The Royal Bank of Scotland Group

Q1 IMS 2013

ANALYSTS PRESENTATION

Held at the offices of the Company
280 Bishopsgate London EC2N 4RB
on Friday 3rd May 2013

FORWARD-LOOKING STATEMENTS

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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, please go ahead Stephen.

Stephen Hester

Good morning everyone, thank you for joining us for the Q1 Analyst Call. As usual, Bruce van Saun is with me, and in a moment we will go through the headlines of the numbers we've announced today, but clearly we will spend the most time taking any questions you may have. Our IR team, Richard O'Connor and company, are of course available all day and thereafter to intermediate any other queries that come up.

I think that we feel that this is an important set of numbers, and a positive set of numbers. Of course psychologically, being back in the black without any funnies, as it were, is helpful at every level. Having net asset value going up is helpful. Most importantly though, beneath this, before anything else, RBS has got to deliver a cleaned up bank. I think that the signs that we are nearing the end of that clean up process and successfully nearing the end, continue to gather pace, strong increasing capital ratios, seeing the turn in Ireland and impairments generally coming down, balance sheet funding in terrific shape and so on and so forth. I think make us feel cheerful that as we pass the end of 2013 and go through 2014 that we will substantially have done that job, with of course, you know, no doubt some bumps in the road, but we will have done that job.

We are seeing what we hope will prove to be green shoots in the economy. We've been able to increase mortgage lending throughout this period, but the first increase in SME net lending, we hope that that continues and have ample resources to support it, if it does, we're certainly doing everything we can to stimulate that. Our customers want to grow and we certainly want to grow as well. Of course, aside from that, there is a lot that we can do to improve how this Group operates. That has to take second place obviously to cleaning up the Bank and supporting our customers, but we're working very very hard to make this bank as effective as it can be for shareholders as we come out of that. The trends are tough for all banks at the moment and we've got some restructurings to complete on the Markets side, as a result of the FPC and other issues we talked about at the end of the first quarter, but I'm confident that we can get through those over the next couple of years and deliver a bank that's not only cleaned up, but thereafter can go onto better things. So it's only one quarter, plenty of toughness ahead of us, but at least the quarter has some good stuff in it I think. Bruce, perhaps you could now take on from there.

Bruce van Saun

Our first quarter performance saw further progress on our path to full recovery, as Stephen indicated. In the first three months of the year we moved nearer to the completion of our Safety and Soundness agenda, the Core bank delivered another quarter of solid profitability, and Non-Core continued with steady asset and risk reduction. Turning to the highlights of the quarter, the main focus has been on bolstering our capital position. We reduced risk weighted assets by 14 billion, or 3%, and this drove our core Tier I ratio up by 50 basis points to 10.8%. On a fully loaded Basel 3 basis, the Core Tier I ratio improved to 8.2%. Our TNAV was 459 pence per share, that's up 13 pence or 3% on the prior quarter, reflecting both the attributable profit and favourable reserve movements.

On the P&L, the Group's first quarter operating profit of over 800 million was up almost 300 million on the last quarter, but down more than 300 million on a year ago. Core's Q1 operating profit was a billion three, which is down 11% on Q4. R&Cs operating profit was up over 100 million on a year ago. It was down a similar amount versus the prior quarter. Markets saw an improvement in operating profit on the prior quarter, but saw a significant decline on a year ago, as lower client volumes and a weaker trading performance impacted our revenues.

Non-Core's operating losses were more than 400 million lower than the prior quarter, due to lower impairments and an improved trading performance. At the pre-tax level, the Group showed a first quarter profit of 826 million, that's a 3.1 positive swing from the prior quarter. Below the line items were minimal.

Looking at our major Group P&L categories, our income of six billion was up 2% on the prior quarter, but it was down 18% on a year ago. The R&C income was down 3% on the prior quarter, reflecting the low rate environment and sluggish growth in our key markets. We're running hard to stand still, so to speak. Markets income, while up 400 million on Q4, relating to more favourable seasonal conditions in asset backed and credit markets in the first part of the quarter, but income was down versus last year. We had a weaker comparative rates performance, given heightened Euro Zone uncertainty, which impacted client activity levels in the latter part of the quarter. Group NIM was stable, 195 basis points versus prior quarter, that's up six basis points year over year. The Core NIM improved by five basis points, due to favourable mix effects, as Markets assets have reduced. While the sequential quarter expense increase reflects incentive compensation adjustments in Q4, Q1 was another quarter of tight underlying expense control.

Group expenses were down 12% year over year, reflecting strong cost performance across the divisions, and we continue to develop further expense programmes. Group impairments were down 29% sequentially, and 21% year over year. The sequential decline was driven by an almost 300 million fall on Non-Core impairments, due to non repeat of Q4 provision strengthening.

The Core saw a 20% decline in impairments on prior quarter, partly reflecting UK corporates non repeat of Q4s single name cases. Ulster Bank's impairments declined nearly 100 million, due to reduced mortgage debt flow and fewer corporate cases in the quarter. We remain cautiously optimistic on Ulster's impairment outlook, as underlying trends appear favourable, though uncertainty remains high.

Group NPLs are down 2% on a constant currency basis, from Q4 12, Non-Core NPLs are down over half a billion pounds. The group provision coverage of NPLs is stable at 52%, while the Non-Core coverage increased to 54% from 52% in the prior quarter.

Below the line items declined sharply from Q4, represent 142 billion benefit in the quarter. One of the key drivers was own credit adjustment. We had a 249 million gain as our spreads widened a little bit in the quarter. We avoided any material top ups to conduct costs, as PPI response rate is tracking to our estimates.

