RBS Trading Update

Monday 19th January 2009 @ 9am

Presenters

- Stephen Hester
- Guy Whittaker

Operator: Good morning ladies and gentlemen. Today's conference call will be hosted by Stephen Hester, Group Chief Executive; please go ahead Stephen.

Stephen Hester: Good morning everyone and thank you for joining the call. I am here with Guy Whittaker, our Finance Director. What we will do as conventional, is just spend a few minutes picking out the principal points from today's release and then hopefully spend most of the call on your Q&As. I suppose an inevitable caveat to open that we have not finished our year end process and therefore will wish to leave until February if you like, the full detailed exposition of our financial position when we can appropriately do it with all of the results that we can be confident about, because obviously the close is quite early and brought forward to reflect both our announcements, our results, the capital restructuring we announced today and the Government measures which all seem to make sense to do together on the same weekend.

There are clearly different components to our release; I will ask Guy in a couple of minutes to go through the trading update. Alongside the trading update, we have reported as you know, the restructuring of our Government held preference shares into ordering equity which is something I wanted to do for some time and have the side benefits on top of obviously restoring our capital ratios to a strong position relative to the international peers, have the other benefits of relieving us of £600 million a year of post tax cost and a dividend blocker, while of course a dividend block is not relevant today it is nice at least to not have that as sort of something at the back of our minds.

In addition to that capital restructuring which was done on the same price formula as before, albeit not the same share price, we have made some additional commitments for UK lending which has been reflecting that additional support and then we have given various outlook statements which we can go through later.

Why don't we dive into the trading update?

Guy Whittaker: Thank you very much Stephen, and good morning. Results for the full year really reflecting I think a continuing weakness in particular credit markets in the fourth quarter, pressure on asset valuations and markedly slowing economic environment. As a result of that, we are now expecting that our underlying operating profit level to breakeven for the full year with profits in our regional commercial, retail and commercial banking businesses GTS and RBS Insurance being offset by losses. GBM after taking into account our write-downs on our previously disclosed credit market positions, at costs of integration of ABN, minority interests, preference shares and a few other items of forecasting and attributable loss to our shareholders of between £7-8 billion for the full year.

Versus the IMS that we have issued in October where GTS and RBS Insurance are broadly in line, retail and commercial banking slightly lower, reflecting in this economic environment impairment costs a little bit higher than we were forecasting in October.

Within GBM, in addition to the disclosure on the 15th December of the impact, the collapse of the Madoff companies; we have seen approximately £2.8 billion reduction in income relating to write-downs, loss on sales and additional reserves within the GBM business, as well as a £600 million addition to our reserves against our CDPC exposures only partly offset by a reduction in variable costs. As a result GBM is coming in around £3 billion lower than we forecast at the time, on the pre-impairment line.

We are seeing impairment costs for the full year across the Group of between £6.5-7 billion; about 3.5 billion relating to our regional markets businesses and around £3 billion relating to Global Banking and Markets of which we disclosed today a £1 billion provision against Lyondell Basel position.

Credit market losses rose from 6.1 billion at the end of Q3 to 8 billion for the full year after taking into account gains on hedges against some of those exposures and of the Group's centre we recorded approximately

£400 million loss as a result of hedging of exposures on the balance sheet which do not under IFRS qualify for hedged accounting treatment.

In addition, we have reviewed the carrying value of goodwill on the balance sheet and pertaining to the RBS assets we are expecting to record at the full year, a goodwill impairment provision of between £15-20 billion.

The balance sheet on a risk weighted basis, at constant currency was flat versus the third quarter numbers, with a sharp depreciation in Sterling against both the Dollar and Euro saw the nominal risk weighted assets go up from 545 billion to just under 590 billion in the entirety of that movement attributable to changes in FX.

As a result of the loss and the balance sheet move, we are now forecasting our Tier 1 ratio to be between 9.5-10%; core Tier 1 between 6-6.5 prior to any of the capital restructurings announced this morning on a proforma basis we would expect our core Tier 1 to be between 6.9-7.4 aligned for the conversion of preference shares into equity.

On the funded balance sheet, GBM, again on the constant currency basis, took around £200 billion off the nominal balance sheet down to around £630 as at the end of September FX rates, as at the end of the year FX rates, nominally around £700 billion.

That was a quick overview of the numbers; I am sure you will have questions. I will just hand it back to Stephen for any further comments.

Stephen Hester: Just a couple of things that we mentioned earlier on, on the Wires Call, so make you get it as well. When we look at the GBM losses across the piece both as to income credit markets and credit impairments, they are spread roughly half and half between the ABN acquisition and RBS' own positions. When we think about them geographically, the US is the biggest area of losses; Europe also significant, and the UK smaller; again in the wholesale, much more in the wholesale area. The goodwill, we have given a range because we haven't yet met with the audit committee to make the final determination on goodwill as part of the year end close, so we can't give you precise breakdown because it is not even decided yet, but broadly it will be the vast majority of the ABN goodwill being written off and a good chunk of the goodwill that is on our balance sheet in respect of Citizens or most particularly in respect of the Charter One acquisition in the US. Then bits and pieces elsewhere; First Active in Ireland and things like that.

