The Royal Bank of Scotland Group

Q3 IMS 2012

ANALYSTS PRESENTATION

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FORWARD-LOOKING STATEMENTS

This transcript includes certain statements regarding our assumptions, projections, expectations, intentions or beliefs about future events. These statements constitute "forward-looking statements" for purposes of the Private Securities Litigation Reform Act of 1995. We caution that these statements may and often do vary materially from actual results. Accordingly, we cannot assure you that actual results will not differ materially from those expressed or implied by the forward-looking statements. You should read the section entitled "Forward-Looking Statements" in our Q3 Results announcement published on 2nd November 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

Stephen Hester – *Group Chief Executive*

Good morning everyone, thank you very much for joining us for our third quarter results call this morning. Bruce Van Saun is with me as usual and I'm sure most of you know there are reams of disclosure and other materials available on our website to support and amplify what we're saying this morning.

The period we are reporting on today I hope you will acknowledge is one with some really important and positive milestones passed in RBS's restructuring; it was also one where our ongoing businesses showed solid performance and resilience. And it was one when, like other banks, we were reminded that the going is still tough – that there's plenty left to do to make the Bank as good as we target and, of course, especially so in reputational terms. But nevertheless I think that we are increasingly coming to the point of clarity that we can complete the restructuring in the five years that we said it would take us. That the cleaner, slimmer and smaller and fitter Bank that 2014 should see, the future RBS, should be one where we can generate significant broad-based investor appeal off a much less complex start. There is heavy lifting to do between now and then but I think what we've done so far gives us confidence we can do that.

Obviously, what happens thereafter in terms of economic pressures, regulatory pressures, pace of growth and so on, we all have to wait and see. But we believe that we are establishing increasingly the platform from which to do good business in the future.

So with that let me ask Bruce to take you through the results.

Bruce Van Saun – *Group Finance Director*

Okay. Thanks, Stephen. The third quarter showed continuing solid progress as we strive to recover and reposition RBS. We made excellent progress against all the key balance sheet targets in our Safety and Soundness agenda. Our Core Bank generated solid profitability, delivering a 10% year-to-date ROE, while Non-Core maintained its excellent pace of asset reduction. We also continued to hit our major milestones including the Direct Line IPO and the exit from the APS scheme, and whilst Santander's decision to withdraw from the branch sale was disappointing we have relaunched the divestment process and we remain optimistic.

Let me turn to the financial highlights of the quarter. The Group's third quarter operating profit of just over 1 billion was up 400 million on the prior quarter and up more than 1 billion on a year ago. Core's Q3 operating profit was 1.6 billion, which is up 8% from prior quarter, 67% on a year ago. Most of our R&C businesses were broadly flat given the sluggish environment, except for UK Corporate which suffered from some single name impairments. Markets saw a sequential quarter improvement in operating profit as revenues were stable and we continued to lower costs. Non-Core's operating losses were nearly 300 million lower in the quarter given favourable market conditions and avoidance of significant impairments.

At the attributable profit level the Group showed a loss of 1.4 billion driven largely by a 1.5 billion pre-tax own credit adjustment. Our credit spreads on five-year maturities have come in from 450 basis points to about 100 basis points year-to-date, reflecting the improving strength of the Group. However, under the current accounting rules this good news is reflected as a charge in our income statements. Our capital position remains robust with a Core Tier 1 ratio of 11.1% if you include APS, 10.4% excluding APS. Our TNAV was down 2.7% to 476 pence per share, reflecting the large own credit adjustment charge; excluding this OCA charge TNAV is broadly flat on the prior quarter.

Next let me turn to the major Group P&L categories. Group income was flat on Q2 at 6.5 billion but it was up 6% or 400 million on a year ago. Core's revenues were also stable sequentially. R&C income was down by 3%, broadly reflecting the impact of sluggish economies and low rates. Market's income was steady versus Q2; as credit spreads tightened moderately, flows were stable and new issue markets were active. We also realised some incremental bond gains in the Group Centre as we rebalanced and downsized our liquidity portfolio. This allowed us to offset several charges in the quarter, protecting our capital ratios. Group NIM was stable, at 194 basis points, while R&C NIM declined slightly by 2 basis points reflecting downward pressure on deposit margins. Expenses remained tightly controlled, down 6% on prior quarter and 5% on a year ago. Our Core cost:income ratio year-to-date is 60%, which is stable versus a year ago.

Group impairments were down 12% or 160 million sequentially; the decline was driven by a fall in Non-Core due to the non-repeat of Q2 project finance charges and a decline in Non-Core's Ulster impairments. Ulster's impairments overall, Core plus Non-Core, were down around 4% on the prior quarter and that represents 42% of the Group's total in Q3. While we see a few early signs of stabilisation in the housing markets we're still fairly cautious and don't see an imminent turn at this point.

Group NPLs are broadly flat versus Q2; they are down billion on last year. Our Group provision coverage of NPLs is 51%, which is up 2% from the beginning of the year. The so-called below the line items were a negative 2.3 billion in the quarter, driven primarily by a 1.5 billion charge for own credit adjustment. Other major items include a 400 million top-up to our PPI provision as claim volumes continue ahead of expectations, and ongoing restructuring costs, which will peak this year.

Several divisions had noteworthy performance in the quarter; in Q3 we were pleased by the performance of UK Retail where operating profit increased by 6% on prior quarter, as income was up modestly, costs were tightly managed down 2% and impairments were flat. Q3 ROE improved to 24%. Markets was another solid performer as operating profit was up 18% on Q2, driven by good cost control. Our Rates, Asset backed products and Credit businesses continued their strong performance as spreads have tightened, given investors' search for yield. Markets year-to-date ROE of 12% compares favourably versus peers. The US R&C, International Bank and Wealth businesses all saw a stable performance in the quarter, while UK Corporate had a soft quarter due to several factors.

Revenues were lower due to non-repeat of the first half one-offs. There was a collapse of the LIBOR base rate spread, deposit margin pressure and weak loan demand. Impairments also increased materially in UK large corporate, driven by a small number of individual cases. The pattern of impairment charges in UK large Corporate can be lumpy given the size of the credits.

