The Royal Bank of Scotland Group

Q3 2010 Interim Management Statement

Analyst conference Call

Held on Friday 5th November 2010.

Presenters

- **Stephen Hester (Group Chief Executive)**
- **Bruce Van Saun (Group Finance Director)**

Operator

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

Stephen Hester - *Royal Bank of Scotland – Group Chief Executive*

Yes. Good morning, everyone. Thank you for joining us. As normal, I'm here with Bruce Van Saun and we plan to take you through, relatively briefly, the highlights of our third quarter results that were announced today, and then of course take as much time as you would like answering your questions. I should point out that with the release today and all on our website is an extremely comprehensive set of information, both slides that summarise our results and of course the very detailed results themselves, full disclosures, supplemental appendices and so on, and so we're certainly trying to continue to be at the absolute forefront of investor friendly disclosure transparency and honesty about our business.

Thinking of the quarter itself, I think that we are more than satisfied at where we are today. The basis for our strategic plan, we believe, continues to be valid. The actions that we are taking to implement our strategic plan are paying off plus or minus in the way we thought they would, more pluses than minuses fortunately to date. I think that we can see that in a big picture way across a few different dimensions. If we think of profitability, we've reported at the Group level three quarters of operating profit, which is probably a year ahead of when we thought we'd actually be able to do that, and in this particular quarter, operating profit something like a billion seven in the core business, up on the previous quarter, and with a much more comfortable business mix. We had an over reliance on unusual levels of investment banking earnings last year, Retail and Commercial is really pulling us up again and the business mix has returned to one that I like, relative to our international peers, of something like two thirds Retail and Commercial, one third investment banking. Non-Core losses are falling, allowing the Group operating profit to go up. Of course, there's all sorts of silly accounting noise around fair value of own debt and APS. The great irony is those charges go up when the economy gets better and vice versa.

But anyway, that's the sort of the P&L stuff. I think our other great task of course is to improve the safety of the bank, and across every measure you can think of, whether it be our capital ratios that are, I think, in good shape for the Basel changes, whether it be improvements in liquidity in government bond holding, loan to deposit ratio coming down well, no fears over refinancing in the next couple of years, the various government programmes, on all of these, I think we've made terrific progress and people have done their jobs well and we expect that to continue. We obviously have our normal, realistic glasses on in understanding that we've got plenty of work left to do before this is a bank that we're really proud of, and some of that work will take time, and of course the external environment will impact on us as it impacts on everyone else. At the moment, in some respects, it's helping us as economies' recovery and impairments can come down. In other respects, it will hold us back if interest rate rises are delayed, that will clearly reduce the pace with which margins recover for a period until that normalises and similarly make loan growth hard to come by. But in any event, I think we feel these are things ahead of us, but it's our job to execute to our plan and to make sure our plan remains valid, and that's indeed what we are continuing to do.

So with that introduction, perhaps I could pass on to Bruce to take you through the specifics of the performance.

Bruce Van Saun – *Royal Bank of Scotland – Chief Financial Officer*

Thank you, Stephen. I would characterise this as a solid quarter with tangible progress evident around our business and our financial targets. Looking at the quarter's highlights, our Group operating profit improved by nearly £0.5 billion on the quarter to £726 million, while the core bank's profit improved 10% on Q2 to £1.7 billion. Retail and Commercial's RoE improved to 14%, driving our core RoE higher by 1% to 12%. Non-Core run down continues slightly ahead of plan as we reduced assets £20 billion in the quarter and Q3 saw significant progress on EU mandated disposals. Core Tier one ratio remains strong at 10.2% and our funding and liquidity metrics improved meaningfully as we issued £18 billion of long-term debt in the quarter. The bottom line though swung to a loss in the quarter of £1.1 billion, reflecting the impact of improving credit spreads on two volatile accounting items, fair value of own debt and APS charge. Fair value of own debt was a debit of £858 million in the quarter, and APS was close behind at £825 million, a combined charge of £1.7 billion. You may recall in the second quarter, these items swung to a combined credit of £1.1 billion, so it makes sense to focus on the underlying results. Year to date, we have a similar bottom line loss of £1.1 billion, which reflects APS at the £825 million, fair value of own debt at £408 million and restructuring costs of £733 million, in aggregate, £2 billion of costs. On an operating basis, Group year to date performance is a profit of £1.9 billion, fuelled by consistent progress in our retail and commercial franchise, as well as steadily declining losses in Non-Core.

At the consolidated level, recent trends on underlying NIM, expenses and impairments continue. On NIM, the headline growth of two basis points from 2.03% to 2.05% looks like a slowing to the recent trend. Unpacking this a bit though, our efforts to aggressively take advantage of market conditions to improve our funding and liquidity position hurt the NIM by about four basis points. So the underlying NIM expansion was actually still quite robust. Driving this performance was Retail and Commercial which contributed five basis points to Group NIM expansion, and GBM/Non-Core with a combined impact of two basis points. R&C continues to see asset margins expand, although we are 75% to 80% or so through this.

On expenses, headline sequential movement was flat, but excluding last quarter's one off US pension credit, we were down 2%. This reflects good discipline across all divisions, led by business services and has been driven by our £2.7 billion cost reduction programme. Impairments were down 21% versus prior quarter, falling for the fifth consecutive quarter. We are benefitting from gradual economic recovery and strong workout efforts. These trends cut across Core and Non-Core, with Ireland being a notable exception.

Now, turning to a summary of divisional performance, let me start with GBM. GBM delivered underlying revenues of £1.6 billion, down about £300 million on Q2, a reasonably good performance given low volumes and investors' increased risk aversion in Q3. Compared with peers, GBM's revenue performance remains in the pack adjusted for business mix. Relative performance was hindered somewhat as areas of the market have faired better in Q3, such as emerging markets and flow credit, which are not GBM's primary focus. That said, we are investing in these areas and expect to strengthen these franchises over time. The quarter started slowly but client flows picked up a bit in September, along with issuer volumes. October results are in line with third quarter experience. GBM's costs fell 3% in the quarter, reflecting the weaker trading environment. The year to date compensation ratio of 34% is in the expected full year 2010 range of 32% to 35%.