Restructuring charges were light, as just over 100 million, but we expect a full year charge of around 900 million as we pull through further Markets restructuring in the second half.

Next, a few comments on our divisional performance. In Q1 UK retail produced another solid quarter of profitability. ROE was 26%, operating profit was flat on a year ago, despite a weaker environment, as well as our temporary withdrawal from the mortgage market as we reaccredited our mortgage advisors. Costs remain tightly managed with staff costs down 16%, year over year, while impairments continued to improve. UK corporate had a soft quarter due to several factors, including the non repeat of some positive one offs in Q4. We also had an overall weak loan demand and deposit margin pressure. However, underlying costs, excluding customer remediation, were tightly controlled, while impairments fell 21% from Q4.

Ulster Bank saw a sharp improvement in operating losses, both year on year and sequentially. Versus the prior quarter, income was flat, costs were down, and impairments fell nearly £80 million, or 25%. Markets experienced a more difficult FIC operating environment in Q1 versus a year ago, as Euro Zone uncertainty, and the lack of last year's LTRO boost led to reduced client activity and we had tightened risk appetite, especially in our rates business. A strong performance from the asset backed business helped to offset this somewhat.

We're bringing down risk and capital in Markets. RWAs on the year are down 23% to 89 billion. We're on our way to resizing and reshaping the business to fit within an 80 billion B3 RWA target. We will provide more details on that in the coming months. It's likely here that revenue impacts lead expense offsets, but we believe the business can deliver a sustainably attractive ROE in the medium term. This remains an important business for us, we are aiming to protect strength in our key FIC franchises, while serving our corporate and investor customers well. Non-Core posted stronger operating performance in the quarter. Operating losses almost halved to 500 million. The improvement was largely driven by reduced friction costs on disposals, as well as lower impairments.

Non-Core assets declined to 53 billion in the quarter. The five billion reduction, or six billion, excluding currency impact, reflects 5 billion of run off and two billion of disposals. RWAs were down six billion in the quarter to 55 billion. We remain confident of hitting our full year Non-Core asset target of 40 billion.

Just quickly turning the balance sheet, the group loan to deposit ratio improved further to 99%, due to Non-Core asset reduction and strong deposit inflows. Core's loan to deposit ratio was steady at 90%, reflecting continued muted customer loan demand. Deposits constitute 71% of the Group's Q1 funding base.

All our key funding and liquidity metrics remain robust. Our liquidity buffer grew 11 billion in the quarter to 158 billion, as the run down of non core continued to create excess liquidity. The short term wholesale funding coverage ratio remains highly prudent at 3.7x. In our Q1, the total wholesale funding was covered 1.1x by the liquidity buffer. Our liquidity coverage ratio remains above 100%, and our net stable funding ratio is 119%, which is up a little on last quarter. Note that our total capital ratio improved 1%, in the quarter, to 15.5%, which reflects both the growth in Core Tier 1 and the deconsolidation of direct line Group.

So to sum up, the Group's balance sheet continued to strengthen, our capital levels are robust and the Core Bank continues to deliver solid returns despite the sluggish environment. Looking at our milestones for 2013, we are pleased with the progress made on Direct Line Group, where we're now below 50%. We're also making steady progress on readying the Williams and Glynne branch network for an IPO, and we're also exploring various other alternatives.

The key focus for the balance of the year is completing the recovery plan and landing our capital targets. That will position us well for a bright 2014, along the road to privatisation. With that, I will turn it back to Stephen.

Stephen Hester

Bruce, thank you very much, let's go straight to Q&A.

Question and Answer

Operator

Thank you Stephen. Ladies and gentlemen, if you do wish to ask a question, that's * 1 on your telephone keypad. We will pause for a moment to give everyone an opportunity to signal for questions. We will take our first question from Rohith Chandra-rajan from Barclays, please go ahead.

Rohith Chandra-Rajan

Morning, thank you, it's Rohith from Barclays here. I just wanted to ask a few on the Markets business actually, and particularly on the revenue performance, where FIC income was down more than 30% year on year, which I guess, looks more than twice as bad as sort of sector overall. So I was wondering if you were able to disaggregate the year on year revenue performance between, obviously the change in the risk appetite and derisking/scaling back the business and underlying trading conditions. And then I have a couple of follow ups please.

Stephen Hester

Some of these things are hard Rohith, to do, but let's be honest, the first quarter was a tricky time for us and our Markets business. We had the LIBOR stuff to deal with, we had a bunch of people fall out as a result of that. Of course, the rates business was at the centre of the LIBOR issues. We had the agreement with the FPC and the Government on the future size, we had the associated bonus and claw back type announcements, and I think we also didn't perfectly trade for understandable reasons. So put all of that together, and I think it's very unsurprising that we had a poor rates performance in that quarter in a market that also wasn't generous to rates in any event. It's very hard for me to disaggregate any one of those items, but you know, these created challenges for us. I'm pleased to say I think the business is regaining a bit of its poise, but we clearly said in the first quarter that we expected revenues to come down ahead of costs and capital. As Bruce said, we believe we can make this again a double digit ROE business. It will take us 2013 and 2014 to take the capital and the costs out, to make that run rate work, but I think we can do that, and I think that will leave us with a business that is capable of doing what we needed it to do financially, and for our customers, that is, a part of an overall business mix that is attractive, with over 80% of the Group being retail and commercial, and that's the route we're on. But clearly, it wasn't an easy quarter, and some of those things will feed through until we can finish the capital resizing and resize the expenses, and that will take us two years to do I think.