With respect to outlook, and again we have tried to put a sort of clear outlook statement; I guess the simple starting point on outlook is that the world remains uncertain; I think we and all banks can be certain that there will be more significant losses as the recession plays through, but no one can be certain as to what quantum and what timing; and that is the whole reason why we felt it was important to keep capital ratios high, although you will note that the FSA has clarified in its statement today that they are comfortable with capital ratios coming down substantially during the course of the recession as the higher capital ratios do their job in terms of absorbing losses.

The various other Government support initiatives announced today, I think are valuable and important; they are certainly that, as it relates to funding, as it relates to the asset insurance scheme, clearly the devil will very much lie in the detail, but I know it is the intent of the Government for that to be a valuable and important scheme as part of the armoury of bank support and in turn allowing banks to provide more support in the form of lending and what have you into the UK. We will be engaging swiftly and actively with the Government to see if we can develop something that is supportive and importantly I think to note, that they have decided that that form of support is better than further equity support as the next stage of this, in line with where Governments around the world have been.

You will see in terms of our own progress that we are starting to gain traction in cleaning things up and moving RBS forward. We have highlighted the 200 billion constant currency we took out of GBM balance sheet; you have seen the Bank of China stake sale that we got done last week; you have seen the Board restructuring continues and we have a new Chairman; you have seen cost initiatives which we will be adding to during the year materially; obviously a huge amount of stuff on internal risk; and the strategic plan for the bank, we are working hard on that; timetable still as said before, but I expect us to if you like, announce probably the most important bits of it with our end February results to try and be helpful along with more financial disclosures.

Obviously uncertainties ahead, I think we face those with a benefit of having taken some of the pain that we need to take, having strengthened our finances to fill the hole that that causes, and having if you like ongoing clear support from Governments and Central Banks around the world as other major banks also have.

With that I guess very happy to turn over to Q&A.

Operator: Thank you. If you would like to ask a question please press *1 on your telephone key pad or press the # sign to remove yourself from the question queue. Your first question comes from Rohith Chandra-Rajan from Citigroup; please go ahead.

Rohith Chandra-Rajan: Good morning Stephen, thanks very much. It is Rohith from Citi. I am just wondering in terms of the Government participation, just in terms of your thinking behind moving from the preference shares to the equity base. I know you have talked in the statement about improving the quality of your capital position, but also I guess that takes participation up to a sort of close to 70% in terms of your thinking on that versus your ordinary existing shareholders?

Stephen Hester: A few different things in there. I think that it has been entirely appropriate that the market has come to concentrate more and more on core Tier 1 because in a recession that is really the only loss absorbing layer; preference shares are just a disguised form of leverage valuable only to depositors in the case of insolvency which the Government has made very clearly is not going to happen to any major bank whether that is Citibank or RBS or any of the others, and so I think core Tier 1 is crucial and indeed I think that particularly in the United States this is a penny that has still got to drop fully. That is the first point that I would make.

The second point was your point on shareholders and obviously we can take this from a couple of different places; clearly it is our goal to be standalone and fully on our own two feet with no Government involvement as quickly as we can responsibly do it, but we have to make sure we get there and it is only if we get there that we will preserve value for all our shareholders; and therefore at the moment I do not have any particular hang up over any particular percentage ownership of any of our shareholders. I think the importance is the help of the bank which allows us to generate wealth for shareholders in the future.

Clearly, there will be no dilution of shareholder whatsoever if shareholders choose to take up the [call] back that is being offered in this process and I hope that they do, but if they don't then there will be a transfer of wealth to our private shareholders, because Government will have underwritten at a price other people aren't prepared to buy and if they do the underwriting will fall away and the ownership won't go up; so in a sense you could look at it either way. Everything we are doing is bearing our shareholders interest in mind, but the most powerful interest of the shareholder is that banks remain strong in difficult times, continue to function and therefore have the wherewithal to restructure themselves and restore value in the future.

Rohith Chandra-Rajan: Was there a sort of real concern that without this transfer from your preference to equity that core Tier 1 ratio might have fallen below the sort of 4% threshold?

Stephen Hester: Clearly there is no near term prospect of that, we were way above it in all circumstances, but I think that in the current market that is an appropriate position, and it was too early in the recession to allow our capital ratios to get to where they would have been had we not converted. All of that is a speculation as to what is ahead and none of us really know the answer to that.

Operator: Your next question comes from John Kirk from Redburn; please go ahead.

John Kirk: Good morning everyone. Good morning Stephen. My question relates really to the losses within GBM. I think what worries me most from the statement and I am hoping maybe you can give some comfort on this, is the extent to which losses are now expanding from within the sort of credit market area to the rest of the balance sheet. I guess, given that the credit market exposures which people generally considered to be the toxic pool is only 20 billion against your balance sheet which obviously is nearer 2 trillion; that worries me a great deal. I wonder if you could perhaps give us some more detail on where those incremental losses over and above the 1.9 million in the credit markets area have arisen?

Stephen Hester: To some extent, I suppose what I would say to you is that it is very dangerous to say one off things, but there were a whole series of things in the fourth quarter in particular, that I hope end up being sort of really left field, one off things which went beyond the credit markets which continue to deteriorate; Iceland was one, Madoff is another, the CDBC provision you could argue is part of credit markets although we only if you like gave disclosures on that as part of our October statement. I think that very substantial amounts of the deterioration if you like hopefully come into sort of similar category of credit markets, a sort of one-off market dislocation related items, and as Government support for economies around the world and for markets and all the asset buying and the Central Bank stuff gain traction; that some of those left field items reduce in their magnitude and occurrence.

