

Pillar 3 Disclosure 2011

Pillar 3 Disclosure

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Forward-looking statements

This document contains certain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 with respect to the financial condition, results of operations and business of The Royal Bank of Scotland Group plc ('the Group'). Generally, words such as 'may', 'could', 'will', 'expect', 'intend', 'estimate', 'anticipate', 'believe', 'plan', 'seek', 'continue', 'project', 'should', 'probability', 'risk', 'value-at-risk', 'target', 'goal', 'objective', 'endeavour', 'outlook', 'optimistic' and 'prospects' or similar expressions or variations on such expressions identify forward-looking statements.

Any forward-looking statements set out herein represent the Group's expectations or beliefs concerning future events and involve known and unknown risks and uncertainty that could cause actual results, performance or events to differ materially from those expressed or implied in such statements. For example, certain of the market risk disclosures, some of which are only estimates and, therefore,

could be materially different from actual results, are dependent on key model characteristics and assumptions and are subject to various limitations. For further risks and uncertainties faced by the Group that may impact the statements set out in this document, refer to the Group's Annual Report and Accounts for the year ended 31 December 2011 and any other interim or update information published by the Group, including information furnished to the Securities and Exchange Commission on Form 6-K.

Any forward-looking statements set out herein speak only as at the date of this document. Except as required by the Financial Services Authority (FSA), the London Stock Exchange or other applicable law or regulation, the Group does not have any obligation to update or revise publicly any forward-looking statements, whether as a result of new information, further events or circumstances or otherwise, and expressly disclaims any obligation to do so.

Basis of disclosure

The Pillar 3 disclosures being made by the Group are designed to comply with the FSA Handbook (BIPRU 11). They should be read in conjunction with the Group's 2011 Annual Report and Accounts, approved on 22 February 2012.

There are important differences between the accounting and Capital Requirements Directives (CRD) disclosures, which can be summarised as follows:

- The Basel II disclosures represent a regulatory, rather than an accounting basis of consolidation. Various businesses (for example insurance) are included in the latter, but not in the former. Therefore, these disclosures may not be comparable to other external disclosures made by the Group.
- The definition of exposure differs between Basel II and accounting. The Basel II definition used in the Pillar 3 disclosures is exposure at default rather than the balance sheet or drawn balance plus mark-to-market, as used in the Group's financial reporting.

- It is not always possible to aggregate the disclosures across the different Basel II approaches to obtain a Group view. This is particularly important for the credit risk disclosures.

The information is not required to be and therefore has not been subject to external audit.

Whilst the Group has participated in discussions at the British Bankers' Association and other trade bodies, it is possible that disclosures made by other banks, especially outside the UK, are not directly comparable.

The Group has not omitted disclosures on the grounds that the information may be proprietary or confidential.

Disclosures in relation to remuneration are included on pages 272 to 295 of the Group's 2011 Annual Report and Accounts.

Background

The Basel II framework was implemented in the European Union (EU) through the CRD.

The framework is based on three Pillars:

- **Pillar 1 - Minimum capital requirement:** defines rules for the calculation of credit, market and operational risk;
- **Pillar 2 - Supervisory review process:** requires banks to undertake an individual capital adequacy assessment process (ICAAP) for other risks; and
- **Pillar 3 - Market discipline:** requires expanded disclosures to allow investors and other market participants to understand the risk profiles of individual banks.

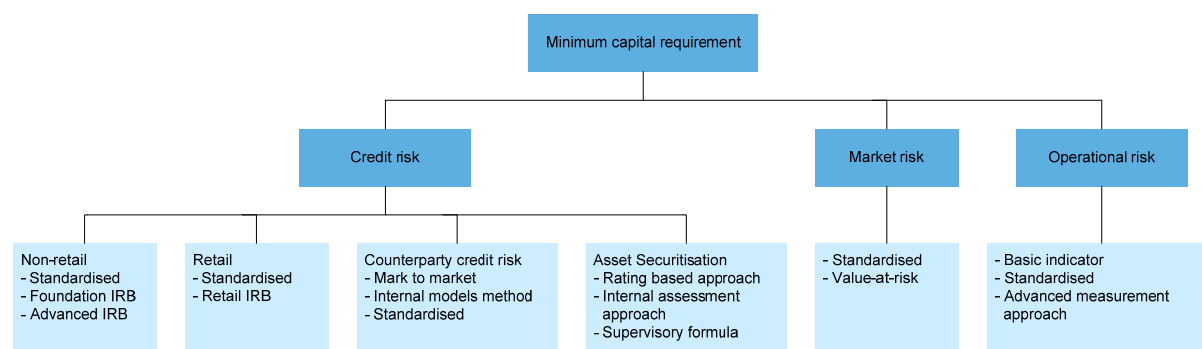
Banks are required to disclose all their material risks as part of the Pillar 3 framework. Some of these requirements have already been satisfied within the Group's 2011 Annual Report and Accounts, available on the Group's website. The 2011 Annual Report and Accounts include a range of risk factors and provides in-depth analysis on the specific risks to which the Group is exposed.

These Pillar 3 disclosures provide additional information over and above that contained in the Group's 2011 Annual Report and Accounts. Specifically, Pillar 3 provides information on the minimum capital requirements under Pillar 1. Liquidity risk, which does not form part of the minimum capital requirements, is discussed on pages 116 to 130 of the Group's 2011 Annual Report and Accounts. Further information on regulatory developments, and in particular on the impact of Basel III and CRD IV, is included on page 115 of the Group's 2011 Annual Report and Accounts.

Pillar 1 - Minimum capital requirement

Basel II requires risk-weighted assets (RWAs) to be calculated for credit, market and operational risk with various approaches available to banks, with differing levels of sophistication. Minimum capital requirement is calculated as 8% of RWAs.

Chart 1: Minimum capital requirement structure



Application in the Group

For credit risk, the majority of the Group uses the advanced internal ratings based (advanced IRB) approach for calculating RWAs.

The Group manages market risk in the trading and non-trading (treasury) portfolios through the market risk management framework. The framework includes value-at-risk (VaR) limits, back-testing, stress testing, scenario analysis and position/sensitivity analysis.

For operational risk, the Group uses the standardised approach which calculates operational risk RWAs based on gross income. In line with other banks, the Group has considered adopting the advanced measurement approach for all or part of the business.

Background continued

Pillar 2 - Supervisory review process

Pillar 2 focuses on risks either not adequately covered in, or excluded from, Pillar 1. The first part of Pillar 2 is the Group Board's individual capital adequacy assessment process (ICAAP) of capital requirements over the short and long-term.

The ICAAP is followed by in-depth discussions between the Group and regulators on the appropriate capital levels (this second stage is called the supervisory review and evaluation process).

For the Group, Pillar 2 currently focuses on pension risk and interest rate risk in the banking book (IRRBB), together with stress tests to assess the adequacy of capital across a range of economic scenarios and time periods. Whilst IRRBB forms part of these Pillar 3 disclosures, pension risk is detailed on page 245 of the Group's 2011 Annual Report and Accounts.

Pillar 3 - Market discipline

The Group is committed to delivering best in class risk and capital disclosures, to ensure that stakeholders understand the risks inherent within the Group. The Pillar 3 disclosures are designed to encourage and promote market transparency and stability. It represents one component of the Group's broader disclosures framework.

Group Internal Audit undertook a review to assess the adequacy and effectiveness of the controls over the systems and processes to produce the Pillar 3 disclosures. The purpose of Group Internal Audit's review is to provide management with assurance over the Pillar 3 disclosure process controls to satisfy regulatory requirements and to prevent material mis-statement.

The Group publishes its Pillar 3 disclosure on an annual basis, in line with the timescales required by the CRD.

The Group's various subsidiaries in Europe are responsible for publishing capital and RWA data externally through an appropriate mechanism (such as websites and annual reporting statements), thereby satisfying the European Banking Authority requirements for member state disclosures. Outside the EU, local subsidiaries may make additional disclosures under Pillar 3, as required by their local regulators.

The Group continues to participate in the British Bankers' Association drive towards consistent Pillar 3 disclosures for UK banks wherever possible. Footnotes are included with the data tables to ensure transparency regarding the approaches used for the disclosures. At the EU and global level, different definitions and assumptions adopted by other banks can make direct comparison difficult.

Scope of application

The Royal Bank of Scotland Group plc is the parent undertaking for all authorised firms in the Group and is subject to consolidated supervision by the FSA. The Pillar 3 disclosure has been prepared for the Group in accordance with BIPRU 11 of the FSA handbook.

Regulatory and statutory consolidations

Control

Inclusion of an entity in the statutory consolidation is driven by the Group's ability to exercise control over that entity. The regulatory consolidation applies a comparable test but is restricted to certain categories of entity. Non-financial companies and insurance companies are excluded from the regulatory consolidation. In addition, certain special purpose entities are excluded from the regulatory consolidation in accordance with FSA rules.

Significant influence or joint control

Where the Group does not have control of an entity but has more than 20% of the voting rights or capital of that entity, then it must be included in the regulatory consolidation on a pro-rata basis unless it falls into one of the excluded categories or the Group has agreed a different treatment with the FSA (by obtaining a waiver). Such entities will only be included in the statutory consolidation on a pro-rata basis where the Group has joint control. Entities where the Group has significant influence will be equity accounted in the statutory consolidation.

Solo-consolidation, impediments to the transfer of capital resources and aggregate capital deficiency

Individual firms within the Group apply the provisions in BIPRU 2.1 (solo-consolidation waiver) in a limited number of cases only. At 31 December 2011, The Royal Bank of Scotland plc had no solo-consolidated subsidiaries whilst National Westminster Bank Plc had three solo-consolidated subsidiaries. The waiver is only used where the business is an extension of the parent bank's activities undertaken through a subsidiary for commercial reasons and which requires solo-consolidation to ensure that there are no adverse consequences to the capital ratios.

The Group operates on an integrated basis with all Group companies being subject to policies, governance and controls that are set centrally. Aside from regulatory requirements, there are no current or foreseen material, practical or legal impediments to the transfer of capital or prompt repayments of liabilities when due.

There were no capital deficiencies (defined as the amount where the actual capital resources are less than the required minimum) in respect of subsidiaries not included in the Group consolidation.

Governance

Risk governance

The Group is committed to the highest standards of corporate governance in every aspect of the business, including risk management. For further information refer to pages 103 to 106 of the Group's 2011 Annual Report and Accounts.

Risk appetite

Risk appetite is an expression of the level of risk that the Group is prepared to accept in order to deliver its business objectives. Risk and balance sheet management across the Group is based on the risk appetite approved by the Board, which regularly reviews and monitors the Group's performance in relation to risk.

Risk appetite is defined in both quantitative and qualitative terms and serves as a way of tracking risk management performance in implementation of the agreed strategy:

- *Quantitative* - encompassing scenario stress testing, risk concentration, VaR, liquidity and credit related metrics, business risk and regulatory measures; and
- *Qualitative* - ensuring that the Group applies the correct principles, policies and procedures, manages reputational risk and develops risk control and culture.

A key part of the Group's risk appetite is the downsizing of the balance sheet and the macro reshaping of Non-Core assets. The Group is managing down its previous concentration consistent with its Strategic Plan, which is expected to be implemented by 2013. This will be primarily focused in the Non-Core division with risk management playing an integral role in executing the plan.

The annual business planning and performance management process and associated activities ensure the expression of risk appetite remains appropriate. The Group Risk Committee and Group Asset and Liability Management Committee (GALCO) support this work.

Asset Protection Scheme

On 22 December 2009, the Group acceded to the Asset Protection Scheme (APS or 'the Scheme'). For further information refer to pages 247 to 249 of the Group's 2011 Annual Report and Accounts.

Capital

It is the Group's policy to maintain a strong capital base and to utilise it efficiently throughout its activities to optimise the return to shareholders while maintaining a prudent relationship between the capital base and the underlying risks of the business. In carrying out this policy, the Group has regard to the supervisory requirements of the FSA. The FSA uses the risk asset ratio (RAR) as a measure of capital adequacy in the UK banking sector, comparing a bank's capital resources with its RWAs (the assets and off-balance sheet exposures are 'weighted' to reflect the inherent credit and other risks). By international agreement, the RAR should be not less than 8% with a Tier 1 component of not less than 4%. At 31 December 2011, the Group's total RAR was 13.8% (2010 - 14.0%) and the Tier 1 RAR was 13.0% (2010 - 12.9%).

Capital allocation

Capital resources are allocated to the Group's businesses based on key performance parameters agreed by the Group Board in the annual strategic planning process. Principal among these is a profitability metric which assesses the effective use of the capital allocated to the business. Projected and actual return on equity is assessed against target returns set by the Group Board. The allocations also reflect strategic priorities and balance sheet and funding metrics.

Minimum capital and RWAs

The following table details the Group's total RWAs and minimum capital by risk type.