Next, focusing on Retail and Commercial divisions. First, UK Retail continues its strong recovery with profit before impairment loss up 13% on the quarter and operating profit up over 40%. 5% net interest income growth was delivered by a 14 basis point increase in the NIM as well as asset balance growth. Good cost control resulted in very sizeable positive operating leverage in the quarter. UK corporate also continued its good progress. NIM rose eight basis points as the back book continues to re-price. Direct expenses remain tightly controlled and impairments declined in the quarter. ROE in the business is now at 16%. GTS had a very good quarter. We saw customer deposits rise by £3 billion on the quarter and NIM improved for the first time this year.

Costs were managed down 3% sequential quarter. The GMS disposal remains on track for a fourth quarter completion. Wealth's new CEO, Rory Tapner, is in place and work is underway to strengthen and enhance our business. Highlights from the quarter include a 4% gain in net interest income, largely flat direct costs and a 3% rise in assets under management. Citizens saw another profitable quarter as NIM expanded by 14 basis points and impairments fell by 13%. In addition, excluding the second quarter pension one off, costs fell in the quarter. We are taking some balance sheet actions to better position ourselves for the low rate environment, and we continue with our change programmes to boost organic growth. At Ulster, we continue to face significant challenges. The economic environment remains difficult and commercial property markets will take years to recover. Impairments remain elevated and could stay at these levels next quarter before beginning to hopefully trend down in 2011. On a bright note, our profit before impairment loss has now increased for four quarters in a row as we progressively reduce costs and we boosted NIM where we can.

Moving beyond Retail and Commercial and looking at the other two divisions. First, Insurance had a much better quarter than Q2 which was marred by a significant boost to reserves in the motor line relating to prior year bodily injury claims. We took another £100 million top up in Q3 related to the PPO claim book, otherwise we would have been profitable. We now anticipate being increasingly profitable in 2011, as we put prior year matters behind us and our turnaround efforts bear fruit. Non-Core continued their impressive performance in de-risking their portfolios. Losses continued to narrow and assets were reduced by £20 billion in the quarter, primarily through sales, £11 billion, and runoff, £8 billion. We assigned a further £9 billion of assets for disposition, which should close in Q4, or the first half of 2011, and our pipeline remains solid.

Turning to the Balance Sheet, we made excellent progress in the quarter on improving our funding and liquidity position. We have reached £35 billion of term funding year to date, versus our original target of £25 billion, as we've taken advantage of more favourable markets in the second half to get a jump on 2011 requirements. In the last quarter, our strong distribution capabilities within GBM have enabled us to tap the markets across multiple tenors, currencies, maturities and product types. We completed our second covered bond issuance in the quarter, and we re-entered the RMBS market with a £4.6 billion deal in September 2010. This term issuance combined with Non-Core de-levering has driven down short term funding, which fell in the quarter to £178 billion. Now that's down £72 billion, or 29%, from the start of the year. We also boosted the Group liquidity reserve over the quarter to £151 billion, which is our 2013 target. The quality of the reserves has also improved, as FSA eligible government bond holdings have increased to £31 billion. With these actions, the net stable funding ratio is now over 100%. And lastly, our Group loan to deposit ratio improved to 126% with Core already at 101%. On the RWA and capital front, gross RWAs were flat on the quarter, the main moving parts are the continuing Non-Core run off, partially offset by an increase in RWAs in GBM related to the roll off of our remaining relief trades. On a net basis, after APS relief, RWAs increased slightly as APS covered assets continue to run down. Our Core Tier one ratio remains robust at 10.2%. We've given some information on potential impacts of Basel changes in the IMS, which you should study, but the bottom line is that we believe these impacts are manageable and we remain highly comfortable with our capital position.

Let me conclude with a few thoughts on outlook. We continue to be cautious about the macroeconomic and regulatory environment we face. However, we've been coping with this uncertainty throughout 2010 and we've continued to make steady progress. Our business diversification has helped us to navigate this period. While GBM was the star, quote unquote, of 2009, the environment has proved more challenging and that should continue into Q4. Nonetheless, the year to date of the RoE of the GBM business is still at 18%. Now fortunately, as the economy has begun to recover and our investment programmes have kicked in, our Retail and Commercial businesses have picked up the slack and are showing positive momentum. We expect that to continue, although NIM and impairment trends will moderate somewhat. For Non-Core, we expect to continue our good progress on risk reduction in the fourth quarter. Given our healthy asset sale pipeline, we expect to comfortably exceed our target for year-end TPAs. This progress is likely to bring with it an increase in disposal losses. Best guess, I'd put it around £500 million. We also expect Non-Core's property related impairments to remain elevated. We don't see Non-Core impairments trending down more gradually over coming quarters than what we've seen to date in 2010. In sum, we continue to focus on reducing risk, improving our Balance Sheet and strengthening our Core franchises. We expect continued progress on each of these fronts. With that, let me turn it back to Stephen.

Stephen Hester - *Royal Bank of Scotland – Group Chief Executive*

Bruce, thank you very much indeed. Let's go straight to Q&A if we can.

Questions and Answers

Operator

Thank you, Stephen. Ladies and gentlemen, if you would like to ask a question, please press the star key followed by the digit one on your telephone keypad. We will pause for a moment to give everyone an opportunity to signal the questions. Thank you. Your first question comes from Chris Manners from Morgan Stanley. Please go ahead.

Chris Manners – *Morgan Stanley*

Good morning, everyone.

Stephen Hester - *Royal Bank of Scotland – Group Chief Executive*

Hi, Chris.

Chris Manners – *Morgan Stanley*

Yes. So I have two questions for you. The first one was on Basel Three, thanks very much for the information you gave us about the risk weighted asset inflation, post mitigating actions looks like if you total it all up, you're getting plus £100 to plus £115 billion Sterling. I just wondered if you could give us some colour on what the mitigating actions you're going to take are, which types of assets you're going to be trying to run down or change the way you do business. And the second question was just on GBM. I mean, I know in the past you'd said a sort of £2 billion Sterling revenue number per quarter was what you were sort of looking at. Obviously, the £1.6 we've had is somewhat shy of that. Just wondering about, I know it's very difficult to forecast but, how you're thinking about 2011. Thanks.