Non-Core had another terrific result in Q3. We made good progress on asset run down, dropping 7 billion to 65 billion, while RWAs fell even more by 11 billion in the quarter as we continued to emphasize de-risking the markets' portfolio. Year-to-date asset run down is 29 billion. We now expect to hit the 60 billion in TPAs at year-end and we remain confident of hitting 40 billion by the end of 2013. Non-Core's operating loss declined versus prior quarter despite increased trading losses from the further reduction and de-risking of the structured credit portfolio. The quarter's P&L benefited from an improved market environment, lower costs and the absence of significant impairments.

Next let me turn to the balance sheet. In the third quarter we reduced our balance sheet by 20 billion to 909 billion. Group RWAs excluding APS cover fell to 481 billion. Our funding, liquidity and capital metrics improved further. The loan:deposit ratio is now 102% with Core at 91%. Deposits constitute 70% of the Group's funding base. The Group's short-term wholesale funding declined by 13 billion to 49 billion; we are now down 53 billion year-to-date. This now represents only 5% of our funded balance sheet, well below our peer group. We were able to reduce our liquidity buffer, given the shrinkage in short-term borrowings, down to 147 billion. That said, the liquidity buffer cover of short-term wholesale funding rose to 3 times from 2.5 times at the half-year. We remain comfortable with our capital base post the APS exit with a 10.4% Core Tier 1 ratio; now this is up 70 basis points from the beginning of the year. Our target remains to maintain the Group's reported Core Tier 1 ratio above 10% at the 2012 and 2013 year-ends, incorporating various regulatory changes.

So to sum up, the Group's balance sheet strengthened further in the quarter, while Core continues to deliver solid returns. We are pleased with the progress on our 2012 milestones and our route back to normality, including the exit of the APS and the IPO of Direct Line. We see the next 15 months as important to finishing the recovery effort as we position RBS to be a cleaner and more profitable bank thereafter.

With that, let me turn it back to Stephen.

Stephen Hester – *Group Chief Executive*

Bruce, thank you very much and let's go straight into questions.

Questions and Answers

Operator

Thank you, Stephen. Ladies and gentlemen, if you would like to ask a question please press the * key followed by the digit 1 on your telephone keypad. We will pause for a moment to give everyone an opportunity to signal for questions. We will take our first question from Rohith Chandra-Rajan from Barclays, please go ahead.

Rohith Chandra-Rajan – *Barclays*

Good morning, thank you. A couple if I could please; one on the UK Corporate trends that you highlighted, which I guess in terms of the Retail & Commercial businesses, was the sort of the soft area. You talked about both margin and the impairments so I guess, on the margin, just in terms of how you see that progressing from here. We're now back I guess at a level we saw this time last year; you highlighted LIBOR-based spread and deposit pressure. So just interested in your comments on that going forward. And then also just on the provision line: it looks particularly due to a pick-up in the property sector impairments. And just any sort of further comments about credit quality generally in the Corporate book and going forward. Thanks.

Bruce Van Saun – *Group Finance Director*

Yes, sure. Well, first off, I think the first half NIM in UK Corporate was a bit turbocharged from some one-offs which we had flagged. So part of that reduction was just not having those occur again in Q3. I think things that exacerbated the decline further, clearly that collapse in LIBOR relative to base rate had an unanticipated impact, and then we continued to be in a competitive marketplace for corporate deposits. So I think where we are now is around a 3% level and I think that's probably a reasonable run rate, absent the good news that we had in the first half of the year.

On the impairment side of the coin, two years in a row, we had UK Corporate impairments of around 800. The first half of this year we were at about 350 and I think we were cautious to say look, there is some lumpiness in this and we weren't calling out that we were going to be at a reduced run rate. In fact we've seen – I don't know if there is any seasonal pattern to it, but we've seen second half impairments bigger than first half impairments for each of the last two years. So we saw that emerge again this quarter and I think it's fairly contained, so when we look at where is that, you're right, in commercial real estate there were some top-ups on some credits that were already in our workout group.

We have an eye on the shipping portfolio that we have in UK Corporate as well. I think, on a broad basis outside of those areas that we're not seeing anything troubling or alarming, and in the smaller business and commercial space we actually see things have been very stable and they're actually starting to trend slightly favourable. So, again, we look out at Q4, we don't have a crystal ball, but I think you might see again something maybe more akin to Q3 than to the first half, as we kind of balance things out. But I wouldn't really call out an adverse trend when you think about 2013; I think that kind of number of 800, or a little over 800, is probably still a reasonable expectation.

R**ohith Chandra-Rajan** – *Barclays*

Okay, thanks. And you mentioned CRE there. Just in terms of the capital base is there now some CRE slotting impact in the RWAs?

Bruce Van Saun – *Group Finance Director*

Yes, absolutely. So on a year-to-date basis we've actually had, through CRE and through other model changes that we've agreed with the FSA, we've had about 70 basis points of headwind in the overall Group capital ratio. And so that's something that will affect UK Corporate. It's also affecting Non-Core to some extent but Non-Core has a lot going on, so it's a lot of asset reductions trying to offset that. But the places where you'll see the impacts from some of these changes in local regulation – even pre-B3 – UK Corporate would be one, Non-Core would be another and then some of the International Bank, with some of the changes to the large corporate model, would also have a bit of a headwind there as well.

Rohith Chandra-Rajan – *Barclays*

And I think you previously estimated the CRE slotting impact at about 20 billion, so is that still your expectation, and how much of that is in the current numbers?

Bruce Van Saun – *Group Finance Director*

Yes, probably year-to-date we had about half of that in the numbers.

Rohith Chandra-Rajan – *Barclays*

Okay, that's great, thank you very much.

Bruce Van Saun – *Group Finance Director*

Sure.

Operator

Thank you. Your next question comes from Chira Barua from Sanford Bernstein, please ask your question.

