Royal Bank of Scotland
Moderator: Sir Fred Goodwin
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Operator: Good morning ladies and gentlemen and welcome to today's RBS conference call. Our speaker today is Sir Fred Goodwin, Group Chief Executive who is accompanied by Fred Watt, Group Finance Director. Please go ahead Sir Fred.

Sir Fred Goodwin: Thanks. Good morning everyone. Thanks for dialling in this morning. Obviously the objective is to go through our pre-close trading update with you. I don't have a lot to add to what's written in the document itself. It's hopefully self explanatory and straight forward. It's certainly intended to be. There aren't any hidden messages in there, any Machiavellian themes we'd like to develop with you. The business continues to perform well and we would expect our results to be in line with expectations and a good set of underlying financial metrics. We have tried to spell out in the document a little bit of the flavour of how income has been developing, how the various divisions have been performing and the other important credit quality and capital positions, all of which I think are self explanatory and would be in line with your expectations. All of the integrations continue fully on track. Churchill integration has now been completed. Not a lot really to add to what's in the release itself.

We're happy to take questions and pick up any themes that you would like to explore. I've got Fred Watt and Richard O'Connor with me and they will come in as necessary to fill in any points of detail. So without any further delay I'm happy to turn over to you for any questions.

Operator: Thank you Sir Fred. 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 just a moment to give everyone an opportunity to signal for questions. We will take our first question today from Simon Samuels of Citigroup.

Simon Samuels: Morning. It's Simon Samuels here at Citigroup. Can you – sorry it's just sort of trying to understand as I'm sure a lot of people want to understand what you're actually guiding on margins. So obviously we can read to be slightly lower than the first half, is it possible to give some parameters or frameworks for what we're talking about by the phrase 'slightly lower'? You had that 23 bit decline.

Sir Fred Goodwin: Nothing of that order of magnitude, Simon. We went into this on – and again it's a significant component of this as mix related rather than like competitive pressures. We're seeing continued good growth in large corporate lending and mortgages where the profitability is good, the return in capital is good but the margin impact in terms of its mix effect pushes it down slightly and emphasis on the word slightly and the yield curve in the US applies a bit of pressure to Citizen's business but we're – the word slightly is definitely the right word.

Simon Samuels: Okay can I just try and push you just a tiny weeny bit further and you know at the risk of ruining my reputation and being too analytical here…so in the twelve months up to the first half, the margin fell 23 basis points, so kind of 11 basis points sort of per six months run rate if it was equally spread. Are you telling us – to be clear – that it is declining by less than that amount in the second half of the year?

Sir Fred Goodwin: Yeah.

Simon Samuels: That was a yes?

Sir Fred Goodwin: Absolutely, yeah.

Simon Samuels: Okay thank you very much.

Sir Fred Goodwin: Absolutely. I mean don't be in any doubt about that Simon.

Operator: Our next question today comes from Michael Lever with CSFB.

Michael Lever: Hi good morning everybody. I want to come back actually to Simon's question on margins I'm afraid and I also want a question on capital. Apologies for this because it's very sort of dull stuff, but if you look at the comment you have made, you said that you expect the margin for the full year to be slightly lower than the first half of 2005. If that margin for the full year happens to be – let's pick a number – seven or eight basis points lower than the first half of 2005 full year, then mathematically the second half margin will have come down by more than double digits compared to the first half. So I want to be absolutely clear on this because you know a full year margin which is just down six or seven basis points still implies a second half margin which would be down compared to the number you published at the first half of the year by double digits. Are you saying that the margin in the second half of the year compared to the margin you reported in the first half of the year, the actual second six months average margin is down by less than double digits basis points?

Sir Fred Goodwin: I think we're getting sucked into detail here Michael. I agree with your arithmetic analysis, you know if it was down by that amount that would equate to a higher full year figure but I don't recognise the numbers that you're talking about. If that's a helpful answer…the danger is we get into one of these discussions where you keep picking numbers until you know.

