous*

And my second question was coming back to something you discussed at the very beginning of the call about the timing of dividends. I noticed that the Treasury recently changed its assumption on when you would start paying a dividend from 2013 to 2015, and you were talking about putting off discussion of attacking the dividend access share to another day. When you talk about another day, is the 2015 timeline something that you would recognize, or do you think you could do a bit better than that?

Stephen Hester

There's been no Board discussion about this. I think the observation I've made is that I would expect the FSA to take a dim view of dividends unless it feels that the capital position is ahead of where Vickers needs it to be, i.e., the 10% sort of thing with CRD4 brought in. And so I think we have to look at the situation at the end of 2013, understand whether we've hit our targets and what the margins are, and then decide how quickly to bring back a dividend in the light of that.

Bruce Van Saun

Yes. And so again, I think the different analysts have it modelled as '14 or '15. If that is the kind of realm of possibility, then a conversation around DAS and B Shares could kick off some time in the back half of next year, I would think. But again, we have no direct timeline or anything agreed with UKFI in terms of that.

Manus Costello - *Autonomous*

Right, thank you.

Operator

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

Michael Helsby - *Merrill Lynch*

Morning gentlemen. I've just got three questions. On Insurance, the revenue trend is clearly still down, and revenues were down q on q. When do we reach the bottom of that trend given obviously all the restructuring that you've been doing in repositioning the book?

Second... do you want to do them one at a time?

Bruce Van Saun

It's easier for me to remember them if we do them one at a time.

Yes, I think one of the highlights for the Insurance group this quarter was that in-force policies across the different lines of business were actually up 2%, and the motor policies stabilized in the quarter.

So that's precursor for, I think, seeing the revenues, top line revenues bottom out and eventually grow. So if you go back and think about the turnaround, we had taken on risky driver pools that we wanted to drive out, we had taken on some broker business that we didn't want to sustain.

And so the effort was around refocusing on the customers that we think were the good relationships for the longer term; and also meanwhile, getting our act in order, our house in order in terms of the basics of the business pricing, underwriting, claims management, the expense base, which once we got those things properly addressed, we'd be in better position to go out and compete on the front foot for business.

And so we're through, largely through that. We're now seeing that in-force policies are stabilizing, and the objective would be to start that growing again from here.

Michael Helsby - *Merrill Lynch*

Great, thank you. Second question, apologies if this is in the document, but you referred to regulatory increases in the RWAs, but I can't find any reference to the sterling amount that's come in in the half. Is that in the document, or if it's not, could you give us an idea of what it is?

Bruce Van Saun

Yes, I think we've absorbed about GBP15 billion, so we had said that GBP50 billion to GBP65 billion was going to be the CRD4 in credit model impact, and so we put away about GBP15 billion.

So we're running hard in terms of deleveraging and asset reduction, and some of this we have to absorb, CRE slotting and some other model changes which we're taking on board.

Michael Helsby - *Merrill Lynch*

What division's that in, Bruce? Is that in Commercial or Non-Core or...?

Bruce Van Saun

It's mixed around a bit, so there's some in MIB, there's some in Non-Core, and there will be a little bit in UK Corporate as well.

Michael Helsby - *Merrill Lynch*

Okay, thank you. And finally, just more of a broader question really. Clearly, from the outside, there looks to be a hell of a lot of political pressure on Royal Bank of Scotland, and a lot of the international investors that I speak to think that as a result, you're just pretty much un-investable. What can you say to talk to about how you ensure that you've got independence as a board from the Government?

Stephen Hester

Well, I guess here's how I would see it. It remains the case, three and a half years on, that not a single significant strategic or operational decision that we have made, or not made, has been driven externally by political influences. We've been managing the Company for all its shareholders in the best way we know how. And therefore, all I know is what's happened so far and I have no reason to believe that will change. But of course, there are risks in the future, but that's the position so far.

The second thing that I'd say is we all have to recognise that the banking industry is quite politicised everywhere in the world today as a result of its role in the financial crisis, and the tensions, the political tensions arising from the financial crisis, and so banks equals politics, whether that's in Spain, or Germany, or here, or America, or Ireland or you pick it. And in that sense, there are political risks and calculations that have to be made for the banking industry and the regulations that affect it and the other pressures that can be on it, and we've seen that in the UK away from RBS rather recently.