We are, however, as you correctly surmise, but it shouldn't be a surprise to anyone, moving into a second stage where the economic downturn is hitting normal credit in terms of individuals and corporates. In the case of RBS to date, while credit trends have deteriorated across the board as they have in every bank our issue lies less on the retail and commercial markets, although credit losses are increasing there, and lies more on wholesale credit, and that is simply because as a result of ABN Amro we doubled up at the wrong time, and therefore we have large exposures there which have resulted in for example the Lyondell Basel number which obviously is an exposure you ordinarily would not have had to a single company. There will be more of that, but that is not the large part of what we have just reported.

John Kirk: Thanks; and could you just give us a view on how much commercial property in particular, property generally has played its part in your write-downs?

Stephen Hester: Commercial property not huge bar the component that is fully disclosed in the credit market write-downs that related to the largely US mortgage markets.

John Kirk: One final thing. You may not be able to answer this yet anyway, but still trying to understand what the cost of the increased Government support that's been announced today; what the ultimate cost of that will be to you?

Stephen Hester: I am afraid I have absolutely no clue. I think, as I say, my understanding is the Government's intent is that this is a substitute for using equity to support banks and I think therefore in principle should be very welcome to shareholders as to how valuable it is. That is a voyage of discovery for the next few weeks.

John Kirk: Thank you very much.

Operator: Your next question comes from Lee Street from Morgan Stanley; please go ahead.

Lee Street: Good morning. Is it RBS's intension to pay coupons on their Tier 1 securities where they have the option not to pay them; if you could confirm that that would be great.

Guy Whittaker: Those will be declared by the Board at the time we finalise our full year results and it would be remiss of me to either anticipate or communicate the Board's intentions in advance, but certainly in restructuring the capital structure of the Group in a way we've announced this morning I think you can see we continue to place a great emphasis on equity as the principal source of loss absorption.

Lee Street: So effectively up to the Board to decide at the time of the full year results and no indications in advance?

Stephen Hester: That's not a very good characterisation, what Guy just said. It is actually the case for every bank all the time that these decisions are made by Boards when they have to be, that is a statement of fact, but Guy quite properly pointed out that the whole reason to keep capital ratios strong and keep our equity strong, is so that we can continue to operate in normal ways as it relates to our behaviour in markets.

Lee Street: Thank you very much.

Operator: Your next question comes from Peter Toeman from HSBC; please go ahead.

Peter Toeman: A couple of things; I was wondering about your contraction of assets is about 200 billion in constant currency terms, but I was disappointed to see that doesn't seem to have come through into risk weighted assets where you're telling us in constant currency terms the numbers were flat, so I wondered if there was an explanation for that. Secondly, in terms of the 7 billion of attributable loss, I wondered if you'd actually assumed any tax relief on those losses both in the P&L and for determining the capital adequacy ratios.

Stephen Hester: Let me ask Guy to answer the second, but with respect to the first, I think the fact is getting risk weighted assets down is a little bit like running on a treadmill the wrong way around, that with pro-cyclicality of vol and migration of various asset classes going against you and the most intensive RWA assets being the least easy to sell, because of their extreme stress in the markets, that's making it a long haul as it relates to RWAs. Guy, I don't know if you want to pick up the tax shelter point.

Guy Whittaker: We have assumed tax relief on the vast majority of the losses. We have taken a prudent view on the jurisdiction of some of the deferred tax assets and our ability to recover that, but the majority of that we do believe will be tax effective in getting to the £7 billion number.

Peter Toeman: Just going back to the first point, is it possible to give some sort of indication of the impact of currency movements on WRAs relative to the impact of vol to pro-cyclicality; could you quantify both those effects?

Guy Whittaker: I would prefer to do the latter at the time of the full year results rather than lead up the garden path today. Pretty much the entire move from 545 to 590 roughly in RWAs was entirely currency and then on the base case RWAs; I think, we'd be probably looking at something in the order of maybe £10-15 billion worth. I would say that number with a severe health warning at this point; we will clarify it for you in February.

Operator: Your next question comes from John-Paul Crutchley from UBS; please go ahead.

John-Paul Crutchley: Good morning chaps; its JP here. Maybe just pick up on a couple of points if I can. Firstly, on capital; I hear what you say, Stephen, and I guess one of the most difficult numbers to forecast. Royal Bank over the last 12 months or so has been the share count. As you stand here today you obviously know a lot more than you did at the last capital raising and given what the FSA is saying on capital, how confident can you be at this stage that we've reached the end of a need to take capital ratios out, or do you think it's still just impossible to say that given the economics; what is your view on that first up to see if we can draw maybe some kind of line in the sand here?

Secondly, just interested in your views on concentration risk; I guess with Madoff, Lyondell Basel, et cetera, it looks as if there were fairly large concentration risks which have come out of the woodwork and I guess there's always a risk of that continuing, so I wondered if you could maybe just say a few words of the granularity of the portfolio as you've observed it and whether that's still a concern as the downturn plays out.

Further, I wondered if you could comment on the act which you had to do in terms of facing two ways in terms of, obviously retrenching and shrinking the balance sheet, but obviously committing to maintain lending and supporting the economy too and how you intend to keep those balls in the air at the same time too, so I'm just wondering if you could say a few words around those topics.