Table 1: Group RWAs and minimum capital requirement by risk type

Risk type	2011		2010	
	RWAs £m	Minimum capital requirement (1) £m	RWAs £m	Minimum capital requirement (1) £m
Credit risk	344,221	27,538	385,819	30,866
Counterparty risk	61,918	4,953	68,142	5,451
Market risk (2)	64,039	5,123	80,105	6,408
Operational risk	37,922	3,034	37,103	2,968
	508,100	40,648	571,169	45,693
Asset Protection Scheme relief	(69,064)	(5,525)	(105,613)	(8,449)
	439,036	35,123	465,556	37,244

Notes:

(1) Minimum capital requirement is defined as 8% of the RWAs.

(2) Includes the impact of CRD III.

Key points

- Market risk RWAs were impacted by the new CRD III rules but decreased overall by £16.1 billion in 2011 reflecting de-risking of Non-Core and a reduction in trading VaR.
- APS relief decreased by £36.5 billion, reflecting pool movements, assets moving into default and changes in risk parameters.

Capital *continued*

Table 2: Composition of regulatory capital

	2011 £m	2010 £m
Shareholders' equity (excluding non-controlling interests)		
Shareholders' equity per balance sheet	74,819	75,132
Preference shares - equity	(4,313)	(4,313)
Other equity instruments	(431)	(431)
	70,075	70,388
Non-controlling interests		
Non-controlling interests per balance sheet	1,234	1,719
Non-controlling preference shares	(548)	(548)
Other adjustments to non-controlling interests for regulatory purposes	(259)	(259)
	427	912
Regulatory adjustments and deductions		
Own credit	(2,634)	(1,182)
Unrealised losses on available-for-sale (AFS) debt securities	1,065	2,061
Unrealised gains on AFS equity shares	(108)	(25)
Cash flow hedging reserve	(879)	140
Other adjustments for regulatory purposes	571	204
Goodwill and other intangible assets	(14,858)	(14,448)
50% excess of expected losses over impairment provisions (net of tax)	(2,536)	(1,900)
50% of securitisation positions	(2,019)	(2,321)
50% of APS first loss	(2,763)	(4,225)
	(24,161)	(21,696)
Core Tier 1 capital	46,341	49,604
Other Tier 1 capital		
Preference shares - equity	4,313	4,313
Preference shares - debt	1,094	1,097
Innovative/hybrid Tier 1 securities	4,667	4,662
	10,074	10,072
Tier 1 deductions		
50% of material holdings	(340)	(310)
Tax on excess of expected losses over impairment provisions	915	758
	575	448
Total Tier 1 capital	56,990	60,124
Qualifying Tier 2 capital		
Undated subordinated debt	1,838	1,852
Dated subordinated debt - net of amortisation	14,527	16,745
Unrealised gains on AFS equity shares	108	25
Collectively assessed impairment provisions	635	778
Non-controlling Tier 2 capital	11	11
	17,119	19,411
Tier 2 deductions		
50% of securitisation positions	(2,019)	(2,321)
50% excess of expected losses over impairment provisions	(3,451)	(2,658)
50% of material holdings	(340)	(310)
50% of APS first loss	(2,763)	(4,225)
	(8,573)	(9,514)
Total Tier 2 capital	8,546	9,897
Supervisory deductions		
Unconsolidated investments		
- RBS Insurance	(4,354)	(3,962)
- Other investments	(239)	(318)
Other deductions	(235)	(452)
	(4,828)	(4,732)
Total regulatory capital	60,708	65,289

Capital *continued*

The following table details the main terms and conditions of the Group's capital instruments treated as Tier 1 capital under Pillar 1, or Tier 2 capital which includes an incentive for the issuer to redeem. The balances are the IFRS balance sheet carrying amounts, which may differ from the amount which the instrument contributes to regulatory capital. Regulatory balances exclude, for example, issuance costs and fair value movements, while dated capital is required to be amortised on a straight-line basis over the final five years of maturity. For accounting purposes the capital instruments in the following table are included within equity or subordinated liabilities, details of which are included on pages 383 to 393 of the Group's 2011 Annual Report and Accounts.

Table 3: Capital instruments

Description	Pillar 1 treatment	Step-up coupon	2011 £m	2010 £m
RBSG - undated loan capital (Tier 1)				
US\$762 million 7.648% perpetual regulatory Tier 1 securities (callable September 2031)	Tier 1	3 month US\$ LIBOR plus 2.5%	497	494
RBSG - debt preference shares				
US\$156 million Series F 7.65% (redeemable at option of issuer)	Tier 1	-	101	101
US\$242 million Series H 7.25% (redeemable at option of issuer)	Tier 1	-	157	156
US\$751 million Series L 5.75% (redeemable at option of issuer)	Tier 1	-	485	484
US\$65 million Series 1 9.118% (redeemable at option of issuer)	Tier 1	-	43	43
£15 million Series 1 7.387% (redeemable at option of issuer)	Tier 1	-	15	15
£0.5 million 11% and £0.4 million 5.5% (non-redeemable)	Tier 1	-	1	1
NatWest Plc - debt preference shares				
£140 million Series A 9% (non-redeemable)	Tier 1	-	145	144
US\$246 million Series C 7.7628% (redeemable at option of issuer)	Tier 1	-	169	168
RBS US Capital Trusts - debt trust preferred securities				
€391 million 6.467% (redeemable June 2012)	Tier 1	3 month EURIBOR plus 2.1%	340	339
US\$486 million 6.8% (perpetual callable September 2009)	Tier 1	-	309	289
US\$318 million 4.709% (redeemable July 2013)	Tier 1	3 month US\$ LIBOR plus 1.865%	210	190
US\$394 million 6.425% (redeemable January 2034)	Tier 1	3 month US\$ LIBOR plus 1.9425%	382	291
RBS NV US Capital Trusts - debt trust preferred securities				
US\$1,285 million 5.90% Trust Preferred V (redeemable at option of issuer)	Tier 1	-	684	633
US\$200 million 6.25% Trust Preferred VI (redeemable at option of issuer)	Tier 1	-	108	100
US\$1,800 million 6.08% Trust Preferred VII (redeemable at option of issuer)	Tier 1	-	958	889

Capital *continued*

Table 3: Capital instruments *continued*

Description	Pillar 1 treatment	Step-up coupon	2011 £m	2010 £m
RBS US Capital Trusts - equity trust preferred securities				
US\$357 million 5.512% (redeemable September 2014)	Tier 1	3 month US\$ LIBOR plus 1.84%	198	198
US\$276 million 3 month US\$ LIBOR plus 0.80% (redeemable September 2014)	Tier 1	3 month US\$ LIBOR plus 1.8%	153	153
€166 million 4.243% (redeemable January 2016)	Tier 1	3 month EURIBOR plus 1.69%	112	112
£93 million 5.6457% (redeemable June 2017)	Tier 1	Interpolation between 3 month and 4 month LIBOR plus 1.69%	93	93
RBSG - paid in equity trades				
CAD321 million 6.666% (redeemable October 2017)	Tier 1	3 month CDOR plus 2.76%	156	156
US\$564 million 6.99% (redeemable October 2017)	Tier 1	3 month US\$ LIBOR plus 2.67%	275	275
RBSG - equity preference shares				
US\$578 million Series M 6.4% (redeemable at option of issuer)	Tier 1	-	313	313
US\$553 million Series N 6.35% (redeemable at option of issuer)	Tier 1	-	292	292
US\$247 million Series P 6.25% (redeemable at option of issuer)	Tier 1	-	138	138
US\$516 million Series Q 6.75% (redeemable at option of issuer)	Tier 1	-	268	268
US\$254 million Series R 6.125% (redeemable at option of issuer)	Tier 1	-	126	126
US\$661 million Series S 6.6% (redeemable June 2012)	Tier 1	-	321	321
US\$1,281 million Series T 7.25% (redeemable December 2012)	Tier 1	-	615	615
US\$1,013 million Series U 7.64% (callable September 2017)	Tier 1	3 month US\$ LIBOR plus 2.32%	494	494
€1,250 million Series 1 5.5% (redeemable at option of issuer)	Tier 1	-	860	860
€785 million Series 2 5.25% (redeemable at option of issuer)	Tier 1	-	512	512
€471 million Series 3 7.0916% (callable September 2017)	Tier 1	3 month EURIBOR plus 2.33%	325	325
£54 million Series 1 8.162% (redeemable October 2012)	Tier 1	3 month LIBOR plus 2.33%	54	54

Capital *continued*

Table 3: Capital instruments *continued*

Description	Pillar 1 treatment	Step-up coupon	2011 £m	2010 £m
Tier 2 capital securities which contain an incentive for the issuer to redeem				
€10 million floating rate undated step-up notes (callable on any interest payment date)	Upper Tier 2	3 month EURIBOR plus 2.15%	9	9
€178 million 6.625% fixed/floating rate undated subordinated notes (callable on any interest payment date)	Upper Tier 2	3 month EURIBOR plus 2.15%	150	154
£1 million 5% undated subordinated notes (callable September 2012)	Upper Tier 2	6 month LIBOR plus 0.75%	1	2
€176 million 5.125% undated subordinated notes (callable July 2014)	Upper Tier 2	3 month EURIBOR plus 1.65%	161	166
€170 million floating rate undated subordinated notes (callable July 2014)	Upper Tier 2	3 month EURIBOR plus 1.60%	141	145
£56 million 6% undated subordinated notes (callable September 2014)	Upper Tier 2	5 year UK Gilts yield plus 1.85%	62	61
£87 million floating undated subordinated step-up notes (callable January 2015)	Upper Tier 2	5 year UK Gilts yield plus 2.98%	91	89
£54 million 5.125% undated subordinated notes (callable March 2016)	Upper Tier 2	5 year UK Gilts yield plus 1.95%	61	58
CAD474 million 5.37% fixed rate undated subordinated notes (callable May 2016)	Upper Tier 2	3 month CDOR plus 1.48%	347	340
£51 million 6.25% undated subordinated notes (callable December 2012)	Upper Tier 2	5 year UK Gilts yield plus 2.35%	53	55
£103 million 9.5% undated subordinated bonds (callable August 2018)	Upper Tier 2	Higher of 9.5% or 5 year UK Gilts yield plus 2.375%	137	130
£35 million 5.5% undated subordinated notes (callable December 2019)	Upper Tier 2	5 year UK Gilts yield plus 1.84%	37	35
£21 million 6.2% undated subordinated notes (callable March 2022)	Upper Tier 2	5 year UK Gilts yield plus 2.05%	45	43
£53 million 7.125% undated subordinated step-up notes (callable October 2022)	Upper Tier 2	5 year UK Gilts yield plus 3.08%	56	54
£22 million 5.625% undated subordinated notes (callable September 2026)	Upper Tier 2	5 year UK Gilts yield plus 2.1%	23	21
£19 million 5.625% undated subordinated notes (callable June 2032)	Upper Tier 2	5 year UK Gilts yield plus 2.41%	13	20
AUD450 million floating rate subordinated notes 2017 (callable February 2012)	Lower Tier 2	3 month BBSW plus 0.78%	298	295
CAD700 million 4.25% subordinated notes 2015 (callable March 2015)	Lower Tier 2	3 month CDOR plus 0.72%	444	452
US\$1,500 million floating rate subordinated notes 2016 (callable January 2012)	Lower Tier 2	3 month US\$ LIBOR plus 0.7%	971	967
US\$500 million floating rate subordinated notes 2016 (callable January 2012)	Lower Tier 2	3 month US\$ LIBOR plus 0.78%	324	322
€500 million 4.5% subordinated notes 2016 (callable January 2012)	Lower Tier 2	3 month EURIBOR plus 0.85%	420	450
€500 million floating rate subordinated notes 2017 (callable June 2012)	Lower Tier 2	3 month EURIBOR plus 0.75%	419	432
AUD410 million floating rate subordinated notes 2014 (callable July 2012)	Lower Tier 2	3 month BBSW plus 0.87%	272	272
AUD590 million 6% subordinated notes 2014 (callable July 2012)	Lower Tier 2	3 month BBSW plus 0.87%	392	391
AUD450 million 6.5% subordinated notes 2017 (callable February 2012)	Lower Tier 2	3 month BBSW plus 0.78%	303	302
US\$1,500 million floating rate subordinated callable step-up notes 2017 (callable August 2012)	Lower Tier 2	3 month US\$ LIBOR plus 0.7%	971	966
CHF200 million 2.75% subordinated notes 2017 (callable December 2012)	Lower Tier 2	3 month CHF LIBOR plus 0.62%	138	138
£60 million 6.375% subordinated bonds 2018 (callable April 2013)	Lower Tier 2	3 month LIBOR plus 2.54%	64	66

Capital *continued*

Table 3: Capital instruments *continued*

Description	Pillar 1 treatment	Step-up coupon	2011 £m	2010 £m
<i>Tier 2 capital securities which contain an incentive for the issuer to redeem</i>				
€5 million floating rate Bermudan callable subordinated notes 2015 (callable January 2012)	Lower Tier 2	3 month EURIBOR plus 1.5%	4	4
AUD175 million floating rate Bermudan callable subordinated notes 2018 (callable May 2013)	Lower Tier 2	3 month BBSW plus 0.79%	111	111
AUD575 million 6.5% Bermudan callable subordinated notes 2018 (callable May 2013)	Lower Tier 2	3 month BBSW plus 0.79%	378	371
US\$1,500 million floating rate Bermudan callable subordinated notes 2015 (callable March 2012)	Lower Tier 2	3 month US\$ LIBOR plus 0.7%	930	927
€1,500 million floating rate Bermudan callable subordinated notes 2015 (callable March 2012)	Lower Tier 2	3 month EURIBOR plus 0.75%	1,246	1,283
€100 million 5.13% flip flop Bermudan callable subordinated notes 2017 (callable December 2012)	Lower Tier 2	3 month EURIBOR plus 0.94%	78	69
€1,000 million 4.625% subordinated notes 2021 (callable September 2016)	Lower Tier 2	3 month EURIBOR plus 1.3%	948	949

Credit risk

Credit risk is the risk of financial loss owing to the failure of a customer to meet its obligation to settle outstanding amounts. The quantum and nature of credit risk assumed across the Group's different businesses vary considerably, while the overall credit risk outcome usually exhibits a high degree of correlation with the macroeconomic environment.