Michael Lever: Sure.

Sir Fred Goodwin: But I would not be taking it to numbers as large as the ones you are talking about.

Michael Lever: I think I hear your answer. Thank you. Now on the question on capital; I'm looking for a little bit of guidance on the degree of deceleration which has obviously occurred in the risk weighted assets in the second half of the year and also the extent to which your tier one ratio has benefited from capital which will emerge from tier two currently ineligible taxes up for capital ratios, because as I understand it, you set out a target some time ago – the tier one ratio would be over 7%. That target excluded any external capital raising and therefore depended basically on three things; one is the retained earnings including the gain on Santander, two was the rate of risk weighted asset growth and three is the extent to which any tier two capital migrated up to tier one. So what I'm looking for is some guidance on the speed the risk weighted up to gross in the second six months and some guidance on the extent to which tier two capital will be migrating up to tier one to help your target.

Sir Fred Goodwin: Now obviously just the simplest part to answer Michael, is there's no migration of tier two up into tier one or incremental capital raising but I think Fred will say a word about capital raising in a minute – but the moving parts in getting to over 7% as far as I'm concerned are the generation of results in the business, the generation of capital and the risk weighted asset growth. The generation bit is hopefully covered by the announcement this morning, if I deal with the risk weighted asset growth, decelerating isn't really a feeling that you would get within the business Michael. I think the issue is, if we were to look at underlying trend of risk asset growth you would get a good sense of fairly consistent growth through the year. The issue that we're pointing to in the announcement is that there was a spike at the half year which in a mathematical sense yes, there would be a deceleration in the second half but there isn't a deceleration in the business. The business has carried on pretty much unabated but there was a particular spike at the half year which will not be replicated at the full year so the risk weighted asset position does contribute to the capital as well. I'll pass the floor to Fred now on the capital front.

Fred Watt: Thank you. Yes, Michael at the half year I said that there is assumption of 7% was not based on any net capital issuance in the second half. There might be a very small net addition to capital in the second half just because of timing of calling preference shares which we're about to do but I can assure you that if it is a small amount – and it will be – we're not relying on that to achieve a 7% target.

Michael Lever: Right. Mathematically – I'm going to press you a little bit further on this – I mean mathematically it seems to me that the rate of risk weighted asset growth in the second half of the year to achieve an over 7% tier one ratio from a combination of those moving to risk weighted assets and retained earnings, something has to happen. Either risk weighted asset growth must be 4% or less or retained earnings must be higher or a combination of those two things. I mean that seems to be the irrefutable logic and therefore I'm interested in whether risk weighted assets have grown at all from the spot position at 30th June?

Fred Watt: And the answer is, yes they have but you've got to look at the full year growth Michael. This half on half, artificial point in the middle year distorts things particularly this year. Full year growth in RWA's will be entirely in line with what you'd expect at the beginning of the year and entirely in line with what we've achieved in recent times but it does imply a growth in the second half in RWA's, albeit at quite a lot lower rate than appeared to be in the first half.

Michael Lever: Thank you. I'll leave it to somebody else to ask the obvious question on buybacks.

Sir Fred Goodwin: Very kind of you, Michael.

Operator: Our next question today comes from Peter Toeman with HSBC.

Peter Toeman: Morning. I was just wondering if you could give some clarity on your statement about unsecured credit losses because you say in one hand that arrears seem to be levelling off but it's too early to conclude that arrears have peaked. So it seems to be a rather ambiguous statement. I wonder if you'd give us some detail on your thinking here?

Sir Fred Goodwin: I mean it wasn't intended to be ambiguous Peter, but I guess we're seeing a levelling off in arrears which is one of the early metrics that points towards alternate bad debt expense. What we all know is that arrears can pick up again just as quickly as it can slow down, so I think it would be a brave person at this point who would say oh well, that's it, everything's going to be okay. That said, they have moderated and it's gone on for sufficiently long that we feel able to make the observation, but we make it in a spirit of trying to inform people what's going on. I can't predict the future any more than anyone else can, but I think it's a helpful turn of events rather than unhelpful but it wouldn't strike me as quite prudent at this point to say oh, you now, the cycle is done but it's somehow meant to be contradictory.