Stephen Hester: I'm just scribbling down your multiple questions there. I think everyone would find our lives easier if we had certainty in the future and of course the world is sadly not like that. I don't think anyone can know exactly what is ahead of us economically market-wise and therefore in credit terms and that's why one has to have historically high capital ratios for now as a precaution, but I think it is also very clear that in a sense Government thinking has moved on as we've come through the last three months, in fact everywhere around the world, to acknowledging that simply supporting bank credit through share issuance shouldn't be the only policy tool and that's why, if you like, extensive asset support mechanisms are now being deployed in the US in terms of both direct purchasing and deployment of insurance schemes now for [BVA] and Citi and no doubt for more people thereafter, obviously with UBS in Switzerland and now being deployed in the UK and I think that is a very good response. As I said, obviously the devil lies in the detail as to how good in financial terms, but I think that that shows a very positive evolution of thinking here and elsewhere.

With respect to risk concentrations, I would say to you that if I've had a negative surprise in getting inside RBS it is that some of the risk concentrations are inappropriate and we have to work our way through that. That obviously was in part a result of putting two big wholesale banks together at a time when it was then not possible to take the exposures down given market dislocation post the ABN Amro acquisition, so that may be the reason for it, but it is one of the issues that we are having to work through as we come through this, our single main concentration.

Then your final point on lending; I see this as not, frankly, a big issue from the point of view of, if you like, analysts and shareholders. The amount of incremental lending we do in the UK, a) we believe will be profitable; b) is not going to be the key determinant of our financial health and is frankly something we want to do to support one of our core franchises in any event and if that is the price ticket for the continued Government support that we have I think it's a good deal.

John-Paul Crutchley: Thanks very much; that's helpful.

Operator: Your next question comes from Robert Law from Nomura; please go ahead.

Robert Law: Good morning everybody. I've got two questions. Firstly, following on that last answer, Stephen, I think there was a view that the level of loan growth following the first recapitalisation by the Government hasn't prompted the kind of lending that they want to see and certainly in terms of the phraseology they're using here, there seems to be much tougher language, something along the lines of 'agreement subject to external audit', for example, about the pace of loan growth. Can you give us an update on what your understanding is about the requirements there are going to be on the banks to increase their level of lending?

Stephen Hester: If I might say, this is politics, but underlying it is economics. What do I mean by that? It is factually the case that the big banks in the UK, the so-called B7 in the UK, have indeed increased their lending to the UK. However, there is widespread public scepticism as to whether that is a fact or not; it is a fact, but there is public scepticism and so politically it is necessary to, if you like, toughen up the language in order to deal with that political concern, even though factually the big banks are doing what they said they'd do. However, the issue, which I think has become much more front and centre everywhere around the world including the UK, is that a large part of credit provision did not come from the big banks, but came from wholesale funders, securitisation markets, foreign players, many of whom have disappeared or drawn in their horns. This is a massively greater problem for the US than it is for the UK, but it's nonetheless an issue for the UK and so therefore at issue is not really are the big banks doing what they'd said they'd do, they are, but it looks like the big banks need to do more to plug the hole from the people who disappeared and furthermore the various Government initiatives today, similarly to various initiatives in the US are seeking to support securitisation markets and commercial paper markets and things like that in order to also address that hole. I think those are the different things that are going on, which I say is a much bigger issue in the US than in the UK, but is an issue in the UK.

Robert Law: Can I, as a follow on to that, ask you how much, as you put it, the big banks need to do more, how much as a result of this you think your loan appetite will change and where does that leave your overall strategy as communicated when you became CEO of deleveraging the RBS Group?

Stephen Hester: Just to give you some numbers, Robert; our UK loan portfolio outside GBM to all individuals, all mortgages, all corporates, blah, blah, blah, it's not the entire portfolio, because there are some of the bigger [mob than actually] in GBM is about 230 billion and so we increased that by about 10% last year; we've said we'll increase it by another 6 billion today. If you compare that to a 2 trillion balance sheet you can read your own judgement as to whether you think it jeopardises a delivering strategy or not. I don't believe it does and our strategy was in fact in addition to de-levering to if you like, concentrate and strengthen our core franchises and I think in difficult times to be reinforcing our leading market share in the UK provided we do it on correct pricing and credit grounds, which we are free to do, is strategically not such a stupid thing anyway.

Robert Law: Can I just clarify; is that 6 billion on top of a 10% growth, is that what you're implying in that answer?

Stephen Hester: On top of last year's growth, yes.

Robert Law: So this year would be something like 30 billion is your net growth?

Stephen Hester: No, the 10% is not recurring; that just happens to be what we did last year. All we have committed to is an additional 6 billion this year. Now, we made do more than that, but the commitment relates to 6 billion. As you correctly observe, there may be more commitments to be made in exchange for the loss insurance and so there is plenty of room to increase that 6 billion responsibly if the loss insurance is valuable enough to merit it.

Robert Law: Can I move on to the other area briefly; can you give us a feel for what's happened to your expected loss within the capital ratio calculation?

Stephen Hester: I can't; it's around 40. Expected loss is up around 40, Robert.

Robert Law: Thank you.

Operator: Your next question comes from Tom Rayner from Citigroup; please go ahead.