Chira Barua – *Sanford Bernstein*

Morning everyone. I have two questions. The first one is on the Irish commercial real estate book. I've just seen that it is probably the first time you have dropped coverage on that, from 56% to 55%. So given what we are seeing in Dublin commercial real estate do you see a turnaround in that portfolio right now and further the write backs in 2013? That's number one and number two is more to Stephen: this is around Citizens. There's been lots of noise around Citizens being asked to be sold for capital reasons. It would be great if you can highlight the strategy going forward, thank you.

Stephen Hester – *Group Chief Executive*

Bruce, do you want to take the first one?

Bruce Van Saun – *Group Finance Director*

Sure. You know, on the first one, the overall coverage on commercial real estate, – I wouldn't call out anything from that reduction from 56 to 55. There's continued increasing provision coverage on the Non-Core development lending book, which is probably where we have our greatest risk. So at this point on the commercial side I wouldn't say there's anything that says we're seeing a massive deterioration or any kind of early signs of green shoots that would lead to recovery. So, I think we pretty much have the coverage where we want it.

If I extend that over to the residential side, there's been maybe a few green shoots just in terms of asset values have started to stabilise. So for the last three months there you've had either flat or slight rises in housing. But again, I would only call them green shoots; we're not changing our view at this point. We're keeping a cautious view but the things that have driven the Core impairments have been falling asset values and rising delinquencies. If we can start to see asset values solidify here that would start to presage some falling impairment numbers, maybe in 2013.

Obviously, on the delinquencies, that's going to depend on whether the economy gets a little more vigour. There's been about 0.5% GDP growth in Ireland this year; analysts are projecting 1.5% next year and unemployment, which has been stubbornly high at 14.5%, might start to come down a bit next year. But, again, I think people have called the turn before and we'll just have to see how it plays out. So generally I think we're cautious still.

Stephen Hester – *Group Chief Executive*

Thanks, Bruce. On your second question, Citizens, I think the short answer is nothing has changed in the way we think about this. But to reiterate that, the reason that Citizens has always been part of our base case plan A for the ongoing Core of RBS, is no different than it was a few years ago. That is to say that we think it's a good business. That it can be valuable to our shareholders, that it will pass both customer safety and soundness and shareholder value tests, and that not being a second best Lloyds – i.e. every single egg in one economy, but where we don't have the dominant market shares that Lloyds have – that it's to our shareholders interests for us to have a slightly better business balance. The US economy, as we know, tends to grow faster than the UK; it's more fragmented in the banking industry, so you have better growth opportunities organically and in other ways. And it gives us a business balance with 80% Retail & Commercial, only 20% Investment Banking, that a number of our larger competitors would much prefer than the balance they've got.

So now, I think that our base case is that over the long haul RBS shareholders will be better off, from a strategic and balance standpoint of RBS, with this as part of the base case. However, all of that said we're pragmatists and, we completely appreciate in the course of our journey events may change and we may have to look at things through different pressures in different ways. And so we test every bit of our base case every year at least against alternatives. Now – and clearly, you know, in common way the number of other assets we have – we just did one, which was DLG and we've sold one – I think our credentials in selling things are pretty good.

We could sell Citizens. I think selling Citizens today would be a little bit like selling RBS shares for the government it would be selling an asset before it's maximized its value and before the market is profitably valuing financial assets. And so it wouldn't help shareholder value. It would give us obviously a nominally higher capital ratio; I don't think there would be any prospect of that finding its way to shareholders. So it would sit in the Bank and make nothing, but these are the things that we consider.

Clearly, our plan A is to help Citizens develop into the really good bank that we want it to be and to improve its performance. As you know, its performance is way up on last year, which was up on the year before and so on and so forth, but there's still important things to go. And the U.S. economy is sluggish, as the UK one is, even though it has been growing faster. So we remain open minded but with, you know, with clarity of thinking both as to the base case and why it's a base case in strategic terms, and as the need to compare the base case to alternatives now and in the future.

Chira Barua – *Sanford Bernstein*

Thanks for that. If I may just add, this whole debate came out of capital so where do you stand in terms of your interactions with the regulator on capital? Because there has been lots of press around, you know, you being asked to sell Citizens for mostly capital reasons, non-strategic.

Stephen Hester – *Group Chief Executive*

Well that, you know I'm not sure I know the answer to that question. I mean, clearly, the UK authorities – you can see from the FPC announcements – remain at the hawkish end of global authorities on bank regulation and capital. And so you can see those public pressures from UK authorities there. Actually it was kind of interesting yesterday with the new Global SIFI list published, which shows RBS, as a result of our restructuring and strengthening measures and shrinkage measures, moving from the highest level of Global SIFI down into the middle category. Such that if we will held by international standards as opposed to UK standards we could be 1% of capital ratio below the biggest banks and 0.5% of capital ratio below let's say Barclays. But obviously the UK authorities are applying different rules.

So, you know, I think we in all banks are under pressure from regulators to be conservative in capital. Obviously, our capital journey has been outstanding so far at every single moment in last four years; despite headwinds of different sorts we beaten where the regulatory fears were. I'm not complacent about that because obviously things can go wrong on the outside world, but we'll reverse that. We want our capital ratios to climb still further. We want to be on a good track to Basel III, we think we can be, but I can't hide from you that there are regulatory pressures on us and all banks to be more conservative still faster, and these are the discussions that we have all the time.

Chira Barua – *Sanford Bernstein*

Thank you, thanks for that.

Operator

Your next question comes from Chintan Joshi from Nomura, please ask your question.

Chintan Joshi – *Nomura*

Hi, good morning. Can I just follow up on the capital? I mean, we get different messages on how comfortable the regulators are with the capital position from different banks. So I'm just wondering why this difference exists because I mean Lloyd, for instance, is highlighting that the regulator is comfortable with their capital position, and as soon as CRD IV is fixed we can talk about dividends. However, you are taking a bit more cautionary tone; I'm just wondering why this difference?