Organisation

The existence of a strong credit risk management function is vital to support the ongoing profitability of the Group. The potential for loss through economic cycles is mitigated through the embedding of a robust credit risk culture within the business units and through a focus on the importance of sustainable lending practices. The role of the credit risk management organisation is to own the credit approval, concentration and credit risk control frameworks and to act as the ultimate authority for the approval of credit. This, together with strong independent oversight and challenge, enables the business to maintain a sound lending environment within risk appetite.

Responsibility for development of Group-wide policies, credit risk frameworks, Group-wide portfolio management and assessment of provision adequacy, sits within the Group Credit Risk (GCR) function under the management of the Group Chief Credit Officer. Execution of these policies and frameworks is the responsibility of the risk management functions, located within the Group's business divisions. These divisional credit risk functions work together with GCR to ensure that the Group Board's expressed risk appetite is met, within a clearly defined and managed control environment. The credit risk function within each division is managed by a Chief Credit Officer, who reports jointly to a divisional Chief Risk Officer and to the Group Chief Credit Officer. Divisional activities within credit risk include credit approval, transaction and portfolio analysis, early problem recognition and ongoing credit risk stewardship.

GCR is additionally responsible for verifying compliance by the divisions with all Group credit policies. It is assisted in this by a credit quality assurance function owned by the Group Chief Credit Officer and housed within the divisions.

Credit approval

Credit approval authority is discharged by way of a framework of individual delegated authorities that requires at least two individuals to approve each credit decision, one from the business and one from the credit risk management function. Both parties must hold sufficient delegated authority under the Group-wide authority grid. Whilst both parties are accountable for the quality of each decision taken, the credit risk management approver holds ultimate sanctioning authority. The level of authority granted to individuals is dependent on their experience and expertise with only a small number of senior executives holding the highest authority provided under the framework. Daily monitoring of individual counterparty limits is undertaken.

At a minimum, credit relationships are reviewed and re-approved annually. The renewal process addresses: borrower performance, including reconfirmation or adjustment of risk parameter estimates; the adequacy of security; and compliance with terms and conditions. For

certain counterparties, early warning indicators are also in place to detect deteriorating trends of concern in limit utilisation or account performance and to prompt additional oversight.

Risk appetite

Credit concentration risk is managed and controlled through a series of frameworks designed to limit concentration by product/asset class, sector, single name and country. These are supported by a suite of Group-wide and divisional policies, setting out the risk parameters within which business units may operate. Information on the Group's credit portfolios is reported to the Group Board by way of the divisional and Group-level risk committees.

For more information on how the Group's credit risk appetite by product/asset class, sector and single name is managed and controlled, refer to pages 134 and 135 of the Group's 2011 Annual Report and Accounts.

Country risk

Country risk is the risk of material losses arising from significant country-specific events such as sovereign events (default or restructuring); economic events (contagion of sovereign default to other parts of the economy, cyclical economic shock); political events (transfer or convertibility restrictions and expropriation or nationalisation); and natural disaster or conflict. Such events have the potential to affect elements of the Group's credit portfolio that are directly or indirectly linked to the country in question and can also give rise to market, liquidity, operational and franchise risk related losses.

A country watch list framework is in place to proactively monitor emerging issues and facilitate the development of mitigation strategies.

Management of country risk was further strengthened in 2011 with intensified stress testing, portfolio actions on a number of countries and enhancements to risk appetite setting and management systems, contributing inter alia to a reduction in exposures to a range of countries.

During 2011, the Group conducted an analysis of its country risk profile. The outcome of this analysis was used to define more specific scenarios to be used as trigger events in stress testing, on an ongoing basis, at both Group and divisional levels. Such risk scenarios include a major balance sheet deleveraging across Europe, a default of a eurozone sovereign, or one or more stressed member states exiting the eurozone and undergoing currency redenomination, with subsequent contagion effects.

Risk appetite setting was strengthened by various measures. In addition to Greece, Ireland and Portugal, the Group brought Italy and Spain under country limit control. Belgium and Japan followed in January 2012, with other advanced countries scheduled for review in this process throughout 2012. Benchmark ratios systematically guided the setting of medium-term country exposure limits. For more information on how the Group manages country risk, refer to pages 208 to 210 of the Group's 2011 Annual Report and Accounts.

Credit risk continued

Credit risk measurement

Credit risk models are used throughout the Group to support the quantitative risk assessment element within the credit approval process, ongoing credit risk management, monitoring and reporting and portfolio analytics. Credit risk models used by the Group may be divided into three categories, as follows.

Probability of default (PD)/customer credit grade

These models assess the probability that a customer will fail to make full and timely repayment of its obligations. The probability of a customer failing to do so is measured over a one year period through the economic cycle, although certain retail scorecards use longer periods for business management purposes.

Wholesale businesses - as part of the credit assessment process, each counterparty is assigned an internal credit grade derived from a default probability. There are a number of different credit grading models in use across the Group, each of which considers risk characteristics particular to that type of customer. The credit grading models score a combination of quantitative inputs (for example, recent financial performance) and qualitative inputs (for example, management performance or sector outlook).

Retail businesses - each customer account is separately scored using models based on the most material drivers of default. In general, scorecards are statistically derived using customer data. Customers are assigned a score which in turn, is mapped to a probability of default. The probabilities of default are used to support automated credit decision making and to group customers into risk pools for regulatory capital calculations.

Exposure at default

Facility usage models estimate the expected level of utilisation of a credit facility at the time of a borrower's default. For revolving and variable draw down type products which are not fully drawn, the exposure at default (EAD) will typically be higher than the current utilisation. The methodologies used in EAD modelling provide an estimate of potential exposure and recognise that customers may make more use of their existing credit facilities as they approach default. This estimate of default quantum can be reduced by acceptable forms of financial collateral provided by the obligor, or via a balance sheet netting agreement.

Counterparty credit risk exposure measurement models are used for derivative and other traded instruments, where the amount of credit risk exposure may be dependent upon one or more underlying market variables, such as interest or foreign exchange rates. These models drive internal credit risk management activities such as limit and excess management.

Loss given default

These models estimate the amount that cannot be recovered by the Group on a credit facility in the event of default. The Group's loss given default (LGD) models take into account both borrower and facility characteristics for unsecured or partially unsecured facilities, as well as any risk mitigation that may be in place for secured facilities, the cost of collections and a time discount factor for the delay in cash recovery. Various credit risk mitigation techniques are applied to LGD to reflect the reduction in recovery risk including guarantees, credit derivatives and physical collateral.

Credit risk mitigation

The Group employs a number of structures and techniques to mitigate credit risk. Netting of debtor and creditor balances is undertaken in accordance with relevant regulatory and internal policies. Exposure on over-the-counter derivative and secured financing transactions is further mitigated by the exchange of financial collateral and the use of market standard documentation. Further mitigation may be undertaken in a range of transactions, from retail mortgage lending to large wholesale financing. This can include: structuring a security interest in a physical or financial asset; use of credit derivatives, including credit default swaps (CDSs), credit-linked debt instruments and securitisation structures; and use of guarantees and similar instruments (for example, credit insurance) from related and third parties. Such techniques are used in the management of credit portfolios, typically to mitigate credit concentrations in relation to an individual obligor, a borrower group or a collection of related borrowers.

The Group's use of credit risk mitigation and the approach taken vary by product type, customer and business strategy, with minimum standards applied across the Group.

For more information on the Group's credit risk mitigation structures and techniques, including detailed discussion of collateral and other credit enhancements, refer to pages 141 to 143 of the Group's 2011 Annual Report and Accounts.

Credit risk *continued*

Primary types of credit risk mitigants

The following table details how different risk mitigants are incorporated into IRB risk parameters across both wholesale and retail businesses.

Table 4: Incorporation of credit risk mitigants within IRB risk parameters

	LGD	PD	EAD/E* (1)
Real estate (commercial and residential)	✓		
Other physical collateral	✓		
Third party guarantee	✓		
Credit derivative	✓		
Parental guarantee (connected parties)		✓	
Financial collateral (trading book)			✓
Financial collateral (non-trading book)	✓		
Netting (on and off-balance sheet)			✓
Receivables	✓		
Life policies	✓		
Credit insurance	✓		

Note:

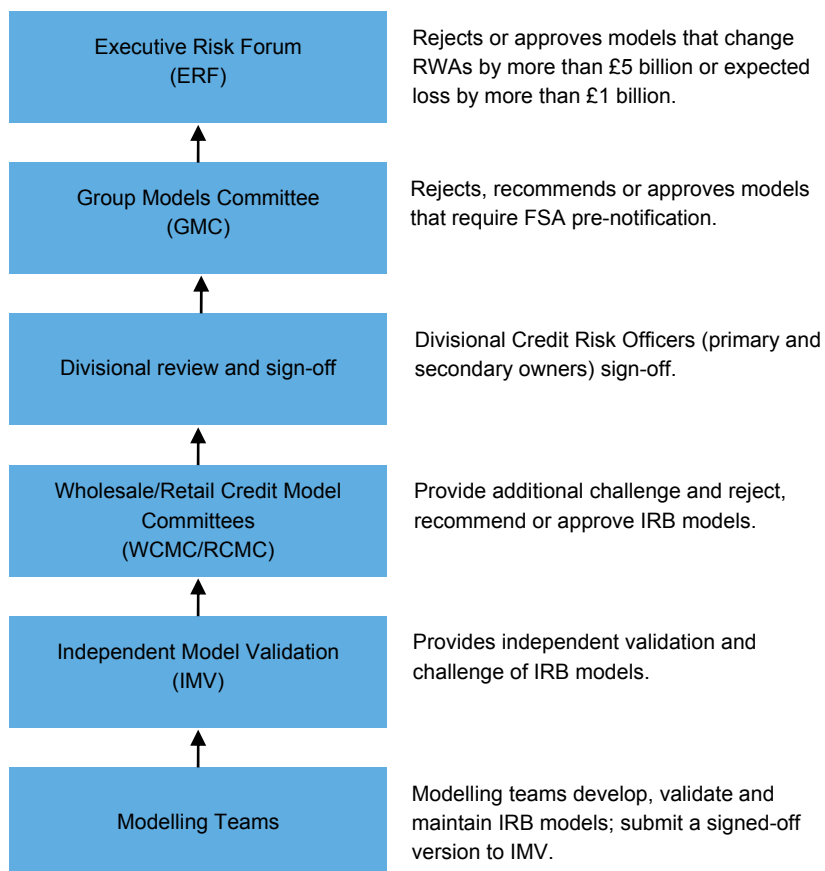
(1) EAD refers to exposure at default in the non-trading book. E* is the term used for the corresponding measure in the trading book.

Model review governance

The Group Risk Analytics Model Review Team is responsible for independent oversight of wholesale and retail models and approaches. Two committees, the Wholesale Credit Model Committee and the Retail Credit Model Committee, review and challenge all models. These committees are composed of members of the Group Credit Risk function and senior managers from within divisional credit risk.

Models and model changes that require pre-notification to the FSA before implementation must first be approved by the Group Model Committee, which is a sub-committee of the Group Risk Committee. The internal model review and approval process and governance arrangements are detailed in the following chart:

Chart 2: Governance structure for model review and approval



Credit risk *continued*

Model validation

The performance and accuracy of credit models are critical in supporting both effective risk management and the calculation of risk parameters (PD, LGD and EAD) used by the Group to determine RWAs. The models are subject to annual reviews internally and, if used as part of the IRB Basel II framework, are first reviewed and approved for use by the FSA. Independent model validation is performed by a Group-level function, Group Risk Analytics. This includes an evaluation of the model development and validation of the data set used, logic and assumptions, and performance of the model analysis.