Tom Rayner: Morning; Tom Rayner here. Can I just go back to the capital restructuring, because I guess you wouldn't want to issue equity at 0.3 times book unless there were absolutely no alternative. I've just got two questions: one, did you actually have a choice about whether to do the swap or not; and secondly, is there not something else you could have done regarding disposals? I notice your comments on overseas lending looking for bigger retrenchments, which we have avoided further diluting your existing shareholders.

Stephen Hester: Tom, can I just repeat my previous point? Existing shareholders will not be diluted by a single penny if they think that the shares of that are valuable at this level. What we're getting is free underwriting is better than been the case, so in a sense that becomes a tautology.

Tom Rayner: There's no rights attached, is there; if they choose not to there's no pre-emption rights attached to this?

Stephen Hester: That's indeed correct. That's the first point. The second point is it was our choice, but it was our judgement that as part of the things we're doing that this was a sensible thing to do; it's not a standalone thing to do, it needs to be taken along with all the future restructuring efforts that we want to engage in and indeed along with the other Government support mechanisms like the insurance scheme and so on. What we're trying to do is give ourselves as many options to come through this as strongly as possible and I think that we see with some of the controversy over asset disposals are being made in the United States and the pricing thereof that one of the ironies, if we aren't careful in this position as a bank, is far from getting rid of the bad bank you may end up getting rid of your good bank and just being left with a bad bank if you are using disposals as your key tool in a market where disposals are not easy.

Tom Rayner: Just on that comment of overseas; should we infer anything about your ambitions with regard to Citizens from that or…?

Stephen Hester: No, you should not. I want to be very clear; the strategy that I made out has not changed, we want businesses that keep the [text] I laid out in October. I expect RBS to continue to be an international bank with strong global scope, but it is the case that the greatest accepters of leverage and some of the weaker businesses lie outside the UK and that's why I expect outside the UK to bear a bigger brunt of the restructuring, not because I have a geographic bias. In the case of Citizens, Citizens is more or less 100% deposit funding and so whatever else its plusses and minuses it isn't for the issuers, it relates to leverage today.

Tom Rayner: Could I just have one very quick final, I promise it'll be my final one? If everything goes to plan and your restructuring works, five years time, what percentage ownership would you like to see in private hands; 100%?

Stephen Hester: Yes.

Tom Rayner: Thanks.

Operator: Your next question comes from Michael Helsby from Morgan Stanley; please go ahead.

Michael Helsby: Good morning. I've just got a few questions. Firstly, just following up on John-Paul's question about single name exposure; could you give us a feel for how many single name exposures you've got of similar or bigger size to Lyondell? Second point, I was wondering if you could give us a feel for in 2008 how much you will have actually written down on your global commercial property book? Third one is just following up on the capital discussion. I think the FSA has put a statement out today reaffirming its comments about the ability of banks to go down to 4% equity Tier -1. Clearly you've decided today that it was too early to take a step towards that ratio, but I was just wondering from within the management philosophy of capital do you see 4% to drop down towards, and that's it, thanks.

Stephen Hester: On concentration I'd like to, that would be one of the issues that we're thinking about for more disclosures at the year end and I don't want to go off at half cock on it. There are however, what I would say is that there are not vast numbers of concentrations at this scale at this level of credit stress, but there are not none either. With respect to commercial property again, I'd like to like to now, just for now leave it to my previous comment which was that not a lot of this relates to commercial property beyond the disclosures in the credit market write-downs, but I prefer in part because we're still closing discussions with the auditors, that some of these numbers might move around, we've globally scoped credit provisions but we can still move around a little bit. And with respect to capital ratios, I think that it would not be likely that any bank of our scale would want to get to 4%, but obviously what does happen in a recession is you have ratios come down and how close they get to their trough and how close you're willing to let them get to their trough I think depends on how uncertain the future looks at any one moment in time. Obviously if the future were to look certain, you'd be happy with lower capital ratios temporarily than if the uncertainties were still accepted, I think that's something one has to judge as time unfolds.

Michael Helsby: Given that it's extremely uncertain, it's fair to assume that you probably want to maintain around about this level of capital?

Stephen Hester: No, I absolutely would expect our capital ratio to come down from here or at least I would expect, or obviously it will depend on what we do on the other side, and what happens on the insurance schemes and so on and so forth; but I would have absolutely no problem if it were to come down from here, but I would hope that it would not come down to 4% probably at all, or certainly prior to the level of uncertainties being raised substantially ameliorated.

Operator: Your next question comes from Mike Trippitt from Oriel Securities; please go ahead.

Mike Trippitt: Hi, Stephen, Good morning. Quite a lot has been covered already, but just one thing on capital allocation really and some of the strategy update you're going to give in February. To what extent does the degree of Government ownership now influence capital allocation and would we expect retrenchment internationally for that reason alone?

Stephen Hester: No, I suppose if I stood up and said you know what our strategy is to close the UK and move to Bermuda and become a hedge fund we might have a debate with our large shareholder but since the strategy is to reinforce our best businesses and in the UK lie some of our best businesses, that won't be our strategy. At the moment I am not feeling pressure from the shareholder to act irrationally, to the contrary the shareholder is emphasising its desire for us to act economically and strategically rationally and that includes having a strong international presence, where that presence can meet the tests, just as in the UK.

Mike Trippitt: Great. Can I just have a very quick follow just I think this might have been mentioned in a previous question, I'm not sure quite what the answer but just on your thoughts on the UK commercial property book and how much of this additional provision for GBM now also outside of GBM reflects any additional provisioning against that book?