Rohith Chandra-Rajan

Okay, so if I can paraphrase what you just said, I mean, is it fair to say that you feel it was an unusually disruptive quarter?

Stephen Hester

Well, I feel that, but running on from that will be the revenue impact of downsizing the business to meet the FPC and other targets that we've committed to, and so I'm not calling for sharp revenue rebounds, rather what we need to do is finish the job of taking the capital out, and taking the expenses out to meet a lower revenue target, which also has the impact of course of derisking and improving the overall company's business mix and so that will take a little bit longer to do as we always said.

Rohith Chandra-Rajan

Thank you. And on that point, can I ask just in terms of the RWA reduction in the Markets business, down 13% in the quarter, in terms of what the drivers of that are, operational risk looks like it was quite a big one, and then also in terms of the 88.5 billion as a Basel II and a half number, I'm just wondering what that is on a Basel 3 basis, just to kind of gauge how far along you are, to getting to the 80 billion?

Bruce van Saun

Yes, the operational risk was really a kind of time series amount, so in terms of the actual constraint on the business, that wasn't a significant constraint. The rest of that was really reduction in the size of the books, size of the balance sheet, size of risk. So we're starting on that process. You know, I think we still have the BIII impacts in sight, in terms of how we're going to mitigate those.

Stephen Hester

The target is the same as we said at the year end results, by the end of 14, we expect to be around 80 billion Basel 3 risk weighted assets.

Rohith Chandra-rajan

Okay, and what's the like for like, as we stand today?

Stephen Hester

About 110 we think.

Rohith Chandra-rajan

Okay, thank you very much.

Peter Toeman

Just on the same point, I think the year end, you've told us that the cost income ratio target for the investment bank was going to be 60%, obviously in this quarter we're well over ten percentage points above that, so I wondered if that target is still extant, whether the revenue performance had been worse than you anticipated, and therefore you're going to actually have to change that 60% cost income target, just putting some sort of cursory numbers together, I felt that if, you know, Q1 is indicative, and Q1 is perhaps 40% of the revenues the business could generate over a full year, then the combination of a billion of revenues in Q1, perhaps two and a half billion for the year, 60% cost income ratio gets you to just about a 10% ROE on your 80 billion of BIII capital.

Stephen Hester

I suspect, I mean, who knows, these are trading businesses, so the quarters go up and down, I suspect we will not hit our ROE or cost income ambitions over the next two years, because I think it will take us two years to restructure the business to get to our capital target and to the cost target, and it needs to go with it. What we will do is work towards a business model that serves our customers well across the Group, and that produces a double digit ongoing ROE, but it will take us I think at least two years to take out the costs that are necessary for that, and therefore the cost income ratio is unlikely to be something, unless there's a particularly favourable trading quarter, that we would hit on a faster basis.

Bruce van Saun

I don't think we're moving the goal posts in terms of the kind of maths that you're doing, if you say you've got 80 billion of RWA equivalents, and you put a 10% capitalisation on that, you've got about 8 billion of equity capital, if we're just working through some maths hypothetically, you roughly need to deliver a billion of pre-tax profit, 800 after tax profit to get to a double digit number hypothetically, and then somewhere your revenues, let's say to deliver that billion, if they're low threes revenues, low twos expenses, you would have a cost to income ratio that's roughly in that ball park. So I think the kind of math you're doing is appropriate. What Stephen's pointing out is we're seeing a reduction in revenues, we have to work really really hard to identify where we're going to take those costs out, try to get them out as quickly as we can, starting in the second half of this year, into next year, and then bring that equilibrium back into balance.
But again, we still think that this is an important business, it can pencil out the right financial metrics and remember on top of that, if all you delivered in this business was a 10% ROE, which is what we did last year, the connected revenues to the other businesses that we book elsewhere, if we attribute that back, we're looking at probably a 3% or 4% uplift to that. So the business kind of looked at in the round is somewhere in the mid teens. So that's kind of the medium term view, we still feel confident in that outlook, but it won't go in a straight line there, there will be zigs and zags because the revenues move around.

Claire Kane

Oh hi there. I have two questions please, the first is on the Basel 3 capital and the changes over the quarter. I think the deductions have changed, have reduced somewhat by about a billion in the quarter from nine to about eight, versus the Basel 2.5, but your RWA movement has moved from 35 billion up to 41 billion. I was wondering if you could talk us through what change and assumptions you've made there.

And then my second question really is on Ireland, I was wondering if you could talk us through your expectations of the likelihood of further repossessions in Ireland, and what would likely do to your impairment charges going forward, or if you think the run rate this quarter is a good run rate for the foreseeable future, or if we could see a continued decline from here, thank you.

Stephen Hester

Let me give Bruce a second to get the Basel 3 answer. On Ireland, I think we believe that the first quarter run rate is sustainable, but there will be quarterly volatility around it, so any one quarter you can have ups and downs, it's not our expectation that there will be some prolonged uplift in mortgages post repossession legislation. Bruce I don't know if you've got the Basel answer, sorry we're scrambling around to get that to you, we might have to give it, come back to you…

Bruce van Saun

You know, I think there was just some modest changes here, I don't have the slide right in front of me, and the details Claire, so we might want to come back to you on that. But in general the change in Core Tier 1 on a current basis, is what drove the improvement in the fully loaded B3 numbers. So if there were any kind of adjustments in the way we displayed it, I don't think those were that material over all.