The validation results are a key factor in deciding whether a model is recommended for ongoing use. The frequency, depth and extent of the validation reflect the materiality and complexity of the risk being managed.

The Group's validation processes include:

Review of developmental evidence - to ensure that the credit risk model adequately discriminates between different levels of risk and delivers accurate risk estimates.

Process verification - to verify whether the methods used in the credit risk models are being used, monitored and updated in the way intended when they were designed. Initial testing and validation are performed at the time the models are developed, with their performance being assessed on an ongoing basis.

Basel II credit risk-weighted assets measurements

RBS has been granted a waiver by the FSA to use the advanced IRB approach to calculate its capital requirements for the majority of its credit exposures. This approach permits the Group to use its own models to determine the amount of capital it requires in accordance with the credit risk parameters (i.e. PD, LGD and EAD) discussed previously.

In some instances, the Group applies the standardised approach, under which exposures are allocated to prescribed exposure classes, which determine the risk-weights applied. For exposures to corporates, sovereigns and institutions, the Group uses the external credit assessments of recognised credit rating agencies (Standard & Poor's, Moody's and Fitch, as appropriate). For all other exposures, e.g. retail or unrated corporates, the Group uses the risk-weights determined according to FSA guidelines.

The tables that follow provide a summary of exposures by either the advanced IRB or standardised approach. The Group also has residual exposures that are assessed in accordance with the project finance slotting approach (refer to table 14 on page 27).

The following table details the Group's credit RWAs and minimum capital requirement by credit risk approach. These balances include both intra-group assets and non-customer assets. The latter are assets owned by the Group that do not have associated credit risk or uncertainty related to obligor performance that might affect their future value.

Table 5: Credit RWAs and minimum capital requirement

	2011		2010	
	Credit RWAs (1) £m	Minimum capital requirement £m	Credit RWAs (1) £m	Minimum capital requirement £m
Credit risk approach				
Advanced IRB	242,023	19,362	270,767	21,662
Standardised (2)	102,198	8,176	115,052	9,204
Counterparty credit risk	61,918	4,953	68,142	5,451
	406,139	32,491	453,961	36,317
Of which - non-controlling interests	2,884	231	2,879	230
	403,255	32,260	451,082	36,087

Notes:

(1) Include both intra-group and non-customer assets.

(2) Credit RWAs estimated under the standardised approach incorporate transitional portfolios such as those of Citizens Financial Group. Such transitional portfolios are exempted from the calculation of the ratio of credit risk RWAs estimated under the standardised approach as a percentage of total credit risk RWAs, to determine whether or not the Group may use the advanced IRB approach.

Key points

- RWAs calculated under the advanced IRB approach decreased 10.6% (£28.7 billion) compared with 2010, predominantly driven by the disposal of Non-Core assets.
- The decrease in counterparty credit risk RWAs was due to a wind-down of the exotic credit trading portfolios.
- RWAs calculated under the standardised approach declined 11.2% (£12.9 billion), reflecting a reduction in the Group's balance sheet and the reclassification of a credit default swap to the advanced IRB approach.

A detailed analysis of the Group's credit RWAs calculated by credit risk approach is contained in the sections that follow. Exposure, as shown in these credit disclosures, is defined as EAD. This is an estimate of the expected level of utilisation of a credit facility at the time of default and will be equal to or greater than the drawn exposure.

Credit risk *continued*

Credit risk by advanced IRB approach

The following table details the Group's credit RWAs and minimum capital requirement by advanced IRB exposure class and sub-class. These balances include non-customer assets but exclude intra-group assets as well as over-the-counter (OTC) derivative and repurchase agreement (repo) products.

Table 6: Credit RWAs and minimum capital requirement by advanced IRB exposure class

Advanced IRB exposure class and sub-class	2011		2010	
	Credit RWAs £m	Minimum capital requirement £m	Credit RWAs £m	Minimum capital requirement £m
Central governments and central banks	2,220	178	3,432	275
Institutions	7,438	595	8,758	701
Corporates	143,409	11,473	169,226	13,538
Retail	62,870	5,030	65,478	5,238
Retail small and medium-sized enterprises (SME)	9,560	765	12,785	1,023
Retail secured by real estate collateral	35,390	2,831	30,619	2,449
Qualifying revolving retail exposures	10,450	836	13,424	1,074
Other retail exposures	7,470	598	8,650	692
Equities (1)	4,581	366	5,191	415
Exchange traded exposures	974	78	1,041	83
Private equity exposures	1,218	97	1,679	134
Other exposures	2,389	191	2,471	198
Securitisation positions	9,103	728	10,261	821
Non-credit obligation assets	12,402	992	8,421	674
	242,023	19,362	270,767	21,662

Note:

(1) Equity exposures treated through the PD/LGD approach in 2011 have a minimum capital requirement of £234 million (2010 - £321 million). Equity exposures treated through the simple risk-weight approach in 2011 have a minimum capital requirement of £133 million (2010 - £94 million).

Key points

- The 10.6% decrease in total credit RWAs was predominantly driven by the reduction in exposure to corporates, itself the result of the disposal of Non-Core assets.
- The decline in securitisation positions was largely driven by the reclassification of diversified payment right vehicles from securitisation positions to loans, in accordance with BIPRU 4.
- The decrease in credit RWAs resulting from exposures to central governments and central banks was due to the impairment of Greek sovereign exposures during 2011.
- The increase in non-credit obligation assets was predominantly driven by the movement of deferred tax from the standardised to the advanced IRB approach.

These trends can be observed in greater detail in the tables that follow.

The Group's commercial real estate loan book totalled approximately £75 billion at 31 December 2011, of which £24 billion was non-performing (AQ10). The non-performing loan book has no RWAs associated with it, instead the Group has recorded impairment provisions and a capital deduction via expected loss. The remaining £50 billion of performing loans have RWAs of approximately £44 billion which translates to an 88% RWA to asset ratio. The Group is in the process of implementing changes to the RWA requirements for commercial real estate portfolios consistent with revised industry guidance from the FSA. This is projected to increase RWA requirements by approximately £20 billion by the end of 2013, of which approximately £10 billion will apply in 2012.

Credit risk *continued*

Advanced IRB gross customer credit risk

Tables 7 to 10 detail the Group's advanced IRB gross customer credit risk by average exposure, geographic area, industry sector and residual maturity band.

Table 7: Advanced IRB gross average exposure at default

Advanced IRB exposure class	2011		2010	
	EAD pre CRM (1,2) £m	Average EAD pre CRM (3) £m	EAD pre CRM (1,2) £m	Average EAD pre CRM (3) £m
Central governments and central banks	116,686	119,426	100,968	84,441
Institutions	29,640	34,551	33,319	34,923
Corporates	316,692	325,332	339,293	355,740
Retail	175,833	177,975	179,936	177,845
Equities	1,221	1,499	1,686	2,259
Securitisation positions	42,236	46,970	53,640	61,897
Non-credit obligation assets (4)	5,781	5,345	5,047	4,840
	688,089	711,098	713,889	721,945

Notes:

- (1) EAD pre credit risk mitigation (CRM) is before the application of on-balance sheet netting.
- (2) EAD excludes non-customer assets along with OTC derivatives and repo products, which are shown separately in the counterparty credit risk disclosures. The credit risk in these products is modelled using the mark-to-market, internal model or repo VaR methods and is reported under the counterparty credit risk approach.
- (3) Average EAD is based on the full year.
- (4) Non-credit obligation assets refer to the residual value of leases only.

Key points

- The decrease in advanced IRB exposure (£25.8 billion) was primarily driven by the fall in corporates, itself the result of the disposal of relatively capital intensive Non-Core assets and exposure repayments.
- The increase in exposure to central governments and central banks was predominantly driven by short-term liquidity placements with highly rated central bank counterparties (mainly in North America and Western Europe).
- The decrease in exposures to institutions was driven by declines in short-term markets financing (STMF), where a strategy-driven expansion of secured funding and short-term trading with highly rated sovereigns has partially offset activity with institutional counterparties.
- The reduction in securitisation positions was driven by the buyback of a number of residential mortgage securitisations. A secondary factor was the reclassification of diversified payment right vehicles from securitisation positions to loans.

Credit risk *continued*

Table 8: Advanced IRB gross exposure at default by geographic area

Advanced IRB exposure class	UK £m	North America £m	Western Europe (excl. UK) £m	Asia and Pacific £m	Latin America £m	CEE and Central Asia £m	Middle East and Africa £m	Total £m
2011 (1,2,3,4)								
Central governments and central banks	6,747	45,592	53,815	8,843	118	1,250	321	116,686
Institutions	1,718	2,675	13,533	7,699	1,615	1,313	1,087	29,640
Corporates	146,309	35,061	90,919	19,115	11,752	5,790	7,746	316,692
Retail	153,898	196	21,105	376	64	51	143	175,833
Equities	639	121	324	112	25	-	-	1,221
Securitisation positions	8,765	12,879	11,694	3,426	5,440	-	32	42,236
Non-credit obligation assets (5)	1,528	175	2,336	909	398	288	147	5,781
	319,604	96,699	193,726	40,480	19,412	8,692	9,476	688,089
2010 (1,2,3)								
Central governments and central banks	6,645	33,944	48,615	9,943	164	1,275	382	100,968
Institutions	4,177	4,356	13,558	7,743	1,372	1,001	1,112	33,319
Corporates	152,132	35,583	99,718	21,909	11,788	7,903	10,260	339,293
Retail	157,795	195	21,316	348	76	60	146	179,936
Equities	693	97	495	177	206	5	13	1,686
Securitisation positions	10,346	16,045	13,518	4,388	9,258	53	32	53,640
Non-credit obligation assets (5)	839	181	2,461	842	387	191	146	5,047
	332,627	90,401	199,681	45,350	23,251	10,488	12,091	713,889

Notes:

- (1) EAD pre CRM is before the application of on-balance sheet netting.
- (2) EAD excludes non-customer assets along with OTC derivatives and repo products, which are shown separately in the counterparty credit risk disclosures. The credit risk in these products is modelled using the mark-to-market, internal model or repo VaR methods and is reported under the counterparty credit risk approach.
- (3) Average EAD for 2011 is based on the full year.
- (4) The geographic area is determined by the country of incorporation for companies and as the country of residence for individuals.
- (5) Non-credit obligation assets refer to the residual value of leases only.

Key points

- The £25.8 billion (3.6%) decrease in advanced IRB exposure was driven largely by the UK (3.9%), Western Europe (3.0%), Latin America (16.5%) and Asia and Pacific (10.7%), partially offset by an increase of 7.0% in North America.
- The decrease in exposures to institutions was driven by declines in STMF, where a strategy-driven expansion of secured funding and short-term trading with highly rated sovereigns has partially offset activity with institutional counterparties.
- Exposure reduction was most notable within corporates, as country risk limits were reduced in Western Europe, and Non-Core asset disposals increased in Western Europe and the UK.
- The decrease in securitisation positions in Latin America resulted from the reclassification of diversified payment right vehicles from securitisation positions to loans. North America also witnessed a decrease in securitisation positions due to the disposal of a securitisation exposure.
- The decrease in exposure to Asia and Pacific was driven by a change of strategy and hence a reduction in risk appetite. This was spread over a number of sectors, mostly in property, natural resources and insurers and funds.