So I do think that bank investors are right to worry about politics, but it's not clear to me that RBS is particularly distinguished in that regard. But, clearly the best way we can insulate ourselves from this is to do our jobs well. I think if we fall down on the job, we invite more interference from whatever quarters. If we do our jobs well, we'll be left to get on with doing it.

Michael Helsby - *Merrill Lynch*

Yes. Well, you're certainly doing that. Good luck.

Operator

Thank you. Your next question comes from Mike Trippitt from Oriel Securities. Please go ahead.

Mike Trippitt - *Oriel Securities*

Good morning. A couple of quick questions on Non-Core, short term first of all, just on the sequential quarterly move in impairments. I wondered if you could just put a bit of colour on the spike up in international banking and although a smaller number, the US Retail and Commercial impairments have doubled q on q?

And then just tied in with that, your revised guidance on the run-off of the Non-Core this year and then going into next year, should we continue to assume that that will be capital neutral going forward, or would you see accelerated losses or impairment charges with that accelerated run off?

Bruce Van Saun

Well, first of all on impairments, we did point out that there was a large project finance write-off that was in the second quarter, and that was about GBP125 million. That principally accounts for the spike.

Given that there's a lot of tall trees in Non-Core, I don't think you should expect to see discrete trends quarter to quarter, those numbers can bounce around a bit from quarter to quarter.

You have to really look at the trends over time, and you can see that impairments have come down dramatically and consistently through time, and we would expect that trend to continue. The book is getting smaller, and most of the really poor assets, such as the Irish Development Land and different assets we've impaired pretty heavily and reserved against pretty heavily.

Mike Trippitt - *Oriel Securities*

That project finance one-off is it in international banking, is it?

Bruce Van Saun

Yes, that's correct.

Mike Trippitt - *Oriel Securities*

Okay, thanks.

Bruce Van Saun

And the US is not... I don't think there's anything worth commenting on there. I think that's just noise from quarter to quarter.

The second question was on run off and in terms of capital accretion or not, and I think again, we do see through the next 18 months/two years that this should be neutral to accretive on an underlying basis. However, there's a few headwinds of the CRE slotting that will maybe not make that as apparent, so we'll try to break that out so that you can see that.

But again, as Stephen indicated, I think there's probably another year of hard work to get from low 60s down to 40%. We'll probably have higher disposal losses next year and lower impairments, and the overall loss should come down a bit. But it won't meaningfully drop until '14/'15, in which case, I think at that point, it steps down pretty significantly.

Mike Trippitt - *Oriel Securities*

Thanks very much.

Operator

Thank you. Your next question comes from Tom Rayner from BNP Paribas. Please go ahead.

Tom Rayner - *BNP Paribas*

Good morning, chaps. Can I just go back, Bruce, to the margin guidance? Because I think I maybe wrongly assumed that it was referring to Retail and Commercial rather than Group. And would you be able to give the same guidance if it was on just Retail and Commercial? And if so, can you say anything additional about Retail versus Corporate? Because there seems to be a bit of diverging trends within the margin progression within those two key divisions.

Bruce Van Saun

Yes. I would call it broadly stable in Retail/Commercial. Maybe slightly up would also apply. So it's somewhere between stable to slightly up there as well. I think we've now seen Retail has been under some pressure. UK Corporate has held its own. And I think at the margin, that's about right.

There's a few things in the first half that are non-repeating items in UK Corporate in the second half. So I think UK Corporate, you could see a little bit of erosion there in the second half.

Tom Rayner - *BNP Paribas*

Okay. And in Retail, deposit pressure you mentioned, and also the hedge. Can you give us a sense of what's the key driver? Because obviously, you're trying to re-price the assets as well in Retail, I guess. Is it the hedge that's really making life more difficult for you?

Bruce Van Saun

Yes, that's one thing, but the second thing is just a mix shift. So if you look over time, we've been trying to get a bigger market share in mortgages, and we've been running down our book in personal unsecured, and so I think that's also had a pretty big impact overall. So we've changed our risk appetite. We're doing more mortgage lending, and doing less on the personal side.