Stephen Hester – *Group Chief Executive*

Well obviously, I don't know if the regulators are giving Lloyds an easier ride or not and if so why they would be; you must ask Lloyds about that, I can't answer for Lloyds. But what I know is that so far, in the last four years, I think we have operated cooperatively with the regulator. They've seen that our actions been leading to a much stronger RBS, they want that, we want that. And I very much hope that that process of cooperation in search of a common goal continues.

Clearly of their nature, the regulators are more concerned about capital and don't have any responsibility to balance it with shareholder value and so on. So we have to balance things that some of the people who comment on us don't have to balance, but that's part of normal life. I never know whether things are just the words someone chooses on a day and what mood they are in or whether there is anything underlying, it's very hard for us to make that comparison. But what I do know is that RBS's path has been consistently positive in terms of becoming safer and sounder, at a pace faster than other people have expected us to do.

By the way, it's just – Bruce mentioned it, but I think we should also refer to it. The market appreciation of how much safer and sounder we are is clearly greater than either rating agencies or some other commentators – you know, our spreads coming in from 450 to 100 over the last year is not just a stunning narrowing in absolute terms and a real change in the creditworthiness perceived by investors and us in the wholesale markets. But it's also a big narrowing relative to other banks. So we are far from complacent. We want to keep going on safety and soundness. But I do feel that the dynamics of RBS have been recovering in an extremely satisfactory way, whether you are looking at us as a regulator or from any other angle.

Bruce Van Saun – *Group Finance Director*

Yes, I think just to add to that, we're at the time of the year where we work on our budgets for next year and we have a capital plan associated with that. We feel good about our capital position and our plan to get through 2013, and we'll be sharing that with the regulator and hopefully we align our views around a common plan there.

Stephen Hester – *Group Chief Executive*

But, you know, there's a reason bank share prices are low and it's because investors generally still don't have enough visibility both on growth through economies growing and the outcome of regulatory pressures. And those two things, those two headwinds on bank share prices and the solidity of their returns, are not going to disappear overnight.

Chintan Joshi – *Nomura*

Fair enough. My next question is on mortgages. If I look at FSA industry data then mortgages that are yielding more than 4.5% used to be 46% of the total in 2009; that's steadily come down to 24% currently and that's kind of bringing down back book mortgage rates for the industry. I'm just wondering if this is a similar trend that you see in your mortgage book? Is the differential between the mortgages that roll-off versus the new mortgages that you take on, is that negative?

Stephen Hester – *Group Chief Executive*

It depends on which books. The back book mortgages that are on SVR, we haven't changed our rate on that for some time. The back book mortgages that were fixed rate deal swapped, obviously as they roll-off then by and large the margins increase from that roll-off when they replaced rather than decrease from the back book. So, you know, the retail bank overall has had some margin squeeze coming from the deposit side but I think the asset margins are broadly stable.

Bruce Van Saun – *Group Finance Director*

Yes.

Chintan Joshi – *Nomura*

And then finally, just on a similar topic: we've seen, as you highlighted, funding pressures have eased considerably. I just wanted to take your thoughts on where you think deposit costs go on the back of that? There's already been an improvement there, and more importantly, what do you think lending rates will do on the back of that? Can that be steady? Or do you think lending rates will have to go lower if deposit rates go lower generally?

Bruce Van Saun *– Group Finance Director*

No, I think, for the last couple of years the UK banks were focused on improving their loans:deposit ratio. So there was quite a bit of heated competition to secure deposits and to improve those metrics. Now what you're seeing is that across the whole UK bank universe a lot of progress has been made, and the marginal value of a new deposit isn't as great as it was when we were going through that recovery phase. There is not the kind of loan demand that you'd like to see so you're not really fuelling significant asset growth by taking in those deposits. So I do think, as you've seen in the US, who've been awash in deposits and liquidity, there's been an effort to start to reprice interest bearing deposits a bit. I think you potentially could start to see that happen through 2013.

The flipside to that is on the non-interest bearing deposits in a low-rate environment, as the hedges continue to tractor through into this lower rate environment. You've still had a headwind there and so there is that dynamic, where I think you can make some of that up on not being as aggressive in the interest bearing deposit pricing side. I'm not sure in the end if lending rates would have to come down and be linked to that. So I'm not sure the moves will be so noticeable that you'd have to drag along your lending rates at the same time.

Chintan Joshi – *Nomura*

Thank you.

Operator

Thank you. Your next question comes from: Raul Sinha from, JP Morgan, please ask your question.

Raul Sinha – *JP Morgan*

Morning Stephen, morning Bruce. Can I have two questions please, very quick ones? Firstly, could you talk to us about your fully loaded Basel III ratio as it was at Q3, and secondly on the NIM in UK Retail, it looks like it's gone back to 353 from 357 sequentially. I was wondering if you could give us some comments there? Do you see stabilisation going forward or do you think the pressure continues to stay high on that?

Bruce Van Saun – *Group Finance Director*

Okay. On B3 we didn't put anything out publicly on that ratio at this point. But I think we did, in response to a question on the half year call, say that we were in the mid sevens and I think that would be the same situation today. We also said that our target would be to arrive at a 9 – 9.5% target range, with a bias to the low end of that range, at December of 2013. Again, that continues to be our view today.

On the NIM and UK retail, again, we have those different dynamics of compression on non-interest bearing deposits and the possibility of backing off on interest bearing deposits. I think in general that could wash. We are changing the business mix to have more mortgages on, as a percentage of our total assets in the UK Retail, which again, mortgages have a lower yield than some of the personal unsecured credit that's been another factor. So I think we are maybe plateauing to slightly negative in UK Retail. But I do think there's other good dynamics going on in that business – on the cost side, on the impairment side – that I think the profitability will stay robust and potentially continue to improve.

Stephen Hester – *Group Chief Executive*

Just back on the capital ratio again, for the sake of clarity, we clearly are aiming to get to above 10% fully loaded Basel. We think that we can transition well ahead of the full Basel transition period and obviously all efforts to date have done that. And our goal is to be 10% or better, or around 10% at each stage of that process as Basel comes in; that will improve our capital ratios. So, hopefully on transitional Basel, whenever that comes in, we'll have got to 10% and so on as we go through. And you can see the underlying capital ratios have been improving very nicely in the last year despite regulatory headwinds.