Credit risk *continued*

Table 9: Advanced IRB gross exposure at default by industry sector (1)

Sector	Central governments and central banks £m	Institutions £m	Corporates £m	Retail £m	Equities £m	Securitisation positions £m	Non-credit obligation assets £m	Total £m
2011 (2)								
Banks	4,681	29,587	471	-	32	-	103	34,874
Financial guarantors	-	-	7	-	-	-	-	7
Hedge funds	-	-	111	-	-	-	-	111
Insurers and funds	-	3	13,805	97	260	198	75	14,438
Manufacturing (cyclical)	-	-	16,092	313	10	-	16	16,431
Manufacturing (non-cyclical)	-	-	14,772	1,985	22	-	28	16,807
Natural resources	-	-	34,709	58	39	115	86	35,007
Non-bank financial institutions	262	50	17,853	87	373	3,005	19	21,649
Personal	-	-	1,384	161,283	-	-	-	162,667
Property	-	-	96,534	4,007	180	-	187	100,908
Retail and leisure	-	-	28,927	3,337	171	646	367	33,448
Securitisations	-	-	8,108	-	1	38,065	-	46,174
Services	63	-	24,327	3,512	30	110	76	28,118
Sovereigns and quasi-sovereigns	111,604	-	171	21	-	-	108	111,904
Technology, media and telecommunications	-	-	18,473	353	103	-	73	19,002
Transport	76	-	40,948	780	-	97	4,643	46,544
	116,686	29,640	316,692	175,833	1,221	42,236	5,781	688,089
2010 (2)								
Banks	4,228	33,016	552	-	131	-	107	38,034
Financial guarantors	-	-	6	-	-	-	-	6
Hedge funds	-	-	557	-	-	-	-	557
Insurers and funds	-	-	13,628	127	401	-	76	14,232
Manufacturing (cyclical)	-	-	17,861	381	9	-	3	18,254
Manufacturing (non-cyclical)	-	-	16,066	2,928	25	-	14	19,033
Natural resources	153	-	36,702	76	21	-	49	37,001
Non-bank financial institutions	245	303	24,503	114	429	2,365	24	27,983
Personal	-	-	1,545	159,584	-	-	-	161,129
Property	-	-	105,641	6,203	330	42	187	112,403
Retail and leisure	2	-	29,601	4,494	142	661	314	35,214
Securitisations	-	-	3,201	-	-	50,361	-	53,562
Services	174	-	25,668	4,616	77	112	30	30,677
Sovereigns and quasi-sovereigns	96,084	-	287	27	-	-	114	96,512
Technology, media and telecommunications	-	-	18,629	431	111	-	70	19,241
Transport	82	-	44,846	955	10	99	4,059	50,051
	100,968	33,319	339,293	179,936	1,686	53,640	5,047	713,889

Notes:

(1) Industry sectors are determined using the standard industrial classification (SIC) codes of the counterparty.

(2) EAD pre CRM is before the application of on-balance sheet netting. EAD excludes non-customer assets along with OTC derivatives and repo products, which are shown separately in the counterparty credit risk disclosures. The credit risk in these products is modelled using the mark-to-market, internal model or repo VaR methods and is reported under the counterparty credit risk approach.

Key points

- The £15.4 billion increase in the sovereigns and quasi-sovereigns sector was predominantly driven by short-term liquidity placements with highly rated central bank counterparties (mainly in North America and Western Europe). This is in relation to the new strategy in STMF explained below.
- The decrease in exposures to banks was driven by declines in STMF, where a strategy-driven expansion of secured funding and short-term trading with highly rated sovereigns has partially offset activity with institutional counterparties.
- A review of single name concentrations led to a decrease in lending limits for borrowers in the property sector and hence exposures to the property sector. Exposures across a number of sectors, notably transport, natural resources and non-bank financial institutions, fell, primarily driven by disposals and repayments of borrowings in the Non-Core book.

Credit risk *continued*

Table 10: Advanced IRB gross exposure at default by residual maturity (1)

Advanced IRB exposure class	Within 1 year (2) £m	After 1 year but within 5 years £m	After 5 years £m	Total £m
2011 (3,4)				
Central governments and central banks	77,595	15,268	23,823	116,686
Institutions	17,102	9,952	2,586	29,640
Corporates	114,959	136,633	65,100	316,692
Retail	36,729	11,640	127,464	175,833
Equities	-	-	1,221	1,221
Securitisation positions	16,081	8,691	17,464	42,236
Non-credit obligation assets (5)	1,054	2,772	1,955	5,781
	263,520	184,956	239,613	688,089
2010 (3,4)				
Central governments and central banks	53,190	19,981	27,797	100,968
Institutions	20,984	8,137	4,198	33,319
Corporates	114,477	152,988	71,828	339,293
Retail	32,674	18,390	128,872	179,936
Equities	-	-	1,686	1,686
Securitisation positions	22,886	10,384	20,370	53,640
Non-credit obligation assets (5)	323	1,870	2,854	5,047
	244,534	211,750	257,605	713,889

Notes:

- (1) Exposures are classified into maturity bandings in accordance with their residual contractual maturity.
- (2) Revolving facilities are included in the within 1 year maturity band.
- (3) EAD pre CRM is before the application of on-balance sheet netting.
- (4) EAD excludes non-customer assets along with OTC derivatives and repo products, which are shown separately in the counterparty credit risk disclosures. The credit risk in these products is modelled using the mark-to-market, internal model or repo VaR methods and is reported under the counterparty credit risk approach.
- (5) Non-credit obligation assets refer to the residual value of leases only.

Key points

- Although total exposure fell to £688.1 billion from £713.9 billion at the end of 2010, exposures with maturities within one year increased, particularly those within central governments and central banks. The increase was driven by an emphasis on short-term liquidity placement and repos and reductions in medium to longer-term sovereign bond holdings.
- Exposures to institutions maturing within one year fell, driven by a decline in STMF activity due to the change in Group strategy explained on page 20.
- Exposures to corporates maturing after one year declined, driven by asset disposals and amortisations in Non-Core.
- Exposures to securitisation positions maturing within one year fell, as the result of the reclassification of diversified payment right vehicles from securitisation positions to loans.

Credit risk *continued*

Asset quality of advanced IRB customer credit risk and counterparty credit risk

The Group utilises a master grading scale for wholesale exposures which comprises 27 grades. These in turn map to ten asset quality (AQ) bands used to rate both wholesale and retail exposures. The relationship between these measures is detailed in the following table. The use of grades and PD estimates within the credit risk management frameworks and processes is explained on page 16.

Table 11: Master grading scale mapping to asset quality bands

Master grading scale	PD range		Asset quality bands
	Lower	Upper	
1	0%	0.006%	
2	0.006%	0.012%	
3	0.012%	0.017%	AQ1
4	0.017%	0.024%	
5	0.024%	0.034%	
6	0.034%	0.048%	AQ2
7	0.048%	0.067%	
8	0.067%	0.095%	AQ3
9	0.095%	0.135%	
10	0.135%	0.190%	
11	0.190%	0.269%	AQ4
12	0.269%	0.381%	
13	0.381%	0.538%	
14	0.538%	0.761%	AQ5
15	0.761%	1.076%	
16	1.076%	1.522%	
17	1.522%	2.153%	AQ6
18	2.153%	3.044%	
19	3.044%	4.305%	AQ7
20	4.305%	6.089%	
21	6.089%	8.611%	
22	8.611%	12.177%	AQ8
23	12.177%	17.222%	
24	17.222%	24.355%	
25	24.355%	34.443%	AQ9
26	34.443%	100%	
27	100%	100%	AQ10

Credit risk *continued*

Tables 12 to 19 detail the key parameters of the advanced IRB RWA calculation for each of the exposure classes. They include OTC derivatives and repo products, which are also detailed in the counterparty credit risk disclosures. However, they exclude products where no PD exists such as securitisation positions and non-customer assets. The credit risk of such products is indicated by either external ratings or ratings derived using the standardised approach.

Table 12: Central governments and central banks by asset quality band

Asset quality band	EAD post CRM (1) £m	Exposure weighted average LGD (2) %	Exposure weighted average risk-weight (2) %	Undrawn commitments (3) £m	Undrawn weighted average CCF (4) %
2011					
AQ1	127,030	8.7	1.5	41,253	6.7
AQ2	762	44.5	10.0	55	28.1
AQ3	1,527	36.6	23.6	222	3.5
AQ4	530	36.6	33.8	62	89.9
AQ5	68	18.8	46.6	31	81.2
AQ6	13	23.4	59.1	2	30.3
AQ7	115	9.7	30.7	4	100.8
AQ8	12	51.3	232.4	-	-
AQ9	-	-	-	-	-
AQ10/default (5)	1,426	88.9	-	-	-
	131,483	10.2	2.0	41,629	6.9
2010					
AQ1	106,837	8.9	1.8	36,563	7.6
AQ2	590	51.9	15.7	183	4.8
AQ3	1,524	38.6	25.1	361	8.7
AQ4	2,047	47.3	59.4	577	14.5
AQ5	397	29.5	47.7	378	15.8
AQ6	55	19.7	54.8	106	38.0
AQ7	174	27.1	82.4	22	85.4
AQ8	8	9.8	45.7	-	-
AQ9	-	-	-	-	-
AQ10/default (5)	-	-	-	-	-
	111,632	10.4	3.6	38,190	8.0

Notes:

- (1) EAD post CRM is exposure at default after the application of on-balance sheet netting and includes the advanced IRB element of counterparty credit risk, but excludes non-customer assets.
- (2) Exposure weighted average LGD for each of the AQ bands is derived by multiplying the EAD of each position in the band by the associated LGD, summing the resulting amounts, and then dividing the resulting amount by the sum of the EADs of the relevant AQ band. The same method applies when calculating weighted average PD.
- (3) Undrawn commitments are defined as the difference between the drawn balance and the relevant limit.
- (4) Undrawn weighted average credit conversion factor (CCF) is the sum of CCF undrawn commitments divided by the sum of undrawn commitments within each of the relevant AQ bands.
- (5) For defaulted assets (AQ10), the best estimate of expected loss (BEEL) methodology, based on downturn LGD, has been used. For these assets the Group takes a capital deduction equal to the difference between expected loss and provisions, and this may result in nil RWAs.

Key points

- The £20.2 billion increase in exposure rated AQ1 was due to a combination of increased repo activity and inflows in STMF.
- In addition, the increase in the AQ1 band reflects significant increases in overnight placements with the US central bank as part of the Group's balance sheet strategy.
- The £1.4 billion increase in exposure rated AQ10 was due to the downgrade of the Greek sovereign exposures from AQ4 during 2011. The £3.4 billion increase in undrawn commitments was predominantly driven by an increase in the German central bank limit, in accordance with the expansion of secured funding and short-term trading activity with highly rated sovereigns detailed on page 22.

Credit risk *continued*

Table 13: Institutions by asset quality band

Asset quality band	EAD post CRM (1) £m	Exposure weighted average LGD (2) %	Exposure weighted average risk-weight (2) %	Undrawn commitments (3) £m	Undrawn weighted average CCF (4) %
2011					
AQ1	64,219	33.7	20.1	36,156	4.8
AQ2	2,354	48.0	43.0	681	13.7
AQ3	3,275	55.7	54.6	2,775	10.2
AQ4	1,797	56.0	93.8	1,102	10.0
AQ5	155	56.6	153.4	175	11.3
AQ6	96	40.9	164.2	29	10.6
AQ7	190	57.0	178.2	64	5.9
AQ8	88	61.8	372.9	33	8.1
AQ9	14	95.9	652.2	-	-
AQ10/default (5)	142	81.7	-	4	102.6
	72,330	36.0	25.6	41,019	5.5
2010					
AQ1	80,108	34.2	22.0	47,410	4.6
AQ2	1,659	48.1	44.7	1,106	11.0
AQ3	3,179	50.8	59.8	1,973	6.3
AQ4	1,433	51.2	80.3	1,810	12.8
AQ5	726	54.9	138.3	533	7.6
AQ6	95	60.4	227.5	101	7.1
AQ7	395	46.9	159.0	173	5.0
AQ8	44	54.2	286.1	41	6.3
AQ9	42	63.0	108.3	5	2.9
AQ10/default (5)	153	82.1	-	20	34.8
	87,834	35.7	26.7	53,172	5.2

Notes:

- (1) EAD post CRM is exposure at default after the application of on-balance sheet netting and includes the advanced IRB element of counterparty credit risk, but excludes non-customer assets.
- (2) Exposure weighted average LGD for each of the AQ bands is derived by multiplying the EAD of each position in the band by the associated LGD, summing the resulting amounts, and then dividing the resulting amount by the sum of the EADs of the relevant AQ band. The same method applies when calculating weighted average PD.
- (3) Undrawn commitments are defined as the difference between the drawn balance and the relevant limit.
- (4) Undrawn weighted average credit conversion factor (CCF) is the sum of CCF undrawn commitments divided by the sum of undrawn commitments within each of the relevant AQ bands.
- (5) For defaulted assets (AQ10), the best estimate of expected loss (BEEL) methodology, based on downturn LGD, has been used. For these assets the Group takes a capital deduction equal to the difference between expected loss and provisions, and this may result in nil RWAs.

Key points

- The decrease of £15.5 billion in EAD was due to lower STMF business activity, detailed on page 20, and the resulting decline in repo and OTC derivative trading activity. The impact of this reduction was most notable within the AQ1 asset quality band and it also drove a slight decrease in LGDs.
- There was a slight reduction in the overall average risk-weights due to improvements in the quality of origination.