Tom Rayner - *BNP Paribas*

And that's coming through the impairment line as well, I guess?

Bruce Van Saun

Yes. You're seeing continued positive moves on impairments and credit loss there.

Tom Rayner - *BNP Paribas*

Okay. Thanks a lot.

Operator

Thank you. Your next question comes from Peter Toeman from HSBC. Please go ahead.

Peter Toeman - *HSBC*

Morning. Two questions. First of all, looking at the market's performance, at the beginning of the year, you talked about GBP70 billion reduction of WRAs in markets. Actually, over the last six months, we're down about GBP13 billion. So am I right in thinking that you're still budgeting for a reduction in markets' WRAs from a reduction in inventory, and therefore the numbers we're looking at here are still not in a status quo, they're still... revenue numbers could still be subject to declines in trading volumes as the size of trading books are reduced?

And then a second question on your comments about discussions on the DAS and B shares taking place at the end of 2013. That puts you at the end of your five-year timescale. So I wonder, will you still be around to navigate RBS back to the private sector?

Bruce Van Saun

Interesting question. So on the first one, which I can give a more definitive answer to, in markets there's a couple of things that work here. So there's advance mitigation taking place of uplifts. There is also I think a restricted posture in terms of the market risk we want to be taking in these markets. And so you're probably seeing these benefit somewhat from that, and some of that would not be sustainable if the markets pick up. If you have a view that the second-half markets aren't going to be great, then maybe that does sustain through the second half of the year.

Obviously, what's coming is that CRD4 uplift, and then various other model adjustments work through with the FSA, and so those are the headwinds.

But I think we're on top of the game there. All things considered, when you look at the exiting of certain businesses, the adjustments to other businesses, using less balance sheet, using less RWAs, to manage through all of that and still put up 14% ROE in the first half in markets and have a performance in line with peers, I think we're pretty pleased with how that's going.

Second question on the DAS and the B shares. Look, I think in terms of the safety and soundness agenda, we will have checked all the boxes by the end of 2013 that we had in the original plan; so Non-Core getting down to GBP40 billion, tick; strong capital ratio; 100% loan to deposit ratio; much improved position of liquidity relative to short-term wholesale funding.

I think we'll be able to say, job complete, where because of the economy, the core businesses may not be at the level of returns that we had hoped for originally, and so that timeframe may be elongated. I'm not sure that, ultimately, our shareholders would view that as a blemish given the ultimate backdrop that we're facing, but we'll just see. We'll see if we're still here in 2014.

Peter Toeman - *HSBC*

Thanks.

Operator

Edward Firth, Macquarie.

Edward Firth - *Macquarie*

Yes, good morning. Just one question. On page 185 of your accounts, you give some excellent disclosure on Commercial Real Estate, and I guess my question is about the defaulted portfolio outside Ulster, which seems to have had this massive increase in average loan to value; from the year end it's gone from 129% to 189%. Could you tell us roughly what's driving that, and what the implications are in terms of provisioning going forward?

Bruce Van Saun

Let me get caught up to you. Page...?

Edward Firth - *Macquarie*

Page 185. You break out the elements that are defaulted and non-defaulted and what the average loan to value are, and you highlight for the rest of the Group there's about GBP12 billion of, I guess you call it, defaulted or nearly defaulted exposure. And it now has an average loan to value of 189%, and at the year-end it was 129%.

Bruce Van Saun

Yes.

Edward Firth - *Macquarie*

It seems to be a huge swing.

Bruce Van Saun

Yes, I guess I'll have to get back to you, or Richard will have to come back to you. I don't want to give you an answer of the top of my head.

Richard O'Connor

There's an explanation on page 186 on the first key points, down the bottom. It's one corporate client substantially provided for. So it's one case distorting the number.

Edward Firth - *Macquarie*

But it looks to me... let's talk about it later, but it looks to me like there's about GBP3 billion of exposure that has swung, which would seem to me a huge exposure.

Richard O'Connor

I'll come back to you on that. Clearly, we can't comment on one case any more than that, but I'll come back to you.