Chintan Joshi

Good morning, just to follow up on the costs, your outlook statements say that you expect costs to be well below consensus. I'm just wondering how much of the cost guidance reflects the weakness in the Markets division versus you know, the other divisions where you might have genuine improvement. If you could just help us breaking that type of, thinking about the size of the direction.

Bruce van Saun

Yes, I think it clearly, it relates to our previous answer on Markets, there's significant reduction that needs to take place in Markets to bring kind of the smaller shape and size back into equilibrium. At the same time, there's significant effort, you know, attacking the retail and commercial cost base and efficiency measures, as well as business services and Group functions, as the group gets smaller, it puts pressure on, you know, our central functions also to be more efficient. So if I had to handicap that, it's probably broadly half and half, so you've got Markets coming down, kind of the rest of the Group including central functions, also reducing, we're putting about probably equal force on both.

Stephen Hester

But clearly, just given the timing, the Market's, if you like, new strategic plan is not likely to be signed off by the board until May/June, and so I think that the bulk of Markets' cost reductions will lie next year in terms of when they're booked, even if the actions start this year.

Chintan Joshi

Bruce, if I just follow up on that comment about half and half, I mean, we can back out the cost to reduction required in Markets, would it be fair for us to take that backed out number and put it in the other divisions?

Bruce van Saun

Again, we said we'd give you more specific guidance on the expense programmes at the half year, we're still working through developing those, but I think broadly that's kind of order of magnitude reasonable.

Chintan Joshi

Thank you, and the next question was on liquidity buffers, they actually increased, whereas for other banks they have been decreasing, what's happening there?

Bruce van Saun

Well again, we're awash in liquidity, so as we run down Non-Core, and as we shrink the Markets balance sheet, we will end up having cash coming in. At this point, we have, and we're starting to see a few green shoots in SME loans, but we're not getting a material pick up just yet in loan growth, and so that cash that's coming in is building into our liquidity buffer at the moment. We did a small buy back in Q1, we bought back two billion of term debt, you know, we've tried to reprice deposits down and we're willing to price some deposits off the balance sheet, but they're fairly sticky, so we're seeing that surplus build up at the moment. Going up by about ten billion in the quarter probably costs us about three basis points to the NIM, so the underlying NIM is actually a bit better than the headline. But you know, this will be hopefully a temporal situation and as the year goes on, and loan demand picks up, we will be able to deploy some of that cash back into the lending book.

Chintan Joshi

And finally, maybe for Stephen, I mean, you have, you are guiding to a 9% Basel 3 Core Tier 1 by end of year presumably you can get to 10% next year. What are your odds on, rather than IPOing Citizens, giving it as a dividend to shareholders?

Stephen Hester

Well I think that as a generic statement, RBS and indeed other banks, you know, are coming close to the point of being strongly cash generative and I expect the profile of RBS to be one, a bank that can return large amounts of cash back to shareholders. We first of all have to get profitable, we have to have our capital levels, you know, at a level that regulators are happy with, and we have to get the government to remove its dividend block. If we can accomplish those three things during the course of next year, and obviously they're not all under our control, then I think you're going to expect us to want to return cash to shareholders and there are all sorts of different ways of doing that, from ordinary dividends to otherwise.

Chira Barua

Hi, just a quick one on Citizens, lots of speculation around, following up on the IPO discussion Bruce, news around you heading over there, if you could give us an update, and also on the branch disposals in the UK, that will be very helpful, thank you.

Bruce van Saun

Well on Citizens, there's really nothing to report at this point, on any changes to the team. What we are doing on Citizens though, is we've set up a steering group similar to what we did with Direct Line group, to prepare it to go public. You know, that steering group, I brought some of the guys who helped me on Direct Line, to work with the Citizens management team. One of the key things we have to do is keep improving its performance and have a real focus on that, so the franchise becomes more valuable and we'll get a better price for the asset, and then there's all the other things that go with being public, in terms of separation from RBS and having all those functions be ready to go, to face off with public shareholders. So that's an effort that is ongoing and we'll just keep focussed. I think it probably takes us the better part of two years, similar to what it took us in Direct Line group.

In terms of the branch disposals, again here, our base line plan, once Santander pulled out, there's really not another trade buyer who has a system that we can ultimately migrate our data to another banks' platform, and so we made the determination that what we need to do is have a baseline plan that creates a stand alone bank, that means we have to build our own technology platforms, so we're going to clone the platform we run RBS and NatWest on today, and drop it into a new bank. We have to get a bank licence because we don't have that for these assets at this point, so we have to get all our models approved and build in all the functions for this to be, again, a public facing company, and again, that takes about a two year time frame as well. So we're working very hard on that, and the baseline would then be to take that public.

We are exploring opportunities to take in a partner, so there may be different alternatives for us to have a financial investor join us in that process. It's a little tricky, since we don't have the legal entity, per se, for them to invest in, but there's different things that we're working through, which could, I think, work out well from, you know, just shortening the timeline to actually full divestment, which as you know, we have a requirement from the EU to do that as quickly as we can.

So that would be the update.

Gary Greenwood

I just wanted to ask about the capital position, obviously you had a good performance in terms of your FLB3 Core Tier 1 ratio improving during the period. But just coming back to the sort of FPC analysis, the deficit potentially there, I was just wondering if you could sort of update us on your thoughts as to how you might meet any deficit over the course of the rest of the year. I notice on the wires there's talk about Coco issuance, so your thoughts there would be helpful please.