Credit risk *continued*

Table 14: Corporates by asset quality band

Asset quality band	EAD post CRM (1) £m	Exposure weighted average LGD (2) %	Exposure weighted average risk-weight (2) %	Undrawn commitments (3) £m	Undrawn weighted average CCF (4) %
2011					
AQ1	99,497	28.3	14.1	62,935	29.5
AQ2	20,555	36.3	19.1	17,357	29.5
AQ3	29,285	35.5	26.3	23,643	32.0
AQ4	47,299	34.5	45.7	21,370	32.7
AQ5	49,530	28.7	64.1	11,771	35.9
AQ6	31,509	28.2	81.9	6,274	42.1
AQ7	22,341	41.6	150.1	4,379	48.3
AQ8	6,774	40.7	151.6	626	39.6
AQ9	10,550	40.8	261.9	700	55.5
AQ10/default (5)	36,346	58.9	0.2	2,065	75.2
	353,686	34.8	49.9	151,120	32.7
Corporates under the project finance supervisory slotting approach (6)					
Category 1 - strong	9,353		67.8	1,190	73.3
Category 2 - good	691		89.8	70	51.0
Category 3 - satisfactory	158		115.0	7	88.6
Category 4 - weak	716		250.0	39	90.3
Category 5 - defaulted	435		2.3	58	91.6
	11,353		78.8	1,364	74.0
2010					
AQ1	86,668	28.2	13.1	66,569	29.1
AQ2	21,026	34.7	18.8	17,726	28.3
AQ3	30,299	32.7	21.7	26,432	29.8
AQ4	50,602	33.4	43.3	26,290	30.6
AQ5	57,125	30.3	67.5	16,119	35.9
AQ6	39,712	29.8	87.3	8,326	39.7
AQ7	26,424	38.8	137.2	4,383	43.8
AQ8	8,971	38.8	179.9	637	53.6
AQ9	12,629	48.3	314.3	1,639	35.7
AQ10/default (5)	35,105	48.8	0.6	2,319	74.4
	368,561	33.8	56.8	170,440	31.7
Corporates under the project finance supervisory slotting approach (6)					
Category 1 - strong	11,612		65.5	1,571	59.9
Category 2 - good	574		84.8	118	54.3
Category 3 - satisfactory	840		115.0	129	87.8
Category 4 - weak	363		250.0	52	85.0
Category 5 - defaulted	22		-	-	-
	13,411		74.3	1,870	62.2

Notes:

- (1) EAD post CRM is exposure at default after the application of on-balance sheet netting and includes the advanced IRB element of counterparty credit risk, but excludes non-customer assets.
- (2) Exposure weighted average LGD for each of the AQ bands is derived by multiplying the EAD of each position in the band by the associated LGD, summing the resulting amounts, and then dividing the resulting amount by the sum of the EADs of the relevant AQ band. The same method applies when calculating weighted average PD.
- (3) Undrawn commitments are defined as the difference between the drawn balance and the relevant limit.
- (4) Undrawn weighted average credit conversion factor (CCF) is the sum of CCF undrawn commitments divided by the sum of undrawn commitments within each of the relevant AQ bands.
- (5) For defaulted assets (AQ10), the best estimate of expected loss (BEEL) methodology, based on downturn LGD, has been used. For these assets the Group takes a capital deduction equal to the difference between expected loss and provisions, and this may result in nil RWAs.
- (6) For project finance, customers are split into five categories. Within each category, customers are also split into two maturity bands: below and above 2.5 years. The risk-weight applied to each exposure is based on a combination of the category and the maturity band. There are no RWAs associated with customers in category 5 as these are addressed via capital deductions.

Credit risk *continued*

Key points

- Exposures to corporates, excluding those calculated using the project finance supervisory slotting approach, declined by £14.9 billion, driven by a decrease in on-balance sheet exposures arising from asset disposals and repayments in the Non-Core portfolios. This decline was seen in all AQ bands with the exception of AQ1 and AQ10, where there was a migration within AQ bands relating to the property sector.
- The overall reduction in exposure was partially offset by the movement of qualifying exposure from retail to corporates due to a new SME lending strategy. This was primarily offset by an increase in OTC derivative exposures to obligors in the insurers and funds sector in the AQ1 band.
- LGD rated AQ3 and AQ10 deteriorated, primarily as a result of the worsening outlook for the property sector. In contrast, the exposure-weighted average risk-weight improved as the mix of new business and existing exposure shifted towards lower AQ bands.
- Undrawn commitments fell in tandem with drawn exposure.
- The reduction in EAD to corporates as calculated under the project finance supervisory slotting approach reflects reductions in exposures in Non-Core term loans and OTC derivatives.

Table 15: Retail SMEs by asset quality band (1)

Asset quality band	EAD post CRM (2) £m	Exposure weighted average LGD (3) %	Exposure weighted average risk-weight (3) %	Undrawn commitments (4) £m	Undrawn weighted average CCF (5) %
2011					
AQ1	-	-	-	-	-
AQ2	15	49.4	8.6	10	100
AQ3	2	58.3	10.2	1	100
AQ4	1,176	71.8	29.9	779	100
AQ5	1,007	43.6	44.9	166	100
AQ6	5,478	43.1	61.7	798	100
AQ7	2,684	41.7	71.0	102	100
AQ8	1,717	41.5	85.7	111	100
AQ9	820	43.1	132.1	19	100
AQ10/default	1,842	56.6	49.5	-	-
	14,741	46.7	64.9	1,986	100
2010					
AQ1	-	-	-	-	-
AQ2	15	49.3	7.6	11	100
AQ3	2	58.3	9.1	1	100
AQ4	1,238	73.6	28.6	888	100
AQ5	1,338	42.2	42.3	200	100
AQ6	7,573	41.4	56.2	1,027	100
AQ7	5,276	39.4	64.3	150	100
AQ8	2,221	41.9	84.5	114	100
AQ9	1,139	43.2	128.7	27	100
AQ10/default	1,680	57.4	51.6	-	-
	20,482	44.4	62.4	2,418	100

Notes:

- Consists primarily of loans and overdrafts to SMEs and are calculated using the retail IRB approach.
- EAD post CRM is exposure at default after the application of on-balance sheet netting and includes the advanced IRB element of counterparty credit risk, but excludes non-customer assets.
- Exposure weighted average LGD for each of the AQ bands is derived by multiplying the EAD of each position in the band by the associated LGD, summing the resulting amounts, and then dividing the resulting amount by the sum of the EADs of the relevant AQ band. The same method applies when calculating weighted average PD.
- Undrawn commitments are defined as the difference between the drawn balance and the relevant limit.
- Undrawn weighted average credit conversion factor (CCF) is the sum of CCF undrawn commitments divided by the sum of undrawn commitments within each of the relevant AQ bands.

Credit risk *continued*

Key points

- Retail SME exposures are concentrated within UK business banking, where the most notable reduction occurred within business loans. This was due to the migration of certain customers from retail SME to corporate SME, with a view to serving them better. This resulted in a £5.7 billion decline in total EAD post CRM exposures to retail SME, predominantly those assigned to the AQ6 and AQ7 bands.
- The marginal deterioration in LGD and risk-weight reflects the impact of the quality of the migrated exposures. The reduction in undrawn commitments reflects the benefit of active management of exposures.

Table 16: Retail secured by real estate collateral by asset quality band (1)

Asset quality band	EAD post CRM (2) £m	Exposure weighted average LGD (3) %	Exposure weighted average risk-weight (3) %	Undrawn commitments (4) £m	Undrawn weighted average CCF (5) %
2011					
AQ1	-	-	-	-	-
AQ2	2,946	6.5	0.8	1,724	100.0
AQ3	-	-	-	-	-
AQ4	25,452	7.9	4.1	3,926	99.9
AQ5	41,511	9.5	9.3	2,429	89.8
AQ6	29,471	16.7	27.2	535	99.3
AQ7	14,902	23.5	62.1	481	67.0
AQ8	1,762	13.7	72.3	10	100.0
AQ9	5,288	23.6	130.3	7	100.0
AQ10/default	4,801	23.2	104.9	23	100.0
	126,133	13.6	28.1	9,135	95.5
2010					
AQ1	-	-	-	-	-
AQ2	2,990	5.0	0.6	1,710	100.0
AQ3	-	-	-	-	-
AQ4	23,701	6.7	3.5	1,836	100.0
AQ5	40,749	10.1	10.2	2,885	89.4
AQ6	31,718	16.9	27.6	910	99.8
AQ7	12,788	17.8	51.3	135	99.5
AQ8	2,703	15.2	74.5	7	99.3
AQ9	3,799	19.7	114.4	-	-
AQ10/default	3,783	18.4	104.3	33	100.0
	122,231	12.6	25.1	7,516	95.9

Notes:

- (1) Consists of mortgages and is calculated using the IRB approach.
- (2) EAD post CRM is exposure at default after the application of on-balance sheet netting and includes the advanced IRB element of counterparty credit risk, but excludes non-customer assets.
- (3) Exposure weighted average LGD for each of the AQ bands is derived by multiplying the EAD of each position in the band by the associated LGD, summing the resulting amounts, and then dividing the resulting amount by the sum of the EADs of the relevant AQ band. The same method applies when calculating weighted average PD.
- (4) Undrawn commitments are defined as the difference between the drawn balance and the relevant limit.
- (5) Undrawn weighted average credit conversion factor (CCF) is the sum of CCF undrawn commitments divided by the sum of undrawn commitments within each of the relevant AQ bands.

Key points

- EAD increased by £3.9 billion, largely as a result of increases in exposure to borrowers in the AQ7 band. The increase was driven by new mortgage lending.
- The difficult economic conditions in Ireland were reflected in the Ulster Bank performance, which weighed on the overall portfolio risk profile and led to an increase in exposure to retail secured by real estate collateral in AQ10 from better AQ bands. However, the deterioration in the credit quality of these exposures was at least partially offset by improvements within UK Retail, most notable in improvements within AQ6.

Credit risk *continued*

Table 17: Qualifying revolving retail exposures by asset quality band (1)

Asset quality band	EAD post CRM (2) £m	Exposure weighted average LGD (3) %	Exposure weighted average risk-weight (3) %	Undrawn commitments (4) £m	Undrawn weighted average CCF (5) %
2011					
AQ1	126	9.1	0.2	2,911	4.3
AQ2	6,492	49.6	1.3	5,028	98.4
AQ3	561	53.9	2.9	275	100.0
AQ4	3,987	56.4	6.5	2,904	91.1
AQ5	5,319	63.4	18.3	16,492	18.9
AQ6	3,179	67.8	39.0	3,861	32.3
AQ7	2,780	69.9	74.6	1,284	48.6
AQ8	2,892	77.0	143.6	465	75.9
AQ9	454	72.0	233.7	33	90.5
AQ10/default	1,068	76.9	55.1	271	0.1
	26,858	61.9	38.9	33,524	39.9
2010					
AQ1	106	8.9	0.2	2,434	4.2
AQ2	6,087	77.0	2.2	4,666	100.0
AQ3	-	-	-	-	-
AQ4	3,844	74.8	7.7	2,940	88.8
AQ5	5,453	72.2	20.9	14,893	21.7
AQ6	3,652	72.3	41.1	6,294	28.7
AQ7	2,822	72.9	83.2	1,811	43.5
AQ8	3,721	77.6	154.2	742	68.4
AQ9	739	82.3	269.4	55	92.8
AQ10/default	1,113	77.7	24.5	265	0.1
	27,537	74.7	48.7	34,100	40.4

Notes:

- (1) Consists primarily of personal credit card and overdraft exposures and are calculated using the retail IRB approach.
- (2) EAD post CRM is exposure at default after the application of on-balance sheet netting and includes the advanced IRB element of counterparty credit risk, but excludes non-customer assets.
- (3) Exposure weighted average LGD for each of the AQ bands is derived by multiplying the EAD of each position in the band by the associated LGD, summing the resulting amounts, and then dividing the resulting amount by the sum of the EADs of the relevant AQ band. The same method applies when calculating weighted average PD.
- (4) Undrawn commitments are defined as the difference between the drawn balance and the relevant limit.
- (5) Undrawn weighted average credit conversion factor (CCF) is the sum of CCF undrawn commitments divided by the sum of undrawn commitments within each of the relevant AQ bands.

Key points

- The overall decrease in EAD was primarily the result of customers reducing their unsecured debt by paying down outstanding balances on revolving lines of credit.
- The apparent improvements in LGD and risk-weight were partially due to the implementation of a new unsecured LGD model during the fourth quarter of 2011.