Stephen Hester - *Royal Bank of Scotland – Group Chief Executive*

Bruce, do you want to take a crack at those?

Bruce Van Saun – *Royal Bank of Scotland – Chief Financial Officer*

Yes, sure. I'd say on the first question, we should point out that there is mitigation and we have tried to project forward to when those Basel changes will be implemented, so those numbers effectively are our current best estimate as mitigation and run-off. Those numbers, if you asked us, for example, on the Basel 2.5 or the so-called CRD3, we had estimated that was £60 billion a few months ago. We've been able to work that down to the £30 billion range, and part of that is the definitions have clarified around certain aspects of how the framework will apply, and we've changed some of our approach to the business in ways that we think will have very minimal P&L impact. So those gross numbers I think we'll continue to work at chipping away on. There might be some further mitigation that we can do but again, we're cognisant of doing it in a way that has modest P&L impact, and I would point out again the acceleration of the Non-Core run down; a bunch of these RWAs stick to Non-Core, so even in the £30 billion in the 2.5, that's about half GBM and it's half Non-Core, so as Non-Core runs off, that drag from this new framework will be less over time. On GBM, the £2 billion a quarter, so you look at that on an annual basis, that's £8 billion. There's seasonality in the business and so if you looked historically, you might put that split at 55% 45%. If you multiply that out, it comes out about £4.4 in the first half and maybe £3.6 in the second half. So I don't think there's anything alarming in hitting a £1.6 number in a quarter where there was a sluggish market environment. And so I think we're still focused on accelerating some of our investments and in broadening out the fixed income franchise, one of the things that we don't have as big a franchise in as we ultimately aspire to is credit flow trading and emerging markets trading, and that's where I think maybe some of our peers had a little tailwind that we didn't quite catch. But we're satisfied with the health of the GBM franchise and I think there's nothing unusual there.

Chris Manners – *Morgan Stanley*

Fantastic. Thank you.

Operator

The next question comes from Aaron Ibbotson from Goldman Sachs. Please go ahead.

Aaron Ibbotson – *Goldman Sachs*

Yes. Hi there. Good morning. I've got two questions on costs, if I may. The first one relates to Non-Core. I guess you guided a while back for a 13% reduction of Non-Core expenses in 2010 over 2009. You're now up 20% nine months. So I guess that's not going to happen this year but I wondered how should we think about costs in Non-Core for next year? Do you still expect them to be sort of down about half from the run rate of 2009? And my second question relates to expenses within GBM. I guess your cost income ratio of around 65% underlying, i.e., adding back the fair value loss, which is the highest you've had since sort of mid 2008, so I just wanted to know if we end up with a lower run rate than the £2 billion you're aiming for, what flexibility do you have with the cost base? Thank you.

Bruce Van Saun – *Royal Bank of Scotland – Chief Financial Officer*

Okay. Let me start off with the Non-Core answer first. I think the Non-Core expenses have, actually, on a sequential basis started to reduce. That will start to accelerate as these disposals pull through. So we've had a bunch of our Retail and Commercial businesses in Asia and Latin America that have been teed up, signed deals pending closing, and those deals are starting to close and so the people and the expenses that go with that will start to come off. So I wouldn't really deviate from the guidance that we offered in the in the seminar. There might be a little slippage of timing or change to timing, but for the most part, the thrust of those expenses is starting to come down. You'll start to see that. On GBM, I think again, one of the big issues with GBM is where do you set the compensation accruals? We try and calibrate, obviously, what we think we're going to pay at the end of the year and try and true that up each quarter, and we look at how we're performing, we look at how that compares relatively. There is an aspect to this where as more of the compensation goes into deferral programmes, you have baked into the cake some fixed element to the expense base that you didn't have before. So to actually move those accruals and see a commensurate reduction to the falls in revenue in any sequential quarter is less apparent. But I think if you focus on where we are in terms of that bonus accrual on a year to date basis at 34%, that's in the range. Coming into the year, we said it's likely that we'll be 32% to 35%. I think we're right there and so obviously, we still have another quarter to go and we'll go through our year-end evaluation of compensation, so that's not the final answer, but at this point, that's a good guesstimate.

Stephen Hester - *Royal Bank of Scotland – Group Chief Executive*

I think the lens we are more likely to look at it is that, along with all our other businesses, we want our businesses to hurdle in excess of the cost of capital and so that's if you like, the first gating. Obviously, GBM's got an 18% RoE year to date, my guess is it ends lower than that at the end of the year, but still that's I think the key thing that we'll look at, as to whether our shareholders are getting what they need out of this and all our other businesses. Next question please.

Operator

The next question comes from Rohith Chandra-Rajan from Barclays Capital. Please go ahead.

Rohith Chandra-Rajan – *Barclays Capital*

Hi there. Thank you. Good morning. I'd like to ask a couple of questions if I could: one on the margin and the second on the non-core assets. Just on the margin, you've been sort of quite clear about the sort of how far through you are on the re-pricing, the asset re-pricing. I'm just wondering about the mix between the sort of the Retail and the Corporate assets, and in terms of the magnitude of re-pricing on Corporate relative to Retail. So you're more of the way through Retail than Corporate. Is the scale of re-pricing opportunity in corporate the same as in retail? Or is it narrower?

Bruce Van Saun – *Royal Bank of Scotland – Chief Financial Officer*

Well, I think if you look at some of the stats on the NIM retail year over year and corporate year over year, either comparable quarter or year to date, they're not far off from each other. So I would say roughly comparable. And the reason we think Retail is further along in the process is the duration of their asset book is shorter than in the Corporate side. So we've said 75% to 80% pretty much through the asset re-pricing, with Retail north of that and Corporate south of that, and I think that's understandable in light of the duration of the asset books.

Rohith Chandra-Rajan – *Barclays Capital*

Okay. Thank you. And then just on the... on the flip side of that, the drag from... the four basis points drag from liquidity in funding. You talked about the liquidity portfolio being the right size, you're ahead of plans on funding. Just in terms of any indication of the scale of that drag as we go forward from here.