Stephen Hester As you say, I've talked about that. I think the issue with commercial property, which makes it particularly difficult to forecast is that unlike the early nineties, interest rates are now very, very low. Secondly, in our case, the exposure to speculative development is very, very low. Therefore the ability to service debt is dramatically different than in the early nineties but of course, the stress on loan to values is very, very large, and that interplay is one that I think is an interesting one, as we see what losses come out over the cycle in commercial property this time, which I suspect will be different in their character, but I think this is mostly ahead of us still as opposed to behind us.

Operator: Your next question comes from Jackie Ineke from Morgan Stanley. Please go ahead.

Jackie Ineke: Hello, apologies for a very broad question here. I'm on the credit side, and unfortunately one of the main questions we get is about full nationalisation because obviously that would affect a number of bonds as well as the equity. Looking at Northern Rock and Bradford & Bingley, the nationalisations there were clearly triggered by the starts of deposit runs, but are there any technical circumstances that could trigger a possibility of a nationalisation at RBS and I'm thinking along the lines potentially of something like your share price falling below the nominal value of 25p, would that trigger anything, or is there anything that you can think of that …?

Stephen Hester: I'm not aware of any such technical risks.

Jackie Ineke: Okay, thank you. Is there anything else that you could possibly think of that could trigger full nationalisation? Has that been discussed so far with the Government?

Stephen Hester: It has been discussed only in the sense that the Government has made it clear that they would wish not to do that. Clearly it would be improper of them or anyone to rule that out as a policy tool with respect to any bank anywhere in the world, but I think not only the UK Government, but every Government in the world has made it clear that it's not their preferred policy response.

Operator: If you would like to ask a question, please press *1 on your telephone keypad. Your next question comes from Leigh Goodwin from Fox-Pitt Kelton; please go ahead.

Leigh Goodwin: Good morning, Stephen; good morning Guy. Just two or three questions actually. First one is just a short one, and actually just maybe thinking optimistically perhaps, with the removal of the preference shares today or in the future, what does that tell us about the point at which you would be in a position to pay dividends. Obviously the earnings have to be there, and so on and so forth, but are there any other constraints upon you following today. Obviously there's a conversion with that regard?

Stephen Hester: There are no other constraints on us beyond what we think is prudent.

Leigh Goodwin: Secondly, back to this point on risk concentrations, and so on, appreciate you'll be giving us a fuller disclosure on this in due course. I just wondered whether you could give us a sense for the urgency with which you feel there's a need to de-risk. Do you feel as if the damage to the credit position of some of those concentrations is mostly done now and it's a question of you've just got to work with it and hope that those things turn around for the best; or do you feel as if you need to take pre-emptive action and this is quite important because I suppose in terms of thinking about the speed of which you're going take pain in the first half of this year in order to de-risk the book?

Stephen Hester: I think the unfortunate aspect of the current market is that because of the extreme disappearance of liquidity and risk capital throughout the system through deleveraging elsewhere hedge funds get moving away; there is a) very, very little risk capital and liquidity and b) what there is, is frightened and greedy and pricing in extremely dire scenarios and extremely high desired returns on capital. Not unreasonably. Therefore, for the overwhelming majority of the sort of assets you would like not to own, the prices at which you can sell even if you can sell at all, more than reflect the probability weighted worse case outcome which is why as I say, I think that the rational answer is that this ends up being a longer haul because dumping assets today makes your problem worse, not better, in many asset categories. That in turn feeds back to the need to keep a certain strength of capital structure, if indeed a solution isn't waving a magic wand and springing free in a matter of months. Obviously, a possible exception to that direction of thought is if a credible asset insurance scheme makes life easier in those areas and that's why I think that's a policy tool that is very interesting today.

Leigh Goodwin: It sounds like, as you say, that it's not like you're looking to take losses front loaded, it's just that it's a question of now having to work through them as impairments as they come through in due course?

Stephen Hester: I want to be clear. Wherever we can sell things at prices that we think out of all these circumstances make sense, we will and I'm very happy to take, I'm very prepared to take losses in selling things, but it has to be a rational thought process; and so we just last week, sold a very major slug of US mortgage exposure, having written it down for the year end, and I was very pleased to get out of that, those opportunities are not as frequent as one would ideally like.

Leigh Goodwin: Okay, then just finally if I may just ask a question, little bit about the funding side, I just wondered whether there's been any major changes that you've seen in the last few months following the introduction of the various schemes that we now have in place, and perhaps also your thoughts on just how important you think the various measures announced today are going to be for you?

Guy Whittaker: It's Guy, I will pick that one up. The general mood in the last three months or so, has been pretty positive on the funding side, and we saw some concerns in the customer base in the events leading up to mid October to the extent any balances moved away from the [Group] in that time, by the end of the year they had all in nominal terms pretty much returned to us. In addition we continued to utilise the various schemes that The Bank of England and other authorities have made available around the world to good effect. Those are being recognised. I think what has not yet happened is a return to the unguaranteed funding programmes in the size and scale that we would like.

If measures that's been announced today continue to show the willingness of Governmental support to the banking sector; that in turn is designed to help improve confidence in banks and that in turn in the fullness of time will I think see us get back into the unsecured issuance market as well. It feels like a little time away.