Credit risk *continued*

Table 18: Other retail exposures by asset quality band (1)

Asset quality band	EAD post CRM (2) £m	Exposure weighted average LGD (3) %	Exposure weighted average risk-weight (3) %	Undrawn commitments (4) £m	Undrawn weighted average CCF (5) %
2011					
AQ1	-	-	-	-	-
AQ2	-	-	-	-	-
AQ3	-	-	-	-	-
AQ4	118	65.8	34.8	1	100.0
AQ5	1,265	69.0	66.2	1	100.0
AQ6	2,153	75.9	94.8	-	-
AQ7	1,718	77.7	119.5	-	-
AQ8	645	75.4	141.3	-	-
AQ9	240	75.5	212.0	-	-
AQ10/default	1,961	78.9	55.1	-	-
	8,100	75.7	92.2	2	100.0
2010					
AQ1	-	-	-	-	-
AQ2	-	-	-	-	-
AQ3	-	-	-	-	-
AQ4	140	78.4	43.3	1	100.0
AQ5	635	62.1	60.3	2	100.0
AQ6	2,929	74.9	93.4	1	100.0
AQ7	1,888	73.0	111.0	-	-
AQ8	1,535	74.1	132.3	-	-
AQ9	401	72.7	204.0	-	-
AQ10/default	2,158	80.3	24.4	-	-
	9,686	74.7	89.3	4	100.0

Notes:

- (1) Consists primarily of unsecured personal loans and are calculated using the retail IRB approach.
- (2) EAD post CRM is exposure at default after the application of on-balance sheet netting and includes the advanced IRB element of counterparty credit risk, but excludes non-customer assets.
- (3) Exposure weighted average LGD for each of the AQ bands is derived by multiplying the EAD of each position in the band by the associated LGD, summing the resulting amounts, and then dividing the resulting amount by the sum of the EADs of the relevant AQ band. The same method applies when calculating weighted average PD.
- (4) Undrawn commitments are defined as the difference between the drawn balance and the relevant limit.
- (5) Undrawn weighted average credit conversion factor (CCF) is the sum of CCF undrawn commitments divided by the sum of undrawn commitments within each of the relevant AQ bands.

Key points

- The reduction in EAD within the AQ6 to AQ9 bands was due to the continued run-off of lower quality unsecured lending in UK Retail.
- The personal loan book saw contractions in the period, driven by difficult market conditions. This contributed to the reduction in EAD within the AQ10 band and overall EAD.

Credit risk *continued*

Table 19: Equities by asset quality band (1)

Asset quality band	EAD post CRM (2) £m	Exposure weighted average LGD (3) %	Exposure weighted average risk-weight (3) %	Undrawn commitments (4) £m	Undrawn weighted average CCF (5) %
2011					
AQ1	-	-	-	-	-
AQ2	-	-	-	-	-
AQ3	9	90	199	-	-
AQ4	-	-	-	-	-
AQ5	-	-	-	-	-
AQ6	383	90	345	-	-
AQ7	310	90	277	-	-
AQ8	13	90	679	-	-
AQ9	7	90	651	-	-
AQ10/default (6)	50	90	-	-	-
Equities calculated using PD/LGD approach	772	90	302	-	-
Equities calculated using simple risk-weight approach					
Exchange traded equity exposures	2	-	370	-	-
Private equity exposures	109	-	370	-	-
Other equity exposures	337	-	370	61	100
	448	-	370	61	100
	1,220				
2010					
AQ1	-	-	-	-	-
AQ2	-	-	-	-	-
AQ3	5	90	194	-	-
AQ4	-	-	-	-	-
AQ5	-	-	-	-	-
AQ6	760	90	279	-	-
AQ7	419	90	333	-	-
AQ8	6	90	570	-	-
AQ9	142	90	12	-	-
AQ10/default (6)	23	90	-	-	-
Equities calculated using PD/LGD approach	1,355	90	264	-	-
Equities calculated using simple risk-weight approach					
Private equity exposures	319	-	370	93	100
Other equity exposures	1	-	190	-	-
	320	-	370	93	100
	1,675				

Notes:

- (1) Exclude equity exposures calculated under the simple risk-weight approach.
- (2) EAD post CRM is exposure at default after the application of on-balance sheet netting and includes the advanced IRB element of counterparty credit risk, but excludes non-customer assets.
- (3) Exposure weighted average LGD for each of the AQ bands is derived by multiplying the EAD of each position in the band by the associated LGD, summing the resulting amounts, and then dividing the resulting amount by the sum of the EADs of the relevant AQ band. The same method applies when calculating weighted average PD.
- (4) Undrawn commitments are defined as the difference between the drawn balance and the relevant limit.
- (5) Undrawn weighted average credit conversion factor (CCF) is the sum of CCF undrawn commitments divided by the sum of undrawn commitments within each of the relevant AQ bands.
- (6) For defaulted assets (AQ10), the best estimate of expected loss (BEEL) methodology, based on downturn LGD, has been used. For these assets the Group takes a capital deduction equal to the difference between expected loss and provisions, and this may result in nil RWAs.

Key point

- Exposure decreased to £1.2 billion at 31 December 2011 from £1.7 billion at 31 December 2010, principally due to a decrease calculated using the PD/LGD approach, itself the result of disposals of equity positions, predominantly in the property and non-bank financial institutions sector. The decrease calculated using the PD/LGD approach was partially offset by an increase of £128 million in exposures calculated using the simple risk-weight (SRW) approach, resulting from a movement to the SRW approach for the EAD calculation of these exposures.

Credit risk *continued*

IRB exposures covered by guarantees and credit derivatives

The Group accepts a number of different types of collateral to mitigate credit risk. The following table details by counterparty type the total advanced IRB exposure covered by guarantees and credit derivatives. However, this only represents exposures covered by certain types of collateral. For details on exposures covered by other types of collateral, refer to the credit risk section.

Table 20: Advanced IRB exposure covered by guarantees and credit derivatives

Advanced IRB exposure class (1,2)	2011 £m	2010 £m
Central governments and central banks	422	481
Institutions	647	227
Corporates	11,242	14,074
Securitisation positions	7	10
Non-credit obligation assets	17	25
	12,335	14,817

Notes:

(1) Exposures covered by guarantees and credit derivatives represent the higher of the value of the guarantee or credit derivatives or the value of the associated EAD post CRM of the facility. Guarantees disclosed do not include parental guarantees where the PD substitution approach is applied.

(2) Excludes tranching credit protection purchased for capital management purposes.

Key point

- Corporates decreased by £2.8 billion, driven by a reduction in the amount of discounted security guarantees outstanding. This was slightly offset by an increase in third-party guarantees within institutions.

Expected loss and impairment

The following table shows the expected loss at 31 December 2009 and 31 December 2010 and the impairment charges recorded in the income statement for each of the following years.

Expected loss, as presented in the table below, represents a year-end projection of losses for the following financial year. It includes both expected losses in respect of assets that have already defaulted (and for which an impairment in compliance with IFRS has been recognised if appropriate) and those in respect of assets that are still performing at that year-end.

Expected loss is calculated by applying the Group's PD, LGD and EAD models to its portfolios. The Group's PD models incorporate differing degrees of through-the-cycle and point-in-time characteristics depending on the portfolio. The LGD and EAD models reflect downturn economic conditions.

The impairment charge is the amount recorded in the income statement. The Group's accounting policy on impairments is set out on page 319 of the Group's 2011 Annual Report and Accounts.

The methodologies and underlying principles followed to calculate expected loss in accordance with regulatory requirements differ significantly from those followed for the recognition of impairments in accordance with financial reporting standards.

Key differences include the following:

- **Timing** - for the period between a default occurring and the associated asset being written-off or recovered, an expected loss will continue to be calculated according to regulatory requirements, while some or all of the associated actual impairment loss may already have been recognised in the income statement.
- **Cyclicality** - for those PD models with predominantly through-the-cycle characteristics (notably wholesale models), expected loss will not, by definition, produce a result that aligns with actual loss experience in every one-year period.

For regulatory capital purposes, the amount by which expected loss exceeds cumulative impairment provisions is deducted from capital; 50% is deducted from Core Tier 1 capital and 50% from Tier 2 capital.

Credit risk *continued*

Table 21: *Expected loss and impairment charge*

Advanced IRB exposure class	Expected loss	Impairment charge	Expected loss	Impairment charge
	2010 £m	2011 £m	2009 £m	2010 £m
Central governments and central banks	6	1,099	2	-
Institutions	169	-	71	-
Corporates	19,640	4,904	13,384	6,252
Retail SME	1,360	277	1,454	258
Retail secured by real estate collateral	892	757	564	513
Qualifying revolving retail exposure	1,522	406	1,593	535
Other retail exposures	2,022	229	2,190	503
Equities	42	-	31	-
	25,653	7,672	19,289	8,061

The table above shows that the difference between the expected loss at 31 December 2010 and the 2011 actual impairment charge was £18.0 billion (£11.2 billion in the prior year). This difference is influenced in particular by the level of defaulted assets. The majority of the expected loss as at 31 December 2010 and 31 December 2009 (£20.9 billion and £13.2 billion respectively) related to already defaulted assets, for which impairment provisions had already been made. The difference between expected loss at 31 December 2010 and the cumulative impairment provisions to that date has already been absorbed within the Group's regulatory capital as a 50:50 deduction from Core Tier 1 and Tier 2 capital. It is thus reflected in the Group's capital ratios.

Key points

- The increase in expected loss to £25.7 billion at 31 December 2010 from £19.3 billion, was driven by the growth in defaulted assets during 2010, primarily in the property sector and Ulster Bank, and by the migration of assets from the RBS N.V. balance sheet (accounting for £2.6 billion of the increase in expected loss). The majority of these migrated assets transferred to the advanced IRB approach during 2010.
- Despite continuing challenges in Ulster Bank and the commercial real estate portfolios during 2011, the impairment charge for the year decreased by 4.8% compared to 2010, driven largely by asset disposals and run-off in Non-Core.
- The 2011 impairment charge in the central governments and central banks exposure class reflects the impairment of Greek government bonds.

Probability of default (PD) and exposure at default (EAD)

Wholesale credit grading models are hybrid models where the PD has been calibrated to each grade using historic data, and are expected to remain stable in their mapping to each grade over a cycle. However, the grade assignments to individual customers take into account current economic conditions and the customer's credit quality. The customer grade is therefore expected to change over a cycle.

Retail PD models are targeted to be point-in-time methodologies to facilitate pricing, setting of risk appetite and loss estimation. Models are regularly calibrated to produce robust estimates incorporating a degree of conservatism.

The following table details the PD estimated at the beginning of the past two reporting periods, compared with actual default rates experienced during the reporting periods. PD is the average counterparty PD for wholesale exposures and the average account level PD for retail exposures. Exposures in default at the start of the period are excluded since the probability of default is 100%. The actual default rate presented in the following table is calculated as the number of defaults observed during the year divided by the number of obligors or accounts at the start of the period.

The EAD ratio displayed represents the predicted model EAD at the end of the prior period against the actual exposure at the time of default for all assets that defaulted during the period.

Table 22: *Predicted probability of default, actual default rates and EAD outcomes versus predictions*

IRB exposure class	Probability of default				Exposure at default
	Predicted at 31 December 2010 %	Actual 2011 %	Predicted at 31 December 2009 %	Actual 2010 %	Predicted to actual 2011 %
Central governments and central banks	0.41	0.44	0.31	-	155
Institutions	0.43	-	0.44	-	-
Corporates	2.73	5.12	2.53	5.63	118
Retail SME	4.28	3.63	5.57	3.95	104
Retail secured by real estate collateral	2.37	1.74	2.04	1.91	101
Qualifying revolving retail exposure	2.65	2.07	2.82	2.37	102
Other retail exposures	5.23	4.52	6.05	5.24	108
Equities	3.64	3.51	2.28	0.98	-

Credit risk *continued*

Key points

- The difference between predicted default rates and outcomes in the corporate exposure class is largely driven by property cases, where default rates remain very high relative to longer-term averages. Per FSA direction, the Group is moving specialised property exposures to the regulatory slotting approach.
- Movements in retail probabilities of default largely reflect recalibrations, taking into account portfolio experience. The probability of default for retail secured by real estate

collateral (residential mortgages) has risen owing to Ulster Bank, where model calibration reflects material uncertainties in the domestic market in addition to realised default rates.

- The EAD ratio is over 100% for each asset class, evidencing that the exposure outstanding at the time of default was lower on average than had been predicted at the start of the year.

Loss given default (LGD)

The scope of the wholesale LGD disclosure is all defaulted cases that closed during the period. Closure of a case comprises either the write-off of a debt or the return of any residual debt to the performing book, or a combination of the two involving partial write-offs.

In retail exposure classes, LGD models are used to estimate losses over defined outcome periods ranging from 36 to 72 months. The population of actual losses included in the table below are defaulted exposures with outcomes observed during 2011.

In the following table, EAD weighted actual LGD for the reporting period is compared against EAD weighted average LGD across the total portfolio, defaulted and non-defaulted, at the beginning of the period.

Table 23: *Loss outcomes versus predictions*

IRB exposure class	Loss given default - estimated 31 December 2010 %	Loss given default - actual 31 December 2011 %
	Corporates	33.4
Retail SMEs	44.4	41.0
Retail secured by real estate collateral	12.6	8.7
Qualifying revolving retail exposure	74.7	80.4
Other retail exposures	74.7	83.6

Key points

- Loss outcomes from some low materiality portfolios are not included in the table. The data included represent portfolios that comprise greater than 97% of Group IRB RWAs for the exposure classes shown. Central governments and central banks, institutions and equities are not included owing to nil or very low volumes of observations, making disclosure not meaningful.
- The relatively lower loss experience versus average LGD assigned across the corporates portfolio in part reflects the resolved nature of the population reported. Loss rates on defaulted cases that, as at the reporting date, continue to be managed by the Group's remediation and recoveries functions tend to be higher, evidenced by provision coverage levels.
- The excess of actual losses over average portfolio LGD in qualifying revolving and other retail exposures largely reflects the differing profile of defaulted and non-defaulted accounts. Portfolio average estimates are based on all accounts at the stated observation point. The nature of this population differs from the defaulted accounts on which actual losses are disclosed. A comparison of actual losses to predicted LGD on the same specific population (as opposed to portfolio averages) shows that predicted values in each case were higher than actual values.