Bruce Van Saun – *Royal Bank of Scotland – Chief Financial Officer*

Yes we obviously did a big quarter in Q3 and we did it throughout the quarter, so some of that impact, you'll get a full quarter effect of that in the fourth quarter, so we've said the trends in the business lines should continue, but some of the issuance, and we'll do a little more issuance in the fourth quarter, would also continue somewhat into the fourth quarter. I do think next year we are expecting a targeted issuance level of about £20 billion, which is down from £35 billion, so the drag from this issuance and then turning around and investing that in the liquidity portfolio should be somewhat less in 2011.

Rohith Chandra-Rajan – *Barclays Capital*

Okay. Thanks. That's very helpful. And if I could then just also ask, just on the Non-Core run down. I mean, you're doing what you had said you would do at the half year, in terms of accelerating the reduction in the Non-Core asset base. In terms of sort of the gains or losses recognised in the quarter, given the £20 billion reduction, I notice there is some gains on the super senior but I wonder if you could talk about the gain as a... the gain or loss as a whole, and also in terms of the pipeline to get you to, I think you're saying well below the £143 target for the year.

Bruce Van Saun – *Royal Bank of Scotland – Chief Financial Officer*

Yes. I guess it's hard to disassociate some of the gains on closing down these trading positions with just the underlying improvement in credit spreads, which has been helpful to the top line in terms of Non-Core. I'd say the guidance that I have offered today in the prepared remarks is, when it comes to below the line disposals, we anticipate some cost associated with executing the pipeline we now have, which I put in the ballpark of circa £500 million in Q4. We'll have to wait and see if those deals actually close up but they're in pretty advanced stages at this point. Above the line in terms of closing down some of the trading positions, it's hard to say based on where market conditions are. At this point, so far in October you've seen continuing favourable credit spread trends to some degree, which makes the lifting a little lighter.

Stephen Hester - *Royal Bank of Scotland – Group Chief Executive*

Thank you.

Rohith Chandra-Rajan – *Barclays Capital*

Okay. Thanks very much.

Operator

The next question comes from Peter Toeman from HSBC. Please go ahead.

Peter Toeman – *HSBC*

Two questions really. One is last year you talked about the impact of pro-cyclicality adding about £75 billion to risk weighted assets. I'm a bit disappointed with the rate at which WRAs at the moment are not declining and I wondered if we could look forward to some benefit from pro-cyclicality going forward. The second point refers to your commentary, your very helpful commentary on Basel Three. I haven't been through it in detail, but I noted that your... the big deductions for you would be in sort of deferred tax assets, and I wondered if you were... you seem to be assuming that the deferred tax assets will have entirely disappeared by the time the Basel... new Basel regime is implemented, and should I construe that as a profit forecast?

Bruce Van Saun – *Royal Bank of Scotland – Chief Financial Officer*

Okay. I'm sorry. So the first one was the pro-cyclicality question. On pro-cyclicality, I do think a lot of that impact resides in Non-Core and so as we run down Non-Core, you're going to see those RWAs decrease, and so you'll effectively be taking out some of the pro-cyclicality as you exit those positions. So I'd say I'm cautious on Core benefits in pro-cyclicality although I think we'll start to see some in Non-Core which will blend in with the overall run down in Non-Core. I'd say if we have seen RWAs stay somewhat elevated. Some of that frankly is really just regulatory related issues, so we've had certain model changes and different treatments of event risk and things like that. We've had relief trades that were part of the ABN regime which have rolled off during the year, so we've had some headwinds around capital relief trades and regulatory which have masked some of the improvement and rundown that we've had in Non-Core. I think going forward, we have obviously now in 2010 towards the end of 2011, we have the £30 billion to absorb, £25 to £30 billion, to absorb with respect to Basel 2.5, but I do think we will see as we continue to de-lever and rundown Non-Core, we'll see momentum going in the other direction. On deferred taxes, again, we have I think a view that we will return to profitability shortly and will be increasingly profitable in 2012 and 2013. And then in 2014 when the deduct element of CRD4 comes in, it only phases in around 20% for the first year, so there will be some impact but I think that'll be a manageable impact.

Peter Toeman – *HSBC*

Thank you.

Stephen Hester - *Royal Bank of Scotland – Group Chief Executive*

Thank you.

Operator

Next question comes from Bruce Packard from Seymour Pierce. Please go ahead.

Bruce Packard – *Seymour Pierce*

Morning. It's really a sort of observation on previous answer, that if GBM really was making returns above its cost of capital then it would be viable on a standalone basis, but I suppose the other... the other thing that I was sort of looking at is the Balance Sheet, which you've made four disposals, there's no currency effect, the Balance Sheet's still increasing in size. So I know it's not very much but I just wondered what was... what was going on there.

Stephen Hester - *Royal Bank of Scotland – Group Chief Executive*

Well, just on... just on the first, on GBM. The... obviously GBM like all investment banking operations in all banks has got a raft of regulatory and other changes in the next few years to absorb, which will clearly impact both sides of the capital and the liability structure and keep impacting it and I think that whole industry continues to have a whole series of re-engineering that needs to be executed to ensure that future returns can support shareholders' needs. Secondarily, clearly for all of the investment banks that are part of bigger financial services group, which is most of them there are all sorts of very deep links in costs, in funding and in client flows that go between them, which can be value destructive if you do not have them. But in any event, that's I suppose the way we think about... think about GBM. Bruce, do you want to takeover?

Bruce Van Saun – *Royal Bank of Scotland – Chief Financial Officer*

Yes. On the Balance Sheet we had the £20 billion Non-Core reduction, which was a positive. The two things that rode against that, one was GBM. I'd say that the GBM uptake in terms of the size of their Balance Sheet was just more seasonal in nature. In June and December you tend to have smaller Balance Sheets and in the end of the first quarter and the third quarters, we tend to have larger Balance Sheets. So I don't see anything unusual in that. The other thing is with the term debt issuance we had during the quarter, we invested much of that, of those proceeds into liquidity, so you had liquidity up, you had GBM up and you had Non-Core down. The net of that was slightly up.