So we're very clear we're on a journey; we are progressing very well on that journey. We know the dimensions of the endpoint and believe that we can get there. Obviously we're helped in that process by having a much lower investment bank weighting than some of our competitors through the next phase and the prospect of no insurance company waiting, which is different than some other competitors in the next phase. So we have those things helping us in our transition but we're clear that transition is important and that we will need to make it.

Raul Sinha – *JP Morgan*

Thanks very much.

Operator

Thank you. Your next question comes from Peter Toeman from HSBC, please ask your question.

Peter Toeman – *HSBC*

Yes, morning. Back on the subject of capital: I remember that I think in 2009 you issued some contingent capital to HM Treasury, I think it was about 8 billion and noting the FSA seems quite keen on contingent capital and you want to normalise RBS's relations, have you considered the prospect of maybe issuing contingent capital to the private sector and cancelling out the contingent capital with HM Treasury?

Bruce Van Saun – *Group Finance Director*

Well, I guess our fundamental view is that the contingent capital arrangements in the public domain are still evolving and, you know, given the fact that we have the current arrangement in place we don't need to be on the bleeding edge of that. I personally view LT2 as a preferable security to augment the total capital base, if we were contemplating that. Clearly, it's much cheaper, so it's generally 250 basis points lower cost than a contingent capital instrument. And banks, in times of mild stress, have been able to go into the market and execute liability management exercises around that and turn that into real Core Tier 1 capital and you've never really seen a contingent capital instrument and no one's hit a trigger and actually delivered any Core Tier 1 capital benefit from that. So I think because of the cost of contingent capital and because of those dynamics around the trigger, I think LT2 may be a preferable way to go to augment a total capital position. But, again, we'll watch how things evolve and if the whole market moves in that direction then certainly we wouldn't roll it out.

Peter Toeman – *HSBC*

Thanks.

Operator

Thank you. Your next question comes from Gary Greenwood from Shore Capital, please ask your question.

Gary Greenwood – *Shore Capital*

Oh hi, morning. I've got two questions. The first is just on the branch network sale and in terms of the deadline on the regulatory requirement. Now I'm just wondering if you fear that there might be any penalties if you miss the regulatory deadline? That's the first question. And then the second question's just on slide 14, on the REIL trends. I notice that the REILs have increased in Q3 versus Q2 following a downward trend. Just wondering if that's an inflection point or are you expecting them to resume a downward trend going forward?

Bruce Van Saun – *Group Finance Director*

Yes, sure. So on the first question, you know, look, we were disappointed at Santander's decision but certainly we have worked very, very hard to comply with the divestiture time line. And in everything else that was, you know, part of the agreement with the EC we've met or exceeded expectations. So certainly the divestiture around WorldPay, around the Sempra Commodities joint venture, in terms of DLG and being on track to deliver that, we've got all ticks there. In terms of reducing the balance sheet size we're well below – I think the year five target was 1.6 trillion in terms of assets – we currently just printed in the low 900s. So I think all that would be taken into account if we have to extend the timeline.

So we've started a new process around that; we are engaged in an active sales process now. We have interests in the business; it's a small business but it's quite attractive. So it delivers a high-teens ROE, it's self-funded; it's got a 5% SME market share. So, I mean, it's not surprising that it would be of interest to potential buyers. I think we also have to look again, given our success at the flotation of DLG. That might be a route we could go as well to make sure that we keep the buyer universe honest on the pricing. So, you know, once we figure out which route we're going, if there's a need to extend the timeline we would bring that to the EC and I think they'd take the broader considerations into account, and hopefully there wouldn't be anything but a clean approval on that.

With respect to the REILs: I think it was really just a blip here in terms of the bump up in Q3. If you look at the trend for the last five quarters, we're down 2.5 billion and we really think that that's the broader trend and the bigger picture. There were a few pockets, we have had some uplifts in a couple of areas in Q3, but I think we will be continuing to move down from here.

Gary Greenwood – *Shore Capital*

Excellent, thank you.

Bruce Van Saun – *Group Finance Director*

Okay.

Operator

Thank you. Your next question comes from Chris Manners from Morgan Stanley, please ask your question.

Chris Manners – *Morgan Stanley*

Good morning Stephen, good morning Bruce. I just had a couple of questions for you. The first one was on the net interest margin. I saw Core net interest margin was down about 5% in the quarter, but you're guiding flat Group NIM for the second half. I'm just trying to work out what the prospects are for next year given you have had a good reduction there in the short-term wholesale funding, some of the senior unsecured tenders, and also you've been able to bring down the liquid asset buffer after the rule changes. The second one was on the funding for lending scheme and just, you know, how you're been able to take that opportunity and what impact do you think that's going to have on the business? Thank you.

Bruce Van Saun – *Group Finance Director*

Okay. Well, on the first one, again, it's little early to give guidance on the NIM. Certainly at the annual results meetings we will have completed our budget and we'll give you I think some trend lines on that. But gut feel is that I think we'll continue to have that slightly up bias that we referenced at the half year. So I think, again, it's looking stable at this point second half versus first half, but I think the bias is to move ahead based on some of the feature that you mentioned. In terms of FLS, Stephen, I don't know if you want to comment on that.

Stephen Hester – *Group Chief Executive*

I think that at the moment, FLS is unlikely to result in an explosion of net lending for the industry until the economy is growing more sharply. So I think total loan outstandings probably won't change a lot. Obviously what we are doing, I don't know about other bank, but what we are doing is passing on the interest rate benefit of FLS to our customers. So the customers are getting a benefit. We will not get a P&L benefit out of it; if we get some volume benefit that would be terrific but at the moment I'm cautious on that.

Chris Manners – *Morgan Stanley*

Thank you.