Operator: Our next question today comes from Michael Helsby with FPK Stockbrokers.

Michael Helsby: Hi, thanks. Morning chaps. Just to go into the capital, I just want to be clear in the second half of the year, you get the benefit of the reduced dividend. How much benefit do you get from the split dividend coming through in the second half of the year as well?

Sir Fred Goodwin: Pretty small, Michael. It was actually quite small.

Michael Helsby: Okay, thank you.

Operator: We will now take a question from Ian Smillie with ABN Amro.

Ian Smillie: Good morning, it's Ian Smillie from ABN. Could I please ask, the new business margin comment that you make in retail markets, would it be right in assuming that the current level, which is slightly higher than the first half which is still below the average level of new business margins in the retail business market… you make the comment that the new business margins are showing signs of improvement in the second half – would that number still be lower than the existing average new business margin? In other words the new business is looking a little better but the overall averaging effect which there'll be, drifting down – is that fair?

Sir Fred Goodwin: I think it's fair if that's what Gordon said at the half year, Ian. Gordon said and I can't remember word for word, but it was something like 'for the first time in many months we're writing new business more than the group as a whole and that trend has been with us.

Ian Smillie: And what product are you talking about there, Fred, when you say that?

Sir Fred Goodwin: Unsecured lending in particular.

Ian Smillie: And is that true on most retail market products?

Sir Fred Goodwin: On a good proportion, I mean it's not only confined to unsecured – there's been a general – mortgages, for instance, I would say at a product level it's improved. It's an interesting point Ian, to the general development of margins. I mean the story in the first half wasn't so much about front group margins deteriorating in the first half, it was about mix of business and back group roll off, rather than the front deterioration, but the second half I think is definitely up. Again why we make the comment that particularly in the retail areas, we're seeing front new business or new business margins improving over quite a wide range of products, not universally, but quite a wide range.

Ian Smillie: And when you adjust that for the mix point that you make, is that true for the division as a whole, or because the unsecured group is growing less quickly, does that bring down the average for the division as a whole?

Sir Fred Goodwin: The division's down a little bit because there're a lot of mortgages getting sold, so the mix point is what dominates, if you like.

Ian Smillie: Thank you very much.

Operator: We will now take a question from Tom Rayner of Citigroup.

Tom Rayner: Good morning, it's Tom Rayner of Citigroup here. Hi, I'm not going back to the broad question on margin – I just wondered if you could give us a feel for how important the relative – you've led up to real drivers – I mean how important the shape of the yield curve flattening in the U.S. was and whether there's any signs that as a driver of margins, that may become less or more important going forward.

Sir Fred Goodwin: I think the shape of the yield curve in the U.S. has puzzled people for a little while, Tom, so I find it difficult to say it will be gone in a couple of months or whatever, but I do believe it to be a transient effect rather than a permanent one. It affects the industry as a whole as opposed to just us and what I think it is doing, is highlighting a number of players or participants in the U.S. market who have made a living out of trading around the yield curve rather than perhaps the more mundane activities involved in banking and who are finding life particularly difficult at the moment. I think it could well turn out to be a market-altering circumstance, so the medium-term outcome of it might actually be quite helpful, but at the moment it feels that the yield curve's compressing everyone in the market's margins by a little bit. But you will still like the numbers of Citizens.

Tom Rayner: Sure and just to remind me, when you initially bought Charter One, you did take some measures to reduce interest rate exposure when the Charter One was bought. Was that more directional interest rate risk rather than curve, is that something that can't really be easily hedged away?

Sir Fred Goodwin: I think you're right there, Tom. There are some aspects of structures in the U.S. – it's just very difficult to hedge.