Leigh Goodwin: Yes, but at least what you're saying is that I think insofar as they're intended to work, they're actually working, the support mechanisms and there's no stresses in terms of being able to fund?

Stephen Hester: No, in fact our funding position, if anything over the last three months improved.

Operator: Your next question comes from Simon Pilkington from Cazenove; please go ahead.

Simon Pilkington: Good morning, just one question please. Regarding the timing of today's announcement; in particular what I'm thinking about is where you are with the auditors and you said at the beginning you were going through the year-end process. I guess really what I'm saying is what risk is that the auditors come back and say no, the losses may be bigger. Could you just give us some feel on that please?

Stephen Hester: There of course is that risk, just as there is a risk of things in a sense coming from that field today and us deciding even though it's post balance sheet event to reflect it, but we have tried to be as responsible as we can be in having the known items out there and bracketed.

Guy Whittaker: And important communicating to the market as early as we felt we could do in terms of indicating our trading performance.

Operator: Your next question comes from James Rogers from HSBC; please go ahead.

Nigel Greenwood: It's actually Nigel Greenwood; two questions from me please. The first one is, is there a risk that the Government doesn't quite get what it wants in the sense that it wants the banking system to lend to a variety of industrial sectors and categories and if the commercial decision is left with the banks, whilst it is laudable £6 billion commitments, but actually the most components supplied doesn't get his loan, the Government gets upset in four to six weeks and they move to plan C, whereby they take more direct control over lending?

Stephen Hester: I suppose the future by definition is uncertain, but certainly I have to say my exposure to Government which in recent months has been greater than I ever dreamed it might be, leaves me believing that throughout Government, not just here but internationally, is the desire to minimise uncommercial distortions through economic activity and that is to say that isn't to say that there aren't political pressures here and there which don't from time to time get expression, but I certainly feel that our marching orders are to be commercial.

James Rogers: Thanks and just very briefly on the second question; presumably with the guarantees the risk weighting in any lending you take place, you're actually coming out with a guarantee would be extremely low, wouldn't it, so that effectively could be very beneficial to a your capital ratio?

Stephen Hester: Yes.

James Rogers: And will it be zero or will it be…?

Stephen Hester: We've yet to look at all of these things, is the answer to that.

Operator: You have another question from John Kirk from Redburn; please go ahead.

John Kirk: Just some of these or other elements of this question I think have been answered already, but just wanted to be clear on it. On the issue of funding again, Guy, I think you said that there had been some signs of improvement in the last few months and yet we are here again basically, with another set of support from the UK Government, so clearly all is very far from being well. What can we look at as market participants; what can we look at to determine whether or not you are going to be in a position to independently fund within the foreseeable future; what indicators can we look at? Because we can see things like inter-bank rates and inter-bank spreads coming down quite nicely and yet here we are again with the UK Government picking up the slack. Can you help us to understand that?

Guy Whittaker: There is some considerable activity within the money markets, for going through on an unguaranteed basis and plenty of corporate treasurers and financial institutions are very happy to leave money with us and in fact with other banks, in part, as a result that they know that when it comes to principal repayment in the event of there being another unsecured depositor there, that the Government will provide a guaranteed issuance capability. I think you have seen those measures start to take an impact on the LIBOR rate and they are starting to kick down. It was my thought always that it would take a lot longer to do that, because there was a withdrawal of funding from many of the sources which eventually did place money with the banks in the US money market funds and commercial paper markets and asset backed security markets and the like, all diminished. It seems to me confidence is slowly coming back and I would take that as an encouraging sign and these measures I think will just help continue that trend.

John Kirk: I know what you're saying about money markets and corporate treasurers and so on, but that tends to be very short duration and I guess it's the longer term stuff that's the issue?

Guy Whittaker: In the debt capital markets, there were some early signs; we've seen one or two issuers successfully tap those markets towards the tail end of last year. We have been obviously, and you can understand, in the closed period at this point and it will be our intention to test the waters following the publication of our full year results and just see what sort of investor appetite is at that time.

Stephen Hester: I think what you should look for is an increasing stream of banks being able to issue term debt without Government guarantees. At the moment there's virtually nothing there in term debt, although there's plenty in short term debt, but I think a key indicator would be a rising stream of unguaranteed term issuance, which at the moment we don't see.

Operator: You have another question from Michael Helsby from Morgan Stanley; please go ahead.

Michael Helsby: Just three more quick questions: firstly, I was wondering if you could comment on the Lloyds TSB Group's plan of swapping upper Tier 2 for Tier 1 debt. I think, given your comments about focus on core, it doesn't sound like you'd be going for it, but I was wondering if you could give us your viewpoint on that? Second, you don't mention any losses going through your AFS reserve, but I was wondering if you could just clarify that position and see if there are any sizeable movements going through your AFS, or if it's all gone through the P&L? Third, apologies if I've missed this, but the 2.8 billion loss that you reported or you're saying you're potentially going to have in the GBM trading income; I was wondering if you could give us a bit more colour on that, whether it's due to just trading positions that have gone wrong in FX, or rates, or whether that's just due to other credit movements?