Operator

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

Jason Napier – *Deutsche Bank*

Hi, good morning. Two or three pretty mundane ones actually, which is testament to really good work on the restructuring side by yourselves. The first was International Banking's risk-weighted assets to customer loans is up from 70% to over 100 now, in a little over a year. I just wanted to explore with 40% of revenues being in cash management, I'm just wondering why the capital efficiency of that division isn't sort of better than perhaps I would have expected it to be? That would be the first one.

Second, the balance of the loan book in UK Retail is now nearly 90% mortgages, and cards and personal loans continue ebb as a share of the total. I just wondered whether that was driven by strategy, customer demand or, you know, conduct risk and the like? And then lastly, and this isn't material at a Group level, but it's certainly interesting. In US Retail & Commercial we're seeing net write backs in resi, corporate, commercial especially for last two or three quarters. And I just wondered whether that was something that might be sustained for the near term and how you think about overall bad debt charges for that division next year? Thank you.

Bruce Van Saun – *Group Finance Director*

Yes, sure. So first off, on International Banking: I think it's really just a function of some of the model changes that we've made under the auspices of the FSA. So we've flagged that not only do we have to deal with the Basel inflation of RWAs; we've had other things locally, CRE slotting being most prominent. But also in some of our other models like large corporates credit where the dial is turning to the right, i.e., more conservative. So the places that has most impact on: the capital base of UK Corporate, as certainly CRE slotting is a big impact there; in International Bank it's on the large corporate credit model. And then Non-Core would get an impact from both of those changes. So that's really what's behind that one.

In UK Retail, in terms of the shift towards mortgages, I think we've just had a tighter risk appetite for the business as a policy change that we've made. So we had a kind of below – punching below our weight mortgage market share relative to our share of current accounts, and we've tried to organise ourselves to gain share there. So our stock was about 8% in mortgages. We've been kind of delivering around an 11% share of flow, current account share is 20%. So there's still quite a differential and I think what we found through the last crisis was if you look over long period of time, some of that personal unsecured really was not delivering a proper through the cycle return. So we've tightened the risk appetite in terms of where we want to play on personal unsecured.

We don't want to go too far, we do think there's valid customer needs and we can service a segment of our population with a good risk-adjusted return coming from that. So I don't think you'll see this trend continue. I think we're probably about where we want to be. And then, lastly on the U.S. we've certainly been benefiting from very good credit conditions on the ground and I think that should continue. Whether we can actually see net recoveries I would question that, but I still think that we can probably run a very favourable level of impairments to loans and adVances for some time forward.

Jason Napier – *Deutsche Bank*

Thank you. So just to follow-up on the large corporate credit model changes and so on: is there much more of that to come or is that pretty much all done now?

Bruce Van Saun – *Group Finance Director*

Yes, I mean that's going to continue to flow into Q4, and then I think that one's pretty much behind us. But, we're probably slightly ahead of 50% of the way through that one. On the CRE slotting we're probably also about 50% of the way through that one. So, again, we're just managing through – our capital plans obviously have a glide path for how these models are affecting us; they have the Basel uplifts and all the mitigation and the deleveraging that's happening in Non-Core. So we're just managing that composite picture, as Stephen said, to try to deliver above 10% Core Tier 1 at the end of this year and above 10% at the end of 2013.

Jason Napier – *Deutsche Bank*

Terrific, thank you.

Bruce Van Saun – *Group Finance Director*

Okay.

Operator

Thank you. Your next question comes from Michael Helsby from Merrill Lynch, please ask your question.

Michael Helsby – *Merrill Lynch*

Yes, morning gents, just a couple of questions from me.

Firstly, I'm wondering if I could get your comments on things the Bank of England has been saying recently on asset prices and the carrying value of those. But I was just wondering if you could you give us your take from Royal Bank's perspective. And Bruce, I saw on Bloomberg before on the press conference that you are talking about dividends in 2014; I don't remember you saying that before, I was wondering if you just give me a bit more colour on that. Thank you.

Stephen Hester – *Group Chief Executive*

We all know Bruce is way too cheerful. I didn't closely look at the Bank of England's comments but I think there are sort of three buckets of assertion that some people are making. I think the first is that bank share prices are low because somehow accounting hasn't marked the books properly. Now you guys are professionals in this so you will know what you think. As far as what I can observe, bank share prices are low because banks aren't making enough profit – nothing to do with their book value, it's to do with how much profit they are making and how quickly you guys think that that situation will be correct in the light of economic and regulatory pressures. So it seems to me the solution for bank share prices can only be growth in profits and it's not an accounting issue.

I think the second concern is somehow the back book on lending holding banks back from new lending to the economy. Obviously I can't speak for other banks but I can absolutely unambiguous that the answer to that at RBS is no. We have more funding and more capital than we need to satisfy commercial loan demand, and we are not constrained by our bank book in lending to the real economy. And so I think those are, if you like, two of the key arguments that are made. I think there is a third argument, which is very important from a social standpoint, and that is there are some who seem to believe that forgiveness, or working with customers to avoid making them bankrupt is a bad thing.

I think it's absolutely the other way around. I think if we went around merrily putting people into bankruptcy, throwing people out of jobs, it would have a negative social and economic effect, and also mean that we get less loans back at the end of it ourselves. So we go to enormous efforts to work with borrowers not to put them into bankruptcy and to help them restructure their business and help them emerge as positive, healthy businesses, both to maximize our recoveries and to help the economy. So – and by the way, I think that our social requirement as well as the right business thing to do.

Bruce Van Saun – *Group Finance Director*

Yes. Let me step in then and talk about my views on the future. So I think what we've been very clear about is that this is a big fix it job of RBS and it's going to take us the full five years that we set out in our recovery plan, and we still have 15 months to go. So while we have made very good progress and we're pleased with the progress made we still have some hard yards here to get to the end of 2013. Having said that, we do think we will deliver the key elements of our recovery plan and we'll have the bank in good shape as we look out into 2014.