Tom Rayner: Ok, thanks a lot.

Operator: The next question today comes from Mark Thomas with KBW.

Mark Thomas: Morning. Just a quick one. Your comment on the increment obviously in terms about bad debts in retail, could you give a little bit more in terms of cost – in the first half you said there was heavy advertising expenditure – has that recurred in the second half, or just comment on costs in retail?

Sir Fred Goodwin: I don't remember the advertising one, Mark, maybe we did but I don't think we were signalling that costs in the first half were particularly out of line in retail. Cost going forward, I think don't think there's any guidance I'd give you beyond what you would probably be expecting, there's been no lumpy things in retail costs in the second half, but then I don't think there were in the first half.

Mark Thomas: I thought there was 20 million for advertising in the first half for First Active.

Sir Fred Goodwin: Not in retail. Sorry, we might talking at cross purposes then. That was in Retail Direct.

Mark Thomas: Sorry, could you comment on the cost in Retail Direct as well then?

Fred Watt: You're right. That sort of cost in Retail Direct, you wouldn't see in the second half.

Operator: We will now take a question from Daniel Davies with Exane.

Daniel Davies: Thanks everyone. Fred, I just wanted to ask a question about pension deficits. I don't want to push an agenda here, just really invite you to comment on pension fund deficits as a part of Tier 1 capital, given that it's become a bit topical because of the comments made earlier this week.

Sir Fred Goodwin: It's a very important subject, it's one where you'll remember we made an actual cash contribution last year to the pension fund – those were the 1.1 billion funds – that was in last year's numbers. I think HBOS was just bringing themselves up to speed with what we actually were saying last year in terms of the very huge impact of deficits so there's nothing that's sort of changed in our mind to make an impact, or additional funding required at this stage.

Daniel Davies: Thanks very much.

Operator: As a reminder, ladies and gentlemen, to ask a question, please press *1 on your telephone keypad. We will take a follow-up question now from Michael Helsby with FPK Stockbrokers.

Michael Helsby: Thanks very much. I just want to get back to, on the margin – I mean clearly it feels like the margin guidance in the second half is better than what most people had in – the bad you're saying is in line with expectations. That feels like the cost growth in the second half of the year is running ahead of what people were expecting. Could you just say, is that reasonably correct or if so, where is that coming in, is it in the corporate business?

Sir Fred Goodwin: On that one, Michael, I think we may be off to a wrong premise here and I don't think – we're not anything about costs being in line with expectations but I think where the prescribing margin is where most people had it. I don't know what I've done, I'm not familiar with where your numbers might be so I'm sorry about that, the generality of it, I don't think we are signalling anything out of line.

Michael Helsby: Okay, so basically on the margin, you're saying maybe down about 4 or 5 basis points on the first half?

Sir Fred Goodwin: I think we've said all we're saying about it, I don't…

Fred Watt: We're not implying, Michael, that we are doing a lot better than people were thinking on margin and therefore the second part of your question just isn't relevant.

Michael Helsby: Ok, that's fair enough.

Operator: Our next question comes from Robin Down with HSBC.

Robin Down: Morning. I just have a couple of questions. The first is on the CBFM business across the European sort of banking space, you've seen very strong Q3, in particular dealing profit numbers coming through and I just wondered whether or not you would like to see a similar trend for RBS. The second question – I think everyone's been avoiding asking this one – but the dreaded subject of share buybacks, it's been a while I think since you've updated us on your favourite chart showing maybe, probably at these levels you would do sort of buybacks, but you're moving next year into the sort of 7% plus tier one ratio level where I think previously you talked about maybe doing a buyback. I was just wondering if you had any form of update you could give us on your thinking on that subject.