Stephen Hester - *Royal Bank of Scotland – Group Chief Executive*

But let's be clear, we're not that uncomfortable with our Balance Sheet as such. In other words, in terms of Balance Sheet, we think in terms of the capital ratio, which we're comfortable with, we think in terms of having leverage under 20 times, which we've got, and so what we want to do is to get out of the risky assets that are on our Balance Sheet, which is in Non-Core, and we want to return our loan to deposit ratio to where it already is in core through the run off of Non-Core, and that will make the funding of the current size of balance better. So our goal has switched from an absolute decline in Balance Sheet, although we may have some more absolute decline, to making sure that the quality is really tip top and the resilience is really tip top, and that's about the remaining run down of Non-Core, and then when our Balance Sheet grows in our Core businesses, it is their responsibility to make sure that the deposits grow just as fast, to the extent that it's loans that's growing. So I think we've brought the Balance Sheet down from £1.6 trillion to order of magnitude £1 trillion. That was the real reduction and now it's all about Balance Sheet quality and constituency.

Bruce Packard – *Seymour Pierce*

Okay. Thanks very much.

Operator

Your next question comes from Robert Law from Nomura. Please go ahead.

Robert Law – *Nomura*

Good morning, everybody. I wanted to explore a couple of areas if I may. Firstly, broadly, you refer in the statement to considerable work to do on revenue. Could you comment on what you plan to do there from here?

Stephen Hester - *Royal Bank of Scotland – Group Chief Executive*

Well, Robert, I think that we, in a sense, simplifying it, because this is all exhaustively discussed about in all our strategy documents and so on, that we have targeted RoE that's a bit higher than where we currently are, and we have targeted cost income ratios that are lower than we currently are, and we've said that excluding the elimination of costs in Non-Core, that we expect Core costs to be broadly flat through the combination of cost savings making room for necessary business investment, and therefore that the improvement in cost income ratios in Core needs to be driven by revenue, and that's partly why we're spending money to get that. And so our revenue increases will come from two sources, some of that will be economic conditions, in particular the ability to make liabilities profitable once again once interest rates start rising, as Bruce has mentioned. There remains some level of asset re-pricing still going through but that's tailing off. Secondarily, economic activity improving such that we can grow parts of the business once again. And thirdly, our own ability to compete improving, such that we can get a bigger share of customer wallets in repayment for the better exploitation of our inherent franchises, which is what the restructuring in the core business is all about. So all of the above is designed to improve revenues. The pace with which they improve will be dependent on, A, the pace with which the investments pay off and, B, the pace of economic recovery, and obviously right now you feel that might be a little bit slower, that second one, if you believe in market implied curves, but we'll see what actually happens.

Robert Law – *Nomura*

Right. I was just exploring as to whether there are specific actions specific to you were looking at, but it looks like it's more general.

Stephen Hester - *Royal Bank of Scotland – Group Chief Executive*

No. Well, I mean, every single one of our businesses has got a raft of specific actions which is designed to make them more effective in their current franchises, and that more effectiveness in the end you have to monetise, albeit it typically takes some years for things to become measurable, as it were, in terms of the result. So it's a combination of own help, or self help, and economic recovery that makes up the revenue story.

Robert Law – *Nomura*

Great. Okay. The second area was to expand on the helpful disclosure you've given around Basel Three. Could I invite you to comment about the effect of mitigation over and above the numbers that you've already given? Is there sizeable mitigation in these net numbers?

Bruce Van Saun – *Royal Bank of Scotland – Chief Financial Officer*

Yes. We have indicated that these numbers are post what we see at this point as the mitigation actions that we have on the drawing board, plus Non-Core run off to the extent that we have projected that. We do think that there will be opportunities. We're not stopping here. We do think there'll be further opportunities to look at this and unpack it and see if we can bring that down further, but at this point, that's our best guess.

Robert Law – *Nomura*

So where would it be if you... if you implemented it today?

Bruce Van Saun – *Royal Bank of Scotland – Chief Financial Officer*

It's a higher number. I think it's complex if you're trying to draw parallels with other entities, I don't think it's a worthwhile exercise, given the complexity of our Balance Sheet and the Non-Core run off, so we haven't given that number, Robert.

Robert Law – *Nomura*

Okay. And in terms of the revenue impact of mitigating actions, can you give us some feel for that?

Bruce Van Saun – *Royal Bank of Scotland – Chief Financial Officer*

So far, what we've done at this point is the "de minimis" so we don't expect a material impact to revenues. We're cognisant of trying to balance capital optimisation with the revenue profile. I think it gets harder from here in and some of the things, if we wanted to do further mitigation, could have revenue impact, but at this point, I wouldn't flag anything in particular.

Robert Law – *Nomura*

Okay. And it looks likes you've got about a net, a £100 billion addition to RWAs post mitigation. Would I be right in thinking that most of that is allotted for GBM?

Bruce Van Saun – *Royal Bank of Scotland – Chief Financial Officer*

No. I'd say it's maybe 60% GBM and 40% Non-Core, rough numbers.

Robert Law – *Nomura*

Right. Okay. So if you then apply that to GBM, I mean, your current run rate of profit's about...

Bruce Van Saun – *Royal Bank of Scotland – Chief Financial Officer*

We're 18%. Our RoE year to date is 18%, Robert.

Robert Law – *Nomura*

Yes.

Stephen Hester - *Royal Bank of Scotland – Group Chief Executive*

But it does imply GBM's RWAs could get to, say, £200 billion at the end of the whole process.

Robert Law – *Nomura*

Yes, which would bring down the return on equity to about 14%, and if you then start applying the levy to the GBM business, you start to get down towards cost of equity type numbers, and I wondered what your thoughts about that were, in terms of...