Bruce van Saun

Yes, sure. The number there, that the FPC exercised, talked about, was 25 billion at the start of the year. That number was seen as decreasing to 12.5 billion at the end of the year, and Mervin King himself said that he didn't think banks would need to issue equity to cover that, but that was a manageable deficit for the banks to cover. So, again, none of the banks have been told what exactly their piece of this hole is. I think it's reasonable to assume that banks like ourselves and Lloyds, who are in a recovery plan, are making good progress, and you can see that in the results today, up 50 basis points in the number, and we have a clear path to moving that up to another 80 or so basis points by the end of the year.

So we've had individual discussions with the PRA supervisory team, they see that trajectory, as part of that exercise we work through, you know, how could we augment our overall capital position further. That led to the announcements that annual results around the Markets shrink, you know, the potential to take Citizens public, and then the potential to issue Cocos on the back of our LT2 issuance that we have planned over the next couple of years.

In our view, that is certainly a satisfactory plan we reached agreement with the PRA supervisory team that that was the case. It remains to be seen, that has to now be discussed with the new PRA board, which I think met yesterday, and so I'd assume that, you know, some time over the next week or two, we will hear back from the PRA as to where things stand. But our own view is that we have a good, strong capital position today. That's improving, we have good visibility into that, and we will keep executing on that path.

Gary Greenwood

Obviously the plans that you put in place at the time, the full year results, they were put in place before the FPC announcement came out on the sort of 12.5 billion, which was after management plans for the year. So I'm just trying to understand therefore, are there extra things that you now need to do?

Stephen Hester

As Bruce said, formally, we don't know the answer to that, but my understanding is that the plans that we worked on with the PRA were, as part of their preparation for the FPC meeting, which you heard the announcement, and you know, the PRA I think were comfortable that we were doing the things that we had to do, but obviously they are governed by their board and the board of the FPC, and so I think all banks are waiting to hear if there's more news from that, but certainly we feel that we're doing all the things that we can responsibly do to complete the capital build phase. I think this quarter's results are a strong encouragement in that regard, and obviously the onus is on us to continue that.

Gary Greenwood

And just briefly your thoughts on CoCo issuance, I think you've been sort of warming to that idea when you last spoke.

Bruce van Saun

Yes, overall we're going to issue about five billion of LT2, we have maturities over the next three years, and we've indicated that you know, a coco feature on top of that is something we would actively consider. We did, you may have seen that we have asked our shareholders for authority to issue in ECN format, so in equity conversion format, in addition to the permanent write down structure that Barclays has already executed. So we're watching the market develop, we're waiting to hear back from the PRA, but I think we'd be certainly open to adding that feature on top of our LT2 issuance.

Gary Greenwood

Do you have any preference for the conversion or the write down?

Bruce van Saun

I think you have to have the opportunity to go both ways, because the market is still developing and there are investors who prefer each, and so we want to tap the biggest demand that we can, so we will just have to wait and see what the facts and circumstances are when we're ready to go.

Gary Greenwood

That's great, thanks very much for that.

Andrew Coombs

Yes, good morning. I think the majority of my questions have been answered, but perhaps one new one and then one follow up. Firstly on the UK Retail NII, I'm looking at a margin, they have been broadly stable for four quarters or so, you've seen a bit of a dip this quarter, down 11 basis points Q on Q. You talk about fewer days, and also rate hedges. I'd be interested to know how much of that decline is technical, due to fewer days in the quarter, and how much is due to underlying factors. And then perhaps on that mindset, how much of the savings book do you believe has already been repriced onto new front-book rates. I'm keen to know your thoughts on where that margin might develop from here.

Bruce van Saun

Yes, well look, I think there's no trend in the Q1 numbers on UK Retail. We had in the fourth quarter there were a few one time adjustments that affected the number, which didn't repeat in the quarter, and I think you will see that margin move back. So my view is it's pretty stable. The two offsetting things that are happening there, one is that the hedge that we have on the current accounts continues to chip away a little bit at the margin, but at the same time, we've been able to continue to back down on the pricing on interest bearing deposits. The net of those two things has largely kept us stable. I think that will continue to be the case, in fact, the chipping effect of the hedge is reducing a bit as we kind of go forward in time and we get used to these lower rates. So I think again, there's a chance that we see this move up slightly on the net of the two effects.

The fact that most of the market participants are now in a good LDR position where they've hit their targets, you have the FLS available as an alternative source of funds, allows you to be in a position where you can start to price down. We were paying up for the deposits previously and we need to kind of bring that down to more normalised levels. So I think the net of that means that the picture for that margin is still very stable to slightly up.

Andrew Coombs

Thank you, and then just on a follow up, I wanted to come back to the contingent capital, given the points you've made about seeking authorisation from shareholders for the contingent capital function to be overlaid. Presumably if this decision has been made in discussion with the PRA, perhaps you could share your thoughts, and on the interpretation of how much contingent capital instruments will be allowed to count towards that 7% ratio, the FPC has mentioned on the revised calculation methodology.

Bruce van Saun

Yes, look, we don't know the answer to that, and so I think again, you know, having that in place is an augmentation to the capital position. So I think that will be up to the PRA to determine, how much credit that want to give that. They certainly are sending the signals, that it's a good thing to do, and they will look at it, I think with, you know, as a benefit, and as a plus, when they're considering their overall capital position. So we will just kind of leave it at that and acknowledge that we've been encouraged to strongly consider it.

Andrew Coombs

Okay, thank you very much.