Sir Fred Goodwin: Why don't I deal with that one first. You did quite a good job of answering your own question, Robin. I think the landscape is pretty clear from our point of view. First of all, nothing has changed about that chart, certainly not a dreaded subject around here. The chart guidance remains the same, so in other words it's converted from UK GAAP into IFRS in tax, with 7% and 8% are still important numbers. The guidance today is unequivocal in a sense it says we'll exceed 7 at the end of this year and we're generating capital in the business strongly ahead of risk weighted asset growth and with nothing on the radar screen of acquisitions, so I guess you can all work that through, what sort of options that may or may not create going forward, but it certainly seems to me to create more options than there have been in the recent past.

On the dealing profits subject, dealing profits has kind of faded away as a prescription now under IFRS, but the comment we've put in about financial markets income was trying to give a sense that yes, it has performed pretty well through the year. You'll remember there was financial market activity in this area is hinged very much on what business we do on behalf of customers, so we tend not to see quite the same dramatic peaks and troughs – obviously we've had good results and what is certainly contributing is the good performance in CBFM.

Operator: Our next question today comes from Michael Lever with CSFB.

Michael Lever: Actually, there's one from me and one from my colleague, Jonathan. I just want to go back a little bit to the dreaded subject about buyback, having said I'd leave it to somebody else, I'm afraid it can't be left.

Sir Fred Goodwin: Go for it then, Michael. Is this your question or is this your colleague's question, just so I know.

Michael Lever: This one is mine. My colleague's will follow. You seem to be prepared to make statements which are quoted on Reuters on the subject of buyback which I'll not obviously quote in the pre-close trading statement, that every day brings the possibility of buyback closer, so it's quite clear that the mathematics are that you're generating around 3.5 billion of retentions on the back of consensus earnings, of which you probably need about half to fund organic growth. So

I'm just wondering, I think what I believe the market is perplexed about is why you're being so coy in promising buybacks, until you cease to be so coy in prompting buybacks then I think the market will not believe that its actually coming. Because it's quite clear, as you say, everybody knows you've got more capital than you need to generate organically. So either you're going to spend it on acquisitions, which you say you're not or you're going to return it to shareholders, and the question is only one of timing. Is it the question is only one of timing?

Sir Fred Goodwin: Oh, no let's not get ahead of ourselves Michael, I mean I don't think anyone actually would ever accuse us of being coy about buybacks and we were referencing back to the famous chart we published about three years ago. So ironically the dialogue and buybacks was something that we brought up and have consistently brought up ever since and we've always been quite clear that buybacks are part of the capital management armoury of the bank, and we're quite relaxed about the prospect of making buybacks.

Also in the same dialogue we've been having though with the market we've indicated in the past some of the acquisition ambitions that we've had and indeed have gone on and fulfilled. And as everyone recognises they have made calls on our capital base, which brought us to a place where our capital base was lower as a result of the Charter 1 acquisition which ruled out the prospect of buybacks. But I think we've always been clear that as the capital position began to improve as it would because our business is generating more capital than we would ever use to fund organic growth, that the option of buybacks becomes used as an arithmetic progression becomes one that's available to us.

But really until the Board have made a decision as to when the point arrives and what that point would be and whether increased dividends or buybacks of what they would wish to do with any surplus capital then, it's not for me to start making promises or anything else to the market and anyone else. And so all we highlighted, which is I think the point that you make and indeed I think Robin and Michael made a bit earlier, is that we are moving quite quickly into that space, which feels to me like a good thing to be doing and to alleviate some of the concerns, but I think today's just a trading statement, it's meant to just be giving a directional impact. I think we can, once everybody gets to see what our actual capital position is, what our actual results are I'm sure we will return to a full discussion at that time. And I'm certainly not wanting to be – I don't want to be coy about it but I don't think this would be the moment to have the discussion.

Michael Lever: Okay, thank you. And my colleague would just like to ask a question, Jonathan Pierce.

Sir Fred Goodwin: Hi, Jonathan.