Stephen Hester - *Royal Bank of Scotland – Group Chief Executive*

I mean, I think... I think, Robert, you're exactly right which was why I made the comment earlier on in this call that the investment banking industry as a whole, and I think you'll find no investment bank where you couldn't have this exact same discussion, has to process in the next few years changes to business models to reflect the new amounts of leverage, costs of leverage and capital deployment, and indeed the other industry initiatives such as central clearing of derivatives and so on. All of these will require reengineering within that end of the industry in order to be able to restore or return or keep returns to a level that is acceptable to shareholders, and you've just done the numbers that show it's not a great drama for us, but there is some work for us to do on this, as there is for every investment banking arm of every bank, and so I've always been clear about that, that there's some work to do in this industry, in this... in that bit of the industry which is... which, A, I believe the industry will do and secondarily is why I'm very happy that two thirds of RBS, unlike the majority of our international competitors, is Retail and Commercial which obviously has less reengineering in these areas, although has got reengineering in other areas like fees in retail banking and things like that which it has to also do.

Robert Law – *Nomura*

Right. I mean, I guess I'm just trying to see what ideas you might have in that process and where you might lead that process or whether you'll see what others do.

Stephen Hester - *Royal Bank of Scotland – Group Chief Executive*

I think we're unlikely to have any unique ideas. Wish it were otherwise, but I think we're likely to be... to have similar ideas to other people.

Robert Law – *Nomura*

Thank you.

Bruce Van Saun – *Royal Bank of Scotland – Chief Financial Officer*

And I think it boils down to focusing on the things that you're... that you're really strong at, where you have defensible franchises, then you want to put your capital against those things. And so I think each of the investment banks will step back and look at their business mix and concentrate on certain activities and maybe exit other activities which ultimately could improve the pricing environment for the people who have good franchises.

Robert Law – *Nomura*

Thanks very much.

Stephen Hester - *Royal Bank of Scotland – Group Chief Executive*

Thank you.

Operator

Your next question comes from Edward Firth from Macquarie. Please go ahead.

Edward Firth – *Macquarie*

Yes. Good morning. Just a detail question, so apologies if it's... if it's in the statement somewhere and I've missed it, but could you just clarify, at the 30^{th} September what the RWAs are in the Non-Core business that aren't covered by the Asset Protection Scheme?

Bruce Van Saun – *Royal Bank of Scotland – Chief Financial Officer*

I think it's about half.

Stephen Hester - *Royal Bank of Scotland – Group Chief Executive*

We'll find out. Can we come back in a second once we've found it?

Edward Firth – *Macquarie*

Yes. Sure.

Operator

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

Manus Costello – *Autonomous*

Morning, everyone. I just wanted to focus on the US mortgage situation please. I wondered firstly if you have taken any provision within Citizens for breaches of reps and warranties on US mortgages. And secondly, if I look at the data which has been provided by people like Clayton Holdings, and I look at the level of underwriting which RBS Greenwich achieved during the course of 2005 to 2007, it does look like there is potentially substantial risk for Greenwich of litigation in the future and I wondered if you could talk about how you're dealing with that at the moment please?

Bruce Van Saun – *Royal Bank of Scotland – Chief Financial Officer*

Yes. Sure. We have no reserves at this point. We don't think they're necessary or appropriate. I would say on a Citizens standpoint, Citizens was very focused on prime activity and they don't do any robo-processing of foreclosures and so we think we dodge at this point all those issues at Citizens. It's been... it's been a very clean business as we've gone through and evaluated our risk there.

Manus Costello – *Autonomous*

There have been no... there have been no put backs then from the GSEs to Citizens so far?

Bruce Van Saun – *Royal Bank of Scotland – Chief Financial Officer*

The put backs are in the low single digit millions, so virtually the "de minimis".

Manus Costello – *Autonomous*

Okay.

Bruce Van Saun – *Royal Bank of Scotland – Chief Financial Officer*

And that would similarly be the situation at GBM to date. We are watchful there but I think given the nature of the business that we've undertaken, we're not in anywhere near the risk orbit that some of these big US originators were.

Manus Costello – *Autonomous*

And that, sorry, just expand on that a bit, Bruce, why is that? Is it from a Citizens perspective, sorry, from a Greenwich perspective rather than a Citizens perspective?

Bruce Van Saun – *Royal Bank of Scotland – Chief Financial Officer*

Yes. I think it's really the focus to the business and the type of things that we originated and where the reps and warranties that were offered, we think our legal position is pretty good, pretty solid.

Manus Costello – *Autonomous*

Okay. Thanks.

Stephen Hester - *Royal Bank of Scotland – Group Chief Executive*

We can now answer the RWA question, by the way.

Bruce Van Saun – *Royal Bank of Scotland – Chief Financial Officer*

Yes, and in the RWAs in Non-Core, the total RWAs are £167 billion, of which around £60 are in APS and the balance not in APS. Next question.

Operator

The next question comes from Arturo de Frias from Evolution Securities. Please go ahead.

Arturo de Frias – *Evolution Securities*

Yes. Hi. Good morning. I would like to ask a bit more in detail about profitability for the investment bank, particularly linked to mitigation. I mean, you have said that you think that from now on the impact from mitigation is going to be worse than what it's been until now, but I mean, we don't have any clear idea of how bad is that going to be. Could you at least give us, I mean, I know this is difficult, but could you at least give us some guidance in terms of what could be the impact on return on risk with the assets that you would expect from these mitigations, i.e., those RWAs that you expect to decrease, will it take with them, or do you expect them to take with them a proportional amount of profit to the total RWAs in GBM, or more or less? What's your view there? I just want to have a view of how big is going to be the impact of mitigation on the overall return on risk with the assets of GBM?

Bruce Van Saun – *Royal Bank of Scotland – Chief Financial Officer*

Well, if I could just go back to the beginning of the discussion, I'd say a lot of the mitigation was redefining the GBM focus and business mix, and so getting out of things like structured credit and correlation trading. Those have been moved into Non-Core and so those income streams go away, those RWAs go away. We don't think that was a good deployment of capital to begin with. The thing that is left in GBM we think is a good business, and we'll look carefully at whether any mitigations that we take are net additive to our overall returns in the business. So I would just put your mind at ease that we're not going to do things that we think are not economically good decisions to take. Stephen, I don't know if you want to add to that?

Stephen Hester - *Royal Bank of Scotland – Group Chief Executive*

Yes. No, I think that's right. As I say, our goal will be to try and make sure that GBM continues to earn above its cost of capital and if for whatever reason there will be moments when it didn't, our goal will be to figure out what are the right correcting actions to move back.