Edward Firth - *Macquarie*

Okay. Thanks, Richard.

Operator

Thank you. Your final question comes from Arturo de Frias from Santander. Please go ahead.

Arturo de Frias - *Santander*

Two quick ones, please, one on Retail ROE trends. You have already said relatively clearly that the NIM in retail should be a bit more stable in the second half after having fallen for a few quarters. But the ROE trend, which is what I'm interested in, has been quite decent, mainly due to lower, substantially lower impairment losses.

I guess my question is if and when we see the Retail NIM stabilising, will that or should that increase the Retail ROE, or do you expect some deterioration on impairments to offset that and we will have a stable or stable-ish ROE in retail?

And the second question is also on ROEs about the markets. We all know that this division is highly volatile, and we all know it's very seasonal, and usually Q1 is very strong and then the following quarters are weaker. But I have been a bit surprised to see the substantial decrease in profitability in Q1, or in Q2 versus Q1. And my question would be do you think this is only seasonal, or do you have the impression that because of the downsizing, the underlying ROE potential of this division is falling?

So, yes, that's the question. Thank you.

Bruce Van Saun

Okay. Look, on the first one I think the ROEs have been in a 22% to 24% band for UK Retail, and I think the outlook, as long as the economy is in the situation that it's in and we don't see any more vigorous recovery, I think it can land and stay in that territory. So we may see the NIM stabilising.

I think the continued trend of improvements in impairments loses steam at some point, it's not going to go to zero, but I do think it will stay reasonably consistent until we see the return of more economic vibrancy.

In terms of the market ROE, you're right. The 14% number for the half had a very strong, over 20% Q1 and then a 7% Q2. Having said that, that's certainly in line with peer groups, and so I don't think there's anything from the division’s down-sizing that's actually affecting our numbers out of proportion to anyone else.

I think what we've seen in the past couple of years is a very strong first quarter, a pretty strong second quarter, and then the third and fourth quarters could be even softer than the second quarter. I think last year, that was particularly exacerbated by spread widening, and so many investment banks, including ourselves, lost money on their credit books as spreads widened.

At this point, I think that's probably less likely in the second half of the year, so the comparisons I think there's a good chance to improve upon where we were in the second half of the last year.

Having said that, I do think risk is off at the moment and the market conditions are somewhat challenging, and so we'd still maintain a reasonably cautious stance on the second half of the year. Having said that, July was a pretty good month, so we'll see how it goes.

Arturo de Frias - *Santander*

Sorry, can I have a small follow-on on that one? I happen to think that the whole investment banking industry is going to see lower ROEs in the future because of all the changes we are seeing. So you say we are not very different from the industry, but that was not exactly my question. My question was do you think ROEs are going to be structurally lower going forward?

Bruce Van Saun

Yes, I think we did, when we announced the restructuring at the annual results, and we took you through some of the math there. As you recall, last year, in the first half of the year, we had a 17% ROE and in the second half it was break even. And so for the year, we ended up at around 8%, 7%/8% and that was unacceptable, and we had to develop a plan to improve that so that we got markets back at least to deliver a return on equity that exceeded our cost of equity.

So if you call that 10.5%/11%/11.5%, somewhere in that postal code, that was the plan that we laid out. And so if we're starting at 8%, it's going to still take some period, depending on market conditions, to just build our way back and pull through some of the adjustments that we've made in terms of smaller balance sheets, smaller cost base, more focused approach into the areas of real strength.

That's what we're focused on, and I guess the good news on that is through the first half of the year, we're exceeding our own on internal targets and we're executing that plan quite well. That doesn't mean... it's not guaranteeing success, we're watching it closely, but at least we're off to a good start.

Arturo de Frias - *Santander*

Okay. Thank you.

Stephen Hester

Terrific. Well, thank you very much. We much appreciate all your questions. Richard is available for any follow-ups you may have. We do think that RBS is making progress. Of course, the progress is bounded by the economic and regulatory headwinds, but we're going to continue to keep plugging along in the direction that we've laid out.

Thank you again for listening. Bye bye.

Operator

Ladies and gentlemen, that will conclude today's presentation. Thank you for your participation. You may now disconnect.