Stephen Hester: So working back through that; the 2.8 billion FX rates, commodity in fact, had very strong performances. These really relate to write-downs in credit market trading; inventory; some losses on disposal; some additional reserves against either counterparty risk or widening market spreads; some losses within the equity business; similarly on one or two principal strategy positions; reserves in some cases against certain correlation trading activities and spreads associated with those; and then the carrying value, certain trading assets within the portfolios. We highlighted the two bigger numbers as being Madoff and being the CDPC provision at 600 million; the rest are things which are in order of magnitude less than that, but there are a number of them which contribute to the £2.8 billion.

The second question was, I think, AFS reserves on that one. You'll see there'll be movement in the Bank of China share price; they'll be within these numbers; we're estimating around about a half a billion Pound deficit on the pension fund, on an accounting basis at year end. There'll be some small write-downs, I would think, through AFS, but nothing particular to flag to you and I think the offset to that would be a pretty positive move on the FX side through reserves and probably net net there may be a slightly positive number as a result of all of those.

The Lloyds swap; I think they're different; I'm not as perhaps as familiar with the capital structure of Lloyds as I should be. I think there are a couple of ways of doing it: one could be just looking at a restructure and perhaps … they have said they would like to be in a position to repay the preference shares and this is maybe a way of restructuring their capital to try and do that. It may also economically be a way of generating capital in the near term, by taking away lower coupon outstanding debt and replacing it with higher coupon current debt. That's an option that would be open to us probably within the Tier 2 sector of our capital structure. I think, given our capital structure, creating additional preference share capital at this point wouldn't make sense.

Operator: Your next question comes from Leigh Goodwin from Fox-Pitt Kelton; please go ahead.

Leigh Goodwin: Just a follow-up question, but perhaps more to Steven. There have been a couple of comments you've made about sectors outside of the UK. We've been very focused on what's going on in the UK banks sector and so on and what the UK Government is doing. I was intrigued by your comment about how maybe the penny hasn't quite dropped yet in Europe and maybe in the US in relation to the raising of equity, rather than just preference shares as reducing the cost of capital, because of equity anyway. Also the fact that your losses seem to be concentrated more outside of the UK than inside the UK. I just wondered if you had a comment really on how you see the UK's banking sector and position vis-à-vis other countries more broadly.

Stephen Hester: One's got to be careful in one's terms, because obviously the UK banking sector as in the UK quoted banks are very largely international, with the exception of Lloyds, and therefore obviously are a reflection of the spread of their business and as I mentioned, we happen to have a particularly vulnerability post ABN in a sense being outsized, without having had the chance to rationalise the combined portfolio outside the UK. With respect to losses, I think it is correct that the component of market dislocation that caused losses has been much bigger in the US, given the much greater securitization markets and the fact that the sub-prime crisis started there than elsewhere, although it has infected everywhere.

Similarly the US economy which started going down first has obviously had earlier credit stress than other places, though other places are following. In the UK, as we've reported, certainly there is credit deterioration, to date nothing like on the scale that you can see in the US, particularly in personal lines, but it is there. Obviously one of the reasons why the Government is so actively trying to put in place measures to ease the flow of credit and asset prices in the UK is to ameliorate the trend which otherwise would be a continued downward one; but certainly on a relative basis, that has been less of a big issue. On the other hand, you also have big differences in portfolios; obviously HBOS reported some trends which the other banks had not yet seen in the UK, so there may be a difference in portfolios, or it may be timing differences.

Leigh Goodwin: I suppose what I'm trying to get at it is we're obviously on a day like today, naturally focused on yourselves and maybe what's going on in the UK with the Government support that's been provided, but I get the sense that you think that within the European sector as well as the US sector, there's probably further Government action going to be required at some stage; because a) the scale of the losses coming, as judged by your own performance, may be larger than the market is expecting, but also because the schemes introduced so far probably haven't quite gone far enough to really recapitalise the banks. Is that a fair reading of what you're…?

Stephen Hester: I do think that the picture will probably continue to evolve everywhere around the world, as Governments and Central Banks and banks themselves, in a sense pull all the different levers open to them and I think everyone would like to be able to push a button and say it's all done and over, but I don’t think that’s the nature of what we’re in and therefore I think there are in fact all those things ahead of us as well as behind us.

Operator: Your next question comes from Steven Hayne from Morgan Stanley; please go ahead.

Steven Hayne: Just a question in relation - I hear what you’ve said about commercial property in relation to existing impairment going through the P&L - but just looking forward, in relation to the Government’s statement about the asset protection scheme, I’m just wondering if you can make any observations on … I think a lot of people would assume that would include a number of so-called toxic products; but I’m wondering whether that might include certain parts of commercial property and/or higher LTV mortgages?

Stephen Hester: My understanding is that the proposed insurance scheme does not at the moment have any limitation as to what assets go in; the issue will be pricing, that’s my understanding.

Operator: There are no further questions at this time. I would now like to hand the call back for any closing comments.

Stephen Hester: Well again, thank you for listening and participating in the call. Clearly our IR team are available if there are further follow-up questions during the day and we will hope to give a fulsome presentation, both backward looking and forward looking in February when we come with those results. I hope also in the coming weeks that we will be one of the earlier people to explore the nature of the Government insurance programme as that works through. Clearly this wasn’t an announcement that we relish putting out today, but I think it is important that we deal with our problems and move on and that’s what we’re trying to do. Thank you for listening. Bye-bye.

Operator: Ladies and gentlemen that will conclude today’s RBS trading update. Thank you for your participation, you may now disconnect.