Jonathan Pierce: Hello there. Sorry, it's actually on unsecured arrears again and a comment that you might be going up more slowly than you were. I think you made similar comments in securitisation prospectus a few weeks ago, which covered not just the securitised aspects but credit cards across NatWest, Royal Bank and Tesco. But the data you were basing it off was literally sort of one month delinquencies and actually the two three month cost delinquencies were moving up more sharply than we've seen at any other point in the year, right up to November, but I'm just trying to assess whether your comments on, as I say not that you're moving up more slowly refer literally to one month delinquencies and actually two to three months, is it still moving up quite sharply and fast?

Sir Fred Goodwin: No, I mean I think we made the comment in the spirit I described earlier, which is that that’s how we see the market at this point, well we can't predict the future, history shows these things can move around pretty quickly, but the data we're looking at is not just one month’s data. I would be hesitant to make any observations off of the back of one month’s data, but I'd be the first to acknowledge that none of us know what's going to happen in the future, but it's a break with the trend that we've seen in the recent past and I think that's worth noting and move on. Now I'm not – there's only one way we're going to find out what the performance is, but it’s got to be a lot easier than it was.

Jonathan Pierce: Okay, thank you very much.

Operator: We now have a question from Daniel Davis with Exane.

Daniel Davis: Sorry, just following up on the retail unsecured. I think you made the comments on delinquencies very clear. Could you give us any comments on severity of losses in that same book?

Sir Fred Goodwin: In line with expectations, Daniel, it's nothing particularly to report. There's not a really satisfactory answer in a sense but there's no – when the losses happen they tend to be quite a high proportion of the balance anyway. That's a kind of given. We haven't seen any particular movement thus far what would determine the loss given before. The number you tend to watch more as a level of default, the loss given default is depressingly predictable.

Daniel Davis: Thanks very much.

Operator: We will now take a question from Simon Samuels of Citigroup.

Simon Samuels: Yes, thanks very much, its Simon here again. I was wondering if I could just ask you about the credit quality in CBFM division. I mean your comment is that the credit metrics for the year were showing an improvement and we saw a lot of that at the half year today. So if I could just invite you to talk about the second half, compared to the first half and also where you see that credit charge in CBFM, whether the current level is in your own assessment a long way below where it normally should be or whether you think it will now just step down for a few years to a lower level. So an outlook comment as well as what's happened in the second half of the year?

Sir Fred Goodwin: I think the second half is very much a continuation of the first half, Simon, as a very strong performance in credit across the board in CBFM. Touch wood, nothing in sight to cause that to change at this point, as to whether that represents things in the overall scheme of the world or history of things, I'm not sure. I think funnily enough the market we operate in now in the large corporate, I mean our results in better management and sharing out of risks, I think we maybe moving into a world where ongoing credit costs in CBFM would be lower than perhaps the bad old days, but again its one of these crystal ball gazing things that I'm always slightly nervous about doing. But the second half is the same trends as the first.

Simon Samuels: And just on that, you don't disclose this but if we were to see the gross provisions in CBFM and the recovery to get that P&L charge, I mean is the recovery run rate dramatically different from what you guys would see over a longer time period. Is there a lot of recoveries coming through?

Sir Fred Goodwin: Funnily enough Simon, the absence of the write-offs in the first place, that actually takes the recoveries down to quite a low level, but no it hasn't been written off so there's nothing to recover.

Simon Samuels: Okay, so it's not a depressed number through high recoveries, is what you're saying.

Sir Fred Goodwin: No.

Simon Samuels: Okay, thanks.

Operator: As there are no further questions, I will turn the call back to Sir Fred for closing remarks. Thank you.

Sir Fred Goodwin: Okay, well thanks very much everyone for calling in. I think we – my sense of it is we covered the ground in the questions there but certainly if there are any further questions we'd be happy to hear from you during the course of the day and we'll pick them up from there. But thanks for calling in and I hope you found that useful. Thank you very much.

Operator: Ladies and gentlemen that will conclude today's conference. Thank you for your participation. You may now disconnect.