At that point you would expect that we would have the kind of drags from the clean-up reduce fairly significantly, so there would be no need to incur the big Non-Core losses from disposals. Most of the restructuring costs would be behind us and so our Core attributable profit – which has held up well through a choppy environment – that we've been delivering 6 billion of stable Core profit here, will start to radiate through, which should give us some flexibility on capital management. Obviously we don't know what the regulator will require in terms of top-ups to the capital position that we think is adequate, but my hunch is that we should have enough free cash flow in that period to start to put a dividend in place. I think just from creating the fertile ground, so that government has an ability to consider selling stock, it's really their choice, but putting a dividend in place increases the appeal of the stock to broader constituencies. So that's what we're working towards and certainly what we'd like to try to achieve.

Stephen Hester – *Group Chief Executive*

But obviously we are very conscious that you pay dividends out of earnings, you don't pay dividends out of capital. And so we need ongoing earnings and we need them to be up, or we need the deductions against them to be down, which is why we've spent a lot of time trying to accomplish that.

Michael Helsby – ***Merrill Lynch***

Yes. Can I just come back, Stephen, on your points about the new lending. I think consumer credits been slowly picking up and last month there was a notable increase in consumer credit at an industry level. I think you referred earlier about your appetite and you've been changing the mix. Your bad debts and retail from consumer are now extremely low, probably as low they've been probably for a decade actually. So I was wondering if you could talk about your risk appetite for consumer credit and whether you're seeing any change in utilisation?

Stephen Hester – *Group Chief Executive*

We would like to increase our lending both in retail and in commercial. We are resourced to do it, we'd like to do it and we'll serve our customers better and make more money if that's what happens. However, we can't force people to borrow if they don't want it and we shouldn't be thrusting money at people who may not pay us back. And so the macro lessons of the past are that lending growth does not front run economic recovery; economic recovery front runs lending growth. So unless somehow lessons from the past don't repeat themselves at a macro level it seems likely that both individuals and businesses will want to gather confidence from economic growth resuming before they stick their necks out, in financial terms, by borrowing more. So all we can do is stand ready and try and offer the money responsibly and then obviously it's up to our customers whether they want to take it down and whether their confidence levels in their own futures allow that.

Michael Helsby – *Merrill Lynch*

Okay, clear. Thank you very much.

Operator

Thank you. Our next question comes from Tom Rayner from Exane BNP Paribas. Please ask your question.

Tom Rayner – *Exane BNP Paribas*

Yes, good morning Stephen, good morning Bruce. Actually, Stephen, my question does sort of relate back to just the last point you made about economic recovery coming before lending growth. Because we're just looking at the funding for lending scheme and on paper if there was good loan demand out there to be done, I think the FLS scheme would make it reasonably attractive for banks such as yourselves to actually go out there and meet that demand. And, you know, my sort of question really was can the FLS, by lowering funding costs, which you then pass on to the end customers, actually create any loan demand? It sounds as if you don't think that's the case from your last answer. But I just wanted to check on that and when I looked at your 215 billion of qualifying loans under the scheme: are you saying that sort of by the end of next year you'd expect that sort of number to be broadly similar to what it was at the end of June?

Stephen Hester – *Group Chief Executive*

Well, the FLS, as I said earlier on, does a few different things as it relates to encouraging loan demand as opposed to loan supply. If borrowing is price sensitive at low interest rates then it might - obviously there is some room to doubt as to how price sensitive... In other words, if you're a business and you have a target return on new projects of let's say 10, 15, 20%, does your interest rate moving from 4 to 3% or 5 to 4 or whatever make you build a new factory? You know, there's room for doubt about that. But if there is price elasticity of loans then FLS will encourage it. I suspect there may be a bit more in the mortgage market than in the business, where people are bit more sensitive to outgoing as a percent of their salary. But obviously FLS is partly an experiment in the price elasticity of loans at low interest rates.

The second is if there is a confidence effect, which is sort of non-direct, but nevertheless helps along with other measures in the economy and it may work there. What FLS doesn't do is turn a non-credit worthy borrower into a credit worthy borrower and so, obviously, if the shortage of lending is people who are not credit worthy, it won't change that. So those are, if you like, observations on FLS.

Now, FLS is an imperfect measurement because Non-Core is included and asset finance is excluded. And so we, and no doubt Lloyds at least, will have some strange looking headline numbers under FLS, which is why we give I think the best level of disclosure so far about FLS trends and other trends in our IMS today, which you can read for yourselves. As to whether taking all that together, lending goes up in the next year or not, your guess is as good as mine. We'd love it to do; we have the money to support it. But it needs some help from the economy and I think – and as I say, I think the past pattern would suggest that economic growth needs to be extant for a while before loan growth follows. But obviously we'll see and we're certainly ready to encourage, support and applaud it if we can grow our business on the back of our customers growing theirs.

Tom Rayner – *Exane BNP Paribas*

Okay, thanks. And just on that point, I mean do you think it will be a sensible policy move to tweak the FLS so that it kind of adjusted for Non-Core type assets, which clearly the regulators are happy to see you dispose of for transparency reasons? And focus it on to the Core business, because that's really the aim I guess of the scheme. Or is that just too complicated in reality?

Stephen Hester – *Group Chief Executive*

Well, we certainly pointed out to the Bank of England that FLS discriminates against risk management of Lloyds and RBS because it incentivises us not to run down Non-Core. As it happens, we are going to run down Non-Core anyway. But that aside, that's sort of carping at the margins; I think FLS is a good experiment for the economy. We were the first, loudest and biggest supporters in terms of actually putting actions into place for our customers. And whether or not it benefits us we want to be seen and to actually support our customers and the economy.

Tom Rayner – *Exane BNP Paribas*

Okay. Thank you very much for that.

Operator

Thank you. We have time for one more question and that comes from the line of Andrew Coombs from Citigroup, please ask your question.