Manus Costello

Good morning everyone, I have a couple of questions please. Just firstly on the capital build, would you consider issuing equity to cover the payment of your Tier 1 coupons in the way that some of your peers have done? I know you've got about 700 million a year. I wondered if issuing equity or even suspending those coupons could be a way of building capital, and I'll give you my second one after that.

Bruce van Saun

Look, the total cost of the prefs, kind of on a run rate basis, assuming we're turning on the NV ones, is about a half a bill. We put in our material today, you might not have had a chance to get it, it's somewhere in the back Manus, but that we plan to issue around 300 million of equity, 250 new, 50 from the EBT, that's roughly in line with what we did last year. Last year we did it in a dribble out programme, we would do that again this year. The gap between the 300 and the 500, we also indicated that we have some very minor asset sales that we could generate some gains on, which would cover that off in whole. So that's the plan, that's how we're going to fund that.

I think it is important that we do turn these prefs on, again, as a normal safe bank, we need to continue to do things like that, and that obviously eliminates the blockers and allows us to get the common divided in place, so that's been carefully considered, and I think that PRA understands that, and so we've worked out that funding plan around that.

Manus Costello

When does that dribble out start?

Bruce van Saun

It could start as early as this month.

Manus Costello

Okay. Thank you sorry, I missed that this morning. My second question is just more general, more strategic. You've just done 8p of EPS in the Core book, just over 8p, which is the weakest since the fourth quarter of 2011. You've still got significant headwinds to come from the sale of Direct Line, from Rainbow, from the Markets business that you were talking about still, losing revenues going forwards. I just wondered how you think you're going to be able, if you think you're going to be able to growth that 8p of EPS, and what you think the drivers would be from here. I appreciate the ROE drivers is capital reducers, but just in terms of Core earnings, it feels to me like the bank continues to move backwards and has got significant headwinds still to come. Related to that, do you think given that that outlook is softer, that's it's more realistic for the Government to think about selling the shares at below the fiscal in price.

Bruce van Saun

Well again, I don't think you should, as Stephen indicated, pencil in Markets at this level of performance in terms of the medium term. So again, it was not a fine quarter there, but we're going through transition.

Manus Costello

But didn't you say Bruce, the Markets would be low threes in terms of revenues?

Bruce van Saun

No, I said, you need to do, I just walked through some rough maths, hypothetical maths, but you can get the operating profit back to a bill. If you want to get this to double digits, you just say if there's 80 billion of RWA equivalent and a 10% capitalisation, that's 8 billion, then you kind of need a billion of operating profit, which is 800 after tax, and then you have to look at where your revenue and expense spread is. So last year, we were 4.5 of revenues, we had 3 billion of expenses, we had a billion and a half operating profit in the business. Most consensus I think, knowing we were shrinking the business, took that down to a billion two, it's going to be hard to deliver that this year, certainly given the way we started the year, but we do think that we can get back to a number that is stronger. So anyway, I think you're being a little harsh when you consider that and extrapolate it to the medium term.

The other thing is, yes, we have the Direct Line dilution to deal with, and the Rainbow transaction to deal with. But we also have been losing our shirt in Ireland, so we've had a billion of loss that we've carried around. If you say that normalises, and I think once it starts to turn, it usually turns pretty quickly, you can see, just getting back to break even puts plus a billion on the board. Direct Line was roughly 400 in last year's numbers, Rainbow was maybe 250/300 so you put those in, you can certainly cover those off and leave some for the Markets shrink in the improvement that you're going to get from Ireland.

So you kind of look at that and say, I think those things, those big plates can largely be deal with. With one of the keys being that Ireland needs to normalise. But then beyond that, we're still operating at a fairly sluggish environment, and our retail and commercial businesses I think can all show improvement, as the economy picks up. So for example, in UK Corporate, we still have, you know, an 80 or 90 basis point loans to impairment. That number can improve in a through the cycle fashion. We're still delivering an 6% ROE in the US, that number can improve. So I think as you get some economic vigour, you get some higher interest rate environment, you can see these R&C businesses improve, so I think you're being a bit pessimistic overall Manus.

Manus Costello

And in terms of the government sale, do you think that waiting for the fiscal in price is the right thing to do, or what's your view?

Stephen Hester

Clearly, in the end, this is a political decision and not one that we will get to vote on one way or another. I guess the observation that I would make, or the observations, is that the simple quantum of shares that the Government owns in Lloyds and ourselves would make it most unlikely that those would be distributed in one transaction. So I think one's looking at a number of transactions over a number of years, as indeed was the case in the 80s and 90s, privatisations. And so personally, I am confident that over the course of those transactions that the Government will be able to realise its price over the average of those transactions, even if the Government were to sell at below the in price for the first transaction. In fact, one can see that our share price carries some discounts for Government ownership today, which I think after the first transaction, investors would be in a more cheerful mood on that subject alone.

So it's cogent to believe that the average price will be higher than the first price. It's still clearly a political decision as to how to weigh up, if you like, the politics of the first price versus the undoubted benefits of getting on with privatisation. It clearly benefits in terms of availability to taxpayers, and money to do other things with, benefits in terms of sentiment, I think privatisation would be a symbol of recovery for the UK, just as nationalisation was a symbol of a crisis. I believe firmly that RBS and indeed Lloyds will in the long run perform better, fully privatised, than in the current format. So when it comes we will be ready, we hope it comes sooner, but it's a decision for others and what we have to do is to make sure that we can deliver a cleaned up bank, which we're well on the way to completing, and then over time, a bank that performs better and better, both under our own efforts and with an economic recovery helping us to start growing revenues.