Arturo de Frias – *Evolution Securities*

But... okay, thanks for that, but given that... I mean, your current return on risk with the assets in the investment bank is in the region of 1.4%, and you are giving us net RWA increases, because of Basel Three, so we don't really know what is going to be the size of mitigation, but if we assume for the sake of... or if I assume for the sake of discussion that the mitigation is going to be, I don't know, £40 billion, to put a number on the table, should I apply the 1.4% current return on RWA in GBM to those £40 billion?

Stephen Hester - *Royal Bank of Scotland – Group Chief Executive*

No. What you should do is assume that our effort will be to have GBM make a return in excess of its costs of capital, and in doing that we will play with all aspects of the business, whether it be the cost base, the people, the compensation, the earnings on assets, the asset mix, the amount of assets, all of those will go in the mix in order to try and make a return that repays our shareholders for having that business. That's what we will try and do and frankly, there are so many moving parts that to try and simplify this business down to it's a return on asset X and another asset's Y and that's the answer, I think will lead you in the wrong direction.

Arturo de Frias – *Evolution Securities*

Okay. May I ask you something else please? Again, I know this is... this might be a difficult question because regulators will have their own decisions in the next few months, but what is... I mean, is in our view the chance of a 10% local finish in the UK high or not?

Stephen Hester - *Royal Bank of Scotland – Group Chief Executive*

Well, as I said many, many times, I think that we're focusing on the wrong issue, that banks like RBS and our competitors I think will have capital ratios which of course are bounded by what the regulators require, but what... which in the end are driven by the market place and what our creditors require in order to want to fund us in a safer way than we have been funded before, and for us to have credit ratings without government haloes that are in the AA category.   And so I would expect, if you like, market given credit discipline to be important and for people... and people who think it'll simply be regulated ratio times X I think are in the wrong place on this. That said, it's impossible to know what the UK finish will be and we wait with interest... all the obvious discussions are being had about level playing fields and competitiveness.

Bruce Van Saun – *Royal Bank of Scotland – Chief Financial Officer*

Yes, and I would say you have, on the one hand you have US banks in their third quarter releases saying they think they can operate at 8.5 to 9% and now you have the other example where the Swiss report came out with a 10% recommendation. I think all of that gets taken into account when the global regulators sit down and talk about that. We have said our... publicly, before all of this work on Basel came out, when we embarked on the journey as a plan, that we thought we needed 8% plus Core Tier one ratio, recognising that Core Tier one was quite a bit heavier in terms of overall equity protection, given the changes to RWAs. If you ask me where could we operate and retain the credit rating, I think where the US is saying, 8.5 to 9% is something that I would feel comfortable with. We'd have to see, as Stephen says, whether the rating agencies thought that was appropriate, but again, the regulators aren't taking a poll. They're going to have their discussions and come out with a number and we'll learn what that is in the second quarter of next year.

Arturo de Frias – *Evolution Securities*

Can I ask you broadly the same thing from a different perspective, but would you feel comfortable if in the next few quarters you would see your Core Tier one falling below 10%?

Bruce Van Saun – *Royal Bank of Scotland – Chief Financial Officer*

Would we feel comfortable? I think our own projections are that our Core Tier one is likely to build as we gain profitability, we are not a dividend payer through the EU Stop until the fourth quarter of 2012, so ultimately that's a.... I would say if you look at the next two year outlook that our Core Tier one ratio will be building.

Arturo de Frias – *Evolution Securities*

Okay. Thank you very much.

Operator

The next question comes from Lee Goodwin from Citi. Please go ahead.

Lee Goodwin – *Citi*

Morning, gentlemen. I've actually got just two or three questions, if I may. First one, just a follow up on that debate there. I'm very interested in this point about the market disciplines and what the market will demand post sovereign haloes, in whatever form that takes. I just wonder whether it will be possible for you to venture where you think the market will require Core Tier ones to be for an AA rating? I mean, I know that's desperately difficult to get at. I appreciate that. But if we say we're at 10% now, do you think that's the right ball park for the market?

Bruce Van Saun – *Royal Bank of Scotland – Chief Financial Officer*

Well, I think if you... if you actually, and you can... you can go look at how, for example, the rating agencies have detailed road maps as to the factors they consider in assigning the credit rating, and it comprehends the capital position, the liquidity, the funding position, it goes to lots of other qualitative things, the quality of governance, the quality of risk management in the organisation. It's a very, very diverse algorithm that you need to score well across a number of measures, consistency of earnings, risk appetite, and so we have basically a road map as to how we want to improve across all those dimensions to get there. So it sounds like a little bit of a dodge, but I don't think if it's that number, that translates to the AA, because that number in the context of all these other aspects is what determines where they're going to rate you.

Lee Goodwin – *Citi*

Okay. I mean, I suppose what I was trying to get at there, Bruce, these are... the removal of the halo so to speak is something which really applies to the investment banking divisions of the banks, so it goes back to the earlier points about having to hold, potentially having to hold more capital against that division in order to make the market comfortable with it, and to give you the rating you need as a Group, and I just wonder whether you think that's where you are now without haloes attached shall we say to at least, to the investment banking division is sufficient.

Stephen Hester - *Royal Bank of Scotland – Group Chief Executive*

Can I just point out, by the way, you're not right. The banks with equal sovereign haloes, i.e., the difference between the underlying bank financial strength rating and the top state rating, Lloyds would have just as much of a halo as RBS, for example, as would Bank of America and CitiGroup, which obviously, although they have investment banks, have very, very dominant

Retail and Commercial banks. So you're simply not right in terms of where the halo lands, but Bruce is right, everyone would like a real simple life and it's Tier one ratio X and everything else I'll build into my models as a capital return. I'm sorry, the world just is not like that. We're not at that point of certainty. One single ratio is not going to tell the story in any event, and we just have to live through some in the round, banks improving their quality resilience and seeing how the market, including the rating agencies, takes that and we can't offer you the simplicity, but I understand why you'd like it. We just can't offer it.