Andrew Coombs – *Citigroup*

Good morning. If I could be cheeky I'd like to ask three actually; two on the financials and one on strategy. With regard to the two financial questions the first one is on the central items. There's a large profit on bond disposals in there of 325 million. I'm just interested to know your thoughts on whether that is seen as a one-off item or whether you think there's further liquidity repositioning there in future? Second is on PPI: your redress increased from plus 200 million in the second quarter to plus 300 million in the third. So interested to know if you could share with us the experience in October to see if that had slowed at all. And then finally on strategy: thank you for the comments on Citizens but could you also comment on the other remarks made by your largest shareholder about the possible consideration of scaling back the Investment Bank? Thank you very much.

Bruce Van Saun – *Group Finance Director*

Yes, sure. Maybe I'll take the first two and then, Stephen, you can come in on the third. But, yes, in terms of the bond gains: we have been clipping a moderate level of gains throughout the year. But we stepped that up in Q3 partly in response to seeing a clear ability to lower the overall amount of liquidity that we had to hold. So we brought the liquidity buffer down by 9 billion in the quarter and some of that was released from the bond portfolio that we were holding, which was in very, very safe securities, largely gilts, treasuries and bunds. And, as you know, those have been safe haven assets and certainly were bid up and so we were able to sell some of that. We were largely replenished, by the way, in the quarter, as other movements in the portfolio were positive. And so we still have a fairly sizeable number of unrealised gains available to harvest, down the road, if we choose to do that.

But, again, I think I would look at the number as being probably higher than you would see on a going forward basis. I think Richard and I tried to work out what the net impact is on the quarter from that and I think if you look at some of the reserves that we took, net of the gains, there might be 200 to 2.25 above run rate benefit in central items for the quarter. But, again, we'll continue to have a certain level of gains each quarter for the foreseeable future.

On PPI, again, we have made our best estimate as to where we think response rates are going. That's been challenging I think for the whole industry, that response rates have stayed up higher than we anticipated. We would have expected to see those flatten out. I think in October, so far I don't have the full data, but anecdotally I think they are tracking about to where we expected. We've just had to go out with a positive outreach to our customers and sending a letter notifying them that they should contact us because they might be in a position to claim. And I think the response rate on those letters are about where we thought they'd be. So all of the big banks really stepped on the accruals this quarter, hoping to nail it here given past experience. I can't, say for sure that that will be the case but we'll just have to wait and see. Third one, Stephen, on IB?

Stephen Hester – *Group Chief Executive*

Yes. I guess here's the way we think about it. From a strategic standpoint, as you know, one of the fundamental observations of our strategic plan was that the banking industry itself had got over expanded and too risky, and the area within it that have got the most over expanded and most too risky was Investment Banking activity at RBS and generally. And so a major strategic thrust we have is to recalibrate the balance of Retail & Commercial and Investment Banking within RBS, and the scale and scope of the investment banking activities with RBS. So that's one major strategic thrust of thinking which hasn't changed.

On the other side, we have been equally clear that the world needs markets, the world needs international trade, the world needs more than just cheque books from banks. And there will be other points in the cycle when world economic growth depends on those more international aspects of financial markets, and certainly any bank with aspirations to seriously serve companies, still less insurance companies, pension funds and so on – and obviously one of RBS's distinctive strengths is our corporate business – must be present in a meaningful way in markets in order to provide those services and to participate properly in financial markets. So we know that we must be there to reflect the future of financial services and our customer base and particular strengths. We know we must be there in a much smaller and more narrow way than we were in the past. And those are the two strategic threads, which moves us then from principle to pragmatism in terms of how to give expression to that.

So we have cut the size of our investment banking activities to one third of where they were pre-crisis. I think no other bank in the world has managed that. Roughly we are aspiring to a 80%

Retail & Commercial, 20% Investment Banking. I think even post implementation of their dramatic actions announced in the last week, I don't think UBS gets to 20% in its Investment Bank. So I think if we stopped at 20% we'd still be at the low end of global banks in markets' participation.

Do I feel dug in about 20 versus 23 or 15 or any number? No, I don't, that's an issue of pragmatism. We announced, in January, exit from equities and advisory, which was our equivalent of UBS exiting from fixed income, in the sense that is our big weak suit. We've got probably another year and half of shrinkage to implement what we announced earlier this January and whether we go further or not and to what extent I view it just as a pragmatic response. I think it's not obviously healthy for the employees but it's very healthy for the industry that at long last people who manage investment banks are taking capacity out in a very serious way. That's what the industry needed. I think it gives hope that it can provide a sensible part of the business make up of financial services going forward. And so in a sense that gives support to broadly to our strategy, both the shrinkage and the believing that market activities have a place in a balanced portfolio, especially if you want to service corporates.

Bruce Van Saun – *Group Finance Director*

Yes, and I would just add that so far year-to-date we've executed that revised strategy quite well. So we're on target in terms of the business exits, the balance sheet shrinkage, the headcount reductions in the sustaining businesses and our year-to-date ROE in markets is 12%.

Stephen Hester – *Group Chief Executive*

We have some more shrinkage to do to carry out what's announced. Whether there is more shrinkage on top of that I think depends on the outlook, how we cope with it and making sure that we retain an RBS which is characterised by dominant Retail & Commercial solidity but markets businesses that support our franchise and are attractive in their own right, in terms of ability to compete. And that's the pragmatic balance beneath the strategy.

Andrew Coombs – *Citigroup*

That's very clear. Thank you very much.

Stephen Hester – *Group Chief Executive*

Good. I think we are coming to an end. Obviously you know where to find us if any of you have follow-up questions. Thank you very much for listening and, as I said at the beginning, it's only one quarter but I think the patterns with RBS are reasonably established. We are making excellent restructuring progress; that should give confidence we can deliver a cleanish bank by 2014. There is hard work to do in the meantime, of course. The shift of the hard work is moving probably more to reputational issues from safety and soundness issues, but nevertheless they're equally important and wrenching in dealing with them. Our ongoing businesses I think are proving their value but they're also mimicking their customers. We're running hard to stand still in our Core businesses and until the economy changes that's all we'll be doing. And so, clearly, that has implications for the path of share prices. That's it; we're trudging on, cognisant of the challenges and comforted by the progress we've made. Thank you for listening.