Manus Costello

Thank you.

Michael Helsby

Yes, morning gentlemen, I've got three questions actually, if I can. Just firstly, going back to the Markets revenues. I think in a previous seminar you talked about the corporates and banks being about 72% of your revenue. I was wondering, over the last six months, as Markets has clearly evolved and a few of the issues you've already mentioned, has that percentage changed, has there been a change and a shift in your overall franchise towards more corporate flow. So that's question one.

Bruce, just on costs, I'm just trying to think about the overall quantum of cost saves that you're signalling, and you mentioned a few things, but one of them is obviously the starting point on Markets cost, and obviously you've said they're half and half. So am I right in thinking that the quantum of cost save at a Group level is in the region of one and a half to two billion, or am I just completely misreading things. I was wondering if you've got a view of where the consensus costs are for 2015. So that's question two.

Finally, just to wrap up on this theme, clearly one thing that you've been very very consistent with over the years is that you've always said you will just restructure and restructure until you get to an ROE above cost of equity. Clearly, you know, you're signalling that we're going down another route, so for me the overarching question is, as you're doing that, are you seeing franchise damage along the way, such as we're just in this never ending spiral of restructuring and therefore obviously that's going to hurt, towards Manus's question, that Core earnings power.

Stephen Hester

Can I just, let me just take the last first and then Bruce can gather the more detailed answers on your first question. I would say that the restructuring efforts of the Group are well in their later stages. Except you could argue that all banks are, in a sense, in some sort of permanent restructuring mode. I mean, just think what Barclays are doing on costs or what Lloyds are doing on costs, really across any other bank, for so long as revenue trends are low, banks are going to need to work on the cost, and work on simplification and how to serve customers better with lower costs and so on and so forth. So I think on one level you could say all banks are restructuring. The vast majority of our businesses are now in what I'd call that normal restructuring mode, i.e. no more or less restructuring than any bank is having to do to sort out how you deal with soft revenue trends. The only area of the bank which has got a differential restructuring is the new one that we needed to announce in the first quarter to meet the FPC and other discussion that we were having, and we think that we can do that in the next two years. That is obviously less than, 20% of our business is subject to that particular issue, although it's an important business for us.

Taking the company as a whole, our market shares and all other indicators of franchise health are in good shape. I won't tell you that they're particularly increasing, but they're not decreasing either, and there are some signs of increase in some important things like net promoter score and so on in the UK especially. Of course, in Markets, we will voluntarily relinquish some market share in some areas, as we for example, pulled out of equities, pulled out of M&A and some of the shrinking that we will do this time around. But that aside, there are no signals of difficulty in our Core franchises, to the contrary, although our ambition is not just to stay stable in these areas, but actually to get better, and that clearly is a task ahead of us, and indeed everyone else.

Bruce van Saun

On the costs Michael, again, if you look at Markets being at three, and ultimately needing to get down, say, meaningfully below 2.5 billion, you've got at least a half a billion challenge there, in terms of bringing down the market's costs. If we say roughly matched elsewhere, that is a reasonable expectation of what we're working on. Again, everybody likes to put words in our mouth and it's a little premature, because we don't have all the details on these plans. But that's the kind of things, for the near term, that we're working towards. We did say in the Outlook statement, that the consensus for our expenses ex DLG was 13.2 this year, and that we have confidence that we can deliver that and beat that. Some of that work that starts to benefit us this year would carry over into next year, and so we would expect to see a meaningful reduction next year, and then into 2015.

You know, if you look at historically what we've done on expenses, you know, going back over the four years leading into 2012, we brought down expenses by 18%. So in 2011, we brought them down 6%, in 2012 we brought them down 6%, those are absolute declines, those aren't just the headline cost programmes that get absorbed by investment elsewhere, those are actual reductions in expenses. I'd say I think we have a good track record of being able to do this. It's getting harder, because we've picked a lot of the low and medium fruit. I think we have some visibility into how we're going to be able to achieve this. It's important, if the Group has shrunk, and we're still in a sluggish environment, we have to keep working at this, get more focussed, serve our customers better, make targeted investments. We think we can do that, and then as the economies pick up, we can benefit from that. We will see a lot of operating leverage and positive draws, that's kind of what we're trying to accomplish.

Michael Helsby

Okay, Bruce, you mentioned before that you thought consensus Markets was about 1.2 billion in 15, have you got a sense for…

Bruce van Saun

No, I thought that was this year Michael, I didn't relate that to 15.

Michael Helsby

Oh, my misunderstanding, sorry. But have you got a feel for where 15 is, on costs for the Group overall, or do you not look that far out?

Bruce van Saun

Stay tuned for the half year, I think we will be able to give you something on that at the half year.

Michael Helsby

And just on the franchise overall, in terms of the mix within Markets?

Stephen Hester

The bigger picture is, you're right, we want to have a business that earns us cost to capital. We think all of our businesses, collectively, and individually, have that capability, and there is no sign to us that our restructuring is weakening that capability, although obviously in some places it narrows it, but it's narrowing it deliberately. The trickiest area is Markets, a, because that's probably got the most uncertain general industry trends, b, it's probably got the lowest PE applied to the earnings and c, you know, we had our own particular sets of shocks and that's the most difficult of our businesses, in our current ownership structure, and so all of these things, we're trying to work through in the best way for our customers and the business itself and our shareholders. We think we can come out in an acceptable, sustainable position.

Michael Helsby

But do you think the customer mix has changed?