Lee Goodwin – *Citi*

No. I'm sorry. I mean, maybe we can continue the debate another time. I'm really thinking about the removal of the Group guarantee as it may apply to the funding of the investment bank divisions, but we can come back to that sort of debate. I just want to ask a question on the Basel Three and the impacts you think come under Basel Three, in terms of the definition of Core, and you don't mention pension deficit and I wondered why you didn't mention it and where you think... whether you think that could be a factor as a deduction from the current Basel Two Core Tier one?

Bruce Van Saun – *Royal Bank of Scotland – Chief Financial Officer*

Yes. That's already deducted, so you have the pension deficit. That's in the numbers now. There are further changes around the capital deducts that would be incremental to what we showed today, because what we showed today was the RWA impact of CRD3 and CRD4. But again, we think those are manageable. They phase in over time. They also run down, some of the ones, the... I think the expected loss, the DTAs, material holdings when we exit our investment in insurance, so again it's fairly complex and we may post additional guidance on that as that's clarified when we get to annual results.

Lee Goodwin – *Citi*

Okay. And then my final question is just related to your guidance on the hit that you've had to take in the fourth quarter. I wonder if you could just put that £500 million in context, in terms of how it is equivalent to what you've taken in the third quarter, and also what you think you would realistically be looking to take next year.

Bruce Van Saun – *Royal Bank of Scotland – Chief Financial Officer*

Sure. We didn't take much in Q3. We did take about £400 million back in Q2, so on a cumulative to date basis, the things that show up below the line, i.e., in the exceptional category, it may be about a bill this year. We haven't finalised our budget for next year. I think we'll be in a position to give some guidance on that when we get to annual results.

Lee Goodwin – *Citi*

And can I just check then, Bruce, where you're showing this in your numbers? Are you putting it below the line in the restructuring costs, are you?

Bruce Van Saun – *Royal Bank of Scotland – Chief Financial Officer*

No. It's under where there's disposals. So we had the liability management gain of (overtalking).

Lee Goodwin – *Citi*

Right. It's under that... it's in that line though, so it's not in Non-Core other income, that's what I was trying to...

Bruce Van Saun – *Royal Bank of Scotland – Chief Financial Officer*

Yes. Well, there's some in running down the trading positions, those show up and individual asset sales, like a loan sale, those would show up in other income, but when they're more whole businesses, those would show up under the line.

Lee Goodwin – *Citi*

Yes. Understood. Okay. So it's mixed. Thanks very much. Thank you.

Bruce Van Saun – *Royal Bank of Scotland – Chief Financial Officer*

Okay.

Operator

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

Michael Helsby – *Merrill Lynch*

Thank you. Morning, everyone. I've got two quick questions and then just a broader one. Firstly on the Non-Core margin actually. I think as recently as our conference you put a slide up suggesting the Non-Core margin would be flat going forward and clearly it was... it's down quite a lot versus the second quarter. Have I... have I misinterpreted what that slide was saying or is there something funny going on in Q3? Second question is on the tax rate. The effective tax rate is a hell of a lot lower than the statutory tax rate in the third quarter, and I know the tax rate was a bit of an issue at the half year, because clearly it was very, very high and you left us with the impression that it was going to remain sort of structurally high for the next 18 months, so I was wondering if you could give us an explanation of what's going on with the tax rate? And then just on the broader question, I hear what everyone's trying to ask on the Core Tier one and I hear your response, and I think it's clearly very sensible that you're going to run for what the creditors like, and I think it's... is it... I'm broadly assuming that that's around about 10%. You don't need to comment on that but I guess the key question and the fundamental question is that if it was 10%, would you still be happy that you'd be able to generate a 15% RoE on that level of capital base? And just as an add on to that, I was just wondering if you could give us... clearly the operating performance year to date has been sequentially improving, so I was just wondering if you could give us just a broader sort of confidence message, whether you're more confident in your ability to deliver that RoE today than maybe what you were six months ago. And sorry, that was quite a few questions.

Bruce Van Saun – *Royal Bank of Scotland – Chief Financial Officer*

I think there's a three parter there, if I copied them down correctly, Michael. But the first one, on the Non-Core NIM, I think what you're seeing there is really two things. One is in these disposals, we're selling off assets and so it's hard to forecast what the NIM is, so the yield on those assets is and so you're going to have some mixed shifts as we... as we exit portfolios, and that could cause some volatility in terms of things bouncing around. You also have our higher costs from doing some of this term issuance are allocated out to the divisions, and Non-Core is a recipient of that, so they're taking some of that. So that would explain the NIM. On the tax rate we have I think still a structural situation where we're losing money in Ireland and we're really not able to assume tax shelter on that. We have a similar problem in the Netherlands, although that was less of a drag this quarter, which is why the overall tax rate appeared better than it did in Q2. I do think at these low levels of income that you'll see in 2011, until we actually get back to full powered profitability and some of the drain on losses in Ireland start to abate, you'll see an odd tax rate until we get to 2012 and 2013, which is when it should move back and look more like a typical effective tax rate that's closer to the statutory rate. The third question on the Core Tier one at 10%, I think it's not... even though I think we could operate with somewhat less core tier one than that, I do think for planning purposes, people are bookmarking 10% and saying that could be the outcome. It very well could be. Do we think we can still achieve a 15% RoE on that kind of a Capital ratio? I guess our view has always been over time that need to earn a return that's in excess of our cost of equity and that we would re-price our products in order to get that, or change our allocation of capital so that we can get that, and so I think that's consistent with the ranges of Core Tier one that we would expect to operate with and we haven't moved off our 15% Core RoE target.

Stephen Hester - *Royal Bank of Scotland – Group Chief Executive*

But I think the only... last bit of that was about confidence and I would say our confidence in our execution probably rises for so long as our execution goes well, but obviously the economic climate is something that will be an exogenous and which could delay things if interest rates stay low for longer and we have to see how that... how that works through. I think we're now coming to a good point to end. We'll take one last question if anyone has one. No. Okay. Well, in that case, thank you very much indeed for attending. Obviously Richard O'Connor will be around to answer any follow ups that we didn't deal with on the phone and look forward to speaking to you again for the full year results. Thanks very much. Bye bye.

Operator

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