Stephen Hester

We don't really have, to be honest, we're not really measuring it quarter by quarter, so I can't really answer that in any detail, and I'm nervous to be too precise about Markets, because of a, the overall industry changes and b, you know, the quarterly volatility there is and c, the particular issues around us, which I think will need a bit of time to settle out. So I think we are very clear, the kind of model we're aiming for, I think the path to that on a quarterly basis will show some ups and downs that shouldn't be necessarily linearised.

Mike Trippitt

Good morning, two questions if possible, just on the US business, Bruce you were sort of talking about improving the performance, and I just wondered if you could a bit of an update there on what are the key drivers of that going forward, I know quarterly comparisons are dangerous, but adjusted ROE is sort of in the 8%, 9% mark at the moment, balances look relatively flat, is this a macro recovery story to get the ROE up, or is there more that, more management action you think can be applied?

Bruce van Saun

Yes, look, we've been working hard at this equation and have made some progress. I think we've run the full benefit of lower credit costs at this point, so that's been a big tail wind in moving from a loss position back up to this 8% or 9% territory. As you're seeing, with all regional banks, it's not the greatest environment now in the US to continue to make positive traction on the income line, so you see many of the peer banks are now back at work on the expense base and you know, doing what they can to reprice their deposit base. But a lot of that's already been taken, that opportunity's been taken. So I think what need to focus on is several things. One, looking at the balance sheet, I think we are under penetrated still in some of the commercial space, where we see opportunities, so I think we can grow commercial loans. I think we can grow a better share of wallet, we've recently reintegrated some of the payments products under one roof, and so I think we can do better cross selling there. Then on the consumer side, again there, I think we still see opportunities in loan origination, mortgages, and also better cross sell as well. So I think our customer scores have moved up very nicely, net promoter scores are on the upswing, and so we need to pull some of that through. So there's things that we can do that are under management's control, but I think the broader lift ultimately comes from more economic recovery in the US and higher interest rates. We've had an asset sensitive balance sheet and certainly higher rates would provide some lift to the top line there. So I think it's a combination of things.

Stephen Hester

And clearly, if you look that medium term, most economists would expect the US to grow a bit better than the UK, and a regional bank has got a lot more scope on growing its market shares than any of the banks in the UK market which is more consolidated, have. And so I think the medium term macro, both from our market position and from the overall economy position is a positive one, but it's likely to be a bit like trench warfare until that macro feeds through.

Mike Trippitt

Okay, just a second question. So if one was to sort of think about investment risks, you've ticked a few off here in terms of capital clearly improving, the dividend access share you've talked about is probably a next year exercise. The one sort of comment that seems to just be growing, and the press talk about it, is the good bank, bad bank split. It just strikes me there won't be much of a bad bank left, you know, on the sort of one year view. You would say this is not for you to judge, I know, but is this something we should just cross off the list of investment worries?

Stephen Hester

Look, I wish we could control what the outside world does and we can't. So you're right, there's not a lot we can say about it. I think it is our responsibility to make sure that RBS is just fine under its own steam, and I think that we have consistently shown, and the results again today show, that we will be just fine under our own steam, and that every aspect of the things people worried about on capital and impairments and so on is going in the right direction and towards its later stages.

Clearly, that's our responsibility to deliver that. It's always open to someone else to say, they think it would be a good use of public money to do something else. Other people have to consider what is the best use of public money, and all we can do is say, we're not going to ask for it. We can deliver the turnaround of RBS under our own steam, and therefore everything else is in someone else's court.

Mike Trippitt

Okay thank you.

Chris Manners

Good morning Bruce, good morning Stephen. I have a question for you, just on the loan demand point and some of the Government schemes that have been put in place. We have the FLS extension, we've got the Help to Buy scheme, and as you talked about, there has been a pickup in loan demand. How much capacity do you think you actually have to sort of grow the Core balance sheet, I saw it was in loan terms up 1% quarter on quarter. I mean, do you feel there's a capital constraint there?

Stephen Hester

It's practically unlimited. I think there is, obviously theoretically not unlimited, but there is no pattern of loan recovery on any past recovery that we couldn't comfortably absorb. The funding is obviously really easy, we've got an embarrassment of deposits today, so funding is a no brainer, and when you look at the big capital issues that we have, with the continuing run off of Non-Core, with what we're doing on Markets, with profitability set to return as we go through the next couple of years, my worry is, can we get more loans out of the door, in terms of customers wanting them, not can we fund it.

Bruce van Saun

I think Chris, you will recall that we said at annual results that we thought that loan growth could average 3% across RBS, or 3% to 4% this year. It remains to be seen if we see that pick up in the second half of the year, but certainly at arriving at those 10% and 9% fully loaded targets, we have kind of that type of loan growth factored in, which is quite significant, it's 35 billion over two years. Having said that, I think if the opportunity were there to put out more of that, I think our stakeholders would be pleased, if we grew the book even faster than that, because again, our GSIFI number is to be 8.5% in 2018, and so these, you know, getting to 9 and getting to 10, are quite a bit beyond that.

Chris Manners

Okay, so we could actually expect a bit of a volume tailwind on the core R&C revenues, as well as on the…

Stephen Hester

Well, we don't control the economy, but we're damn sure that ,a, we're going to try, and b, that we will have the resources.

Operator

As we have no more time for questions, Stephen, I will now hand the call back to you for closing comments.

Stephen Hester

Gentlemen, thank you very much, ladies, for joining us, obviously feel free to follow up with the IR team on any further questions you have and much appreciate your time this morning. Thanks, bye bye.