Credit risk *continued*

Credit risk by standardised approach

Several of the Group's portfolios are currently managed using the standardised approach, including the following:

US Retail & Commercial - currently uses the standardised approach for FSA reporting, pending migration to the IRB approach.

Wealth - given the low level of loss experience, uses the standardised approach, as approved by the FSA and required by BIPRU.

RBS N.V. - uses the standardised approach pending final transition of remaining exposures to the advanced IRB approach, and portfolios targeted for disposal.

Exposures estimated using the standardised approach are allocated to specific exposure classes as determined by the FSA's BIPRU 3 and it is these classes that determine the risk-weight used. For exposures to corporates, sovereigns and institutions, the Group uses the external credit assessments of recognised credit rating agencies (Standard & Poor's, Moody's and Fitch, as appropriate). All other exposures are unrated, with the risk-weights determined by the BIPRU rules.

The Group's RWAs and capital requirements by standardised exposure class are detailed in the following table. The balances include non-customer and intra-group assets.

Table 24: RWAs and capital requirement by standardised exposure class

Standardised exposure class	2011		2010	
	Credit RWAs post CRM £m	Minimum capital requirement £m	Credit RWAs post CRM £m	Minimum capital requirement £m
Central governments and central banks	144	12	336	27
Regional governments or local authorities	132	11	211	17
Administrative bodies and non-commercial undertakings	39	3	53	4
Institutions (1)	1,311	105	764	61
Corporates (1)	48,154	3,852	59,690	4,775
Retail	21,693	1,735	24,945	1,996
Secured by real estate property	-	-	5,067	405
Secured by mortgages on commercial real estate	8,443	675	-	-
Secured by mortgages on residential property	6,821	546	-	-
Past due items	1,794	144	2,445	196
Securitisation positions	2,399	192	5,314	425
Other items (2)	11,268	901	16,227	1,298
	102,198	8,176	115,052	9,204

Notes:

- (1) Includes intra-group assets.
(2) Includes non-customer assets.

Key points

- The 11.2% decline in total RWAs calculated for standardised exposure classes was largely driven by a reduction in overall exposure. An additional factor was the reclassification from the advanced IRB to the standardised approach of a credit default swap protecting risk assets.
- Changes to current FSA reporting requirements have resulted in the creation of two new exposure classes (i.e. secured by mortgages on commercial real estate and secured by mortgages on residential property), resulting in the movement of some exposures from corporates, secured by real estate property and retail, to these new categories.

Credit risk *continued*

Standardised gross customer credit risk

Tables 25 to 28 detail the Group's standardised gross customer EAD by exposure class, geographic area, industry sector and residual maturity band.

In all these tables, the gross customer EAD is shown before the application of credit risk mitigation (CRM) i.e. it does not take into account the impact of on-balance sheet netting and financial collateral. It excludes intra-group and non-customer assets as well as OTC and repo products, which are calculated under the counterparty credit risk approach and disclosed on pages 45 to 47.

Table 25: Standardised gross exposure by exposure class

Standardised exposure class	2011 (1,2)		2010 (1,2)	
	Exposure pre CRM £m	Average exposure pre CRM (3) £m	Exposure pre CRM £m	Average exposure pre CRM (3) £m
Central governments and central banks	35,213	30,897	34,854	47,453
Regional governments or local authorities	3,473	3,791	4,262	2,640
Administrative bodies and non-commercial undertakings	180	148	175	200
Multilateral development banks	30	31	31	254
Institutions	3,846	3,244	2,601	2,779
Corporates	52,973	56,174	60,638	58,198
Retail	31,321	31,421	38,050	40,443
Secured by real estate property	-	7,518	14,756	14,835
Secured by mortgages on commercial real estate	8,542	4,951	-	-
Secured by mortgages on residential property	19,359	11,264	-	-
Past due items	1,349	1,653	1,801	1,829
Securitisation positions	1,285	1,503	1,888	2,191
Collective investment undertakings	-	-	-	3
Other items (4)	2,187	2,015	1,146	1,171
	159,758	154,610	160,202	171,996

Notes:

- (1) Exposure pre CRM is before taking into account the impact of on-balance sheet netting and financial collateral.
- (2) Excludes intra-group and non-customer assets along with OTC derivatives and repo products, which are shown separately in the counterparty credit risk disclosures.
- (3) Average exposure pre CRM is based on the full year.
- (4) Includes customer assets only.

Credit risk *continued*

Table 26: Standardised gross exposure by geographic area

Standardised exposure class	UK £m	North America £m	Western Europe (excl. UK) £m	Asia and Pacific £m	Latin America £m	CEE and Central Asia £m	Middle East and Africa £m	Total £m
2011 (1,2,3)								
Central governments and central banks	29,402	4,750	560	144	1	356	-	35,213
Regional governments or local authorities	24	142	3,212	-	1	94	-	3,473
Administrative bodies and non-commercial undertakings	-	169	8	-	-	3	-	180
Multilateral development banks	-	-	30	-	-	-	-	30
Institutions	82	1,045	1,646	1,020	16	37	-	3,846
Corporates	10,245	35,661	3,738	1,130	1,534	505	160	52,973
Retail	6,201	23,269	1,070	330	180	201	70	31,321
Secured by mortgages on commercial real estate	1,851	5,384	1,160	-	35	112	-	8,542
Secured by mortgages on residential property	7,237	10,120	708	926	101	200	67	19,359
Past due items	377	501	379	15	3	73	1	1,349
Securitisation positions	-	1,285	-	-	-	-	-	1,285
Other items (4)	372	1,769	36	-	10	-	-	2,187
	55,791	84,095	12,547	3,565	1,881	1,581	298	159,758
2010 (1,2,3)								
Central governments and central banks	25,327	7,709	838	407	14	559	-	34,854
Regional governments or local authorities	27	113	3,975	-	-	147	-	4,262
Administrative bodies and non-commercial undertakings	1	174	-	-	-	-	-	175
Multilateral development banks	-	-	31	-	-	-	-	31
Institutions	201	395	1,513	459	6	25	2	2,601
Corporates	14,061	36,268	4,773	1,908	2,750	609	269	60,638
Retail	6,718	29,141	1,162	493	202	277	57	38,050
Secured by real estate property	6,787	5,980	789	856	75	207	62	14,756
Past due items	529	896	289	32	1	53	1	1,801
Securitisation positions	37	1,851	-	-	-	-	-	1,888
Other items (4)	247	899	-	-	-	-	-	1,146
	53,935	83,426	13,370	4,155	3,048	1,877	391	160,202

Notes:

- (1) Exposure pre CRM is before taking into account the impact of on-balance sheet netting and financial collateral.
- (2) Excludes intra-group and non-customer assets along with OTC derivatives and repo products, which are shown separately in the counterparty credit risk disclosures.
- (3) The geographic area is determined by the country of incorporation for companies and as the country of residence for individuals.
- (4) Includes customer assets only.

Key point

- Although the overall movement is immaterial, the central governments and central banks exposure class in the UK increased by £4.1 billion due to an increase in government bonds and deposits. The increase was offset by a reduction in exposures to counterparties in North America due to a decline in deposits and mortgage-backed securities held by central banks.

Credit risk *continued*

Table 27: Standardised gross exposure by industry sector

Sector cluster	Central governments and central banks £m	Regional governments or local authorities £m	Administrative bodies and non-commercial undertakings £m	Multilateral development banks £m	Institutions £m	Corporates £m	Retail £m	Secured by mortgages on commercial real estate £m	Secured by mortgages on residential property £m	Past due items £m	Securitisation positions £m	Other items (3) £m	Total £m
2011 (1,2)													
Banks	-	-	-	30	3,789	38	5	6	-	-	-	429	4,297
Financial guarantors	-	-	-	-	-	10	-	-	-	-	-	-	10
Hedge funds	-	-	-	-	-	2	-	-	-	-	-	-	2
Insurers and funds	-	-	2	-	-	2,573	174	374	-	1	245	51	3,420
Manufacturing (cyclical)	-	-	-	-	-	4,432	100	23	1	10	-	91	4,657
Manufacturing (non-cyclical)	-	-	-	-	-	1,791	95	28	3	37	-	81	2,035
Natural resources	-	-	-	-	-	3,020	21	72	-	3	-	246	3,362
Non-bank financial institutions	2,548	-	30	-	33	11,583	111	115	405	51	147	44	15,067
Personal	-	-	-	-	-	1,380	26,761	62	18,483	652	-	50	47,388
Property	-	-	8	-	-	4,400	285	5,378	32	286	-	99	10,488
Retail and leisure	-	-	-	-	24	9,018	2,602	1,712	41	218	-	69	13,684
Securitisations	-	-	-	-	-	3,232	298	41	145	1	893	21	4,631
Services	244	29	14	-	-	7,024	700	676	249	51	-	289	9,276
Sovereigns and quasi-sovereigns	32,421	3,444	126	-	-	102	4	2	-	-	-	328	36,427
Technology, media and telecommunications	-	-	-	-	-	1,822	37	11	-	13	-	30	1,913
Transport	-	-	-	-	-	2,546	128	42	-	26	-	359	3,101
	35,213	3,473	180	30	3,846	52,973	31,321	8,542	19,359	1,349	1,285	2,187	159,758

For the notes and key points relating to this table refer to page 40.

Credit risk *continued*

Table 27: Standardised gross exposure by industry sector *continued*

Sector cluster	Central governments and central banks £m	Regional governments or local authorities £m	Administrative bodies and non-commercial undertakings £m	Multilateral development banks £m	Institutions £m	Corporates £m	Retail £m	Secured by real estate property £m	Past due items £m	Securitisation positions £m	Other items (3) £m	Total £m
2010 (1,2)												
Banks	-	-	-	31	2,596	87	5	-	1	226	470	3,416
Insurers and funds	-	-	-	-	-	3,330	37	-	6	-	10	3,383
Manufacturing (cyclical)	-	-	-	-	-	3,921	65	1	7	-	1	3,995
Manufacturing (non-cyclical)	-	-	-	-	-	2,273	93	3	34	-	-	2,403
Natural resources	-	-	-	-	-	3,276	24	-	32	-	-	3,332
Non-bank financial institutions	4,182	-	26	-	1	7,989	105	416	53	1,262	113	14,147
Personal	-	-	-	-	-	1,499	33,493	14,050	749	-	-	49,791
Property	-	13	-	-	-	9,892	274	24	626	-	247	11,076
Retail and leisure	-	-	2	-	-	11,545	2,767	56	234	-	-	14,604
Securitisations	-	-	-	-	-	4,498	-	-	1	386	-	4,885
Services	2	40	54	-	-	7,751	1,001	205	33	-	-	9,086
Sovereigns and quasi-sovereigns	30,670	4,209	93	-	4	182	11	-	-	14	302	35,485
Technology, media and telecommunications	-	-	-	-	-	1,795	33	-	8	-	3	1,839
Transport	-	-	-	-	-	2,600	142	1	17	-	-	2,760
	34,854	4,262	175	31	2,601	60,638	38,050	14,756	1,801	1,888	1,146	160,202

Notes:

- (1) Exposure pre CRM is before taking into account the impact of on-balance sheet netting and financial collateral.
(2) Excludes intra-group and non-customer assets along with OTC derivatives and repo products, which are shown separately in the counterparty credit risk disclosures.
(3) Includes customer assets only.

Key points

- Reductions in the personal sector driven by lower retail homeowner and personal loan exposures in North America. This was offset by an increase in sovereign and quasi-sovereign and non-bank financial institutions exposures.
- The increase in sovereign exposures was driven by additional UK government gilt purchases during 2011.

Credit risk *continued*

Table 28: Standardised gross exposure by residual maturity

Standardised exposure class	Within 1 year (1) £m	After 1 year but within 5 years £m	After 5 years £m	Total £m
2011 (2,3,4)				
Central governments and central banks	18,082	5,299	11,832	35,213
Regional governments or local authorities	716	1,948	809	3,473
Administrative bodies and non-commercial undertakings	72	66	42	180
Multilateral development banks	-	30	-	30
Institutions	3,035	809	2	3,846
Corporates	7,247	32,128	13,598	52,973
Retail	5,497	11,358	14,466	31,321
Secured by mortgages on commercial real estate	1,837	5,453	1,252	8,542
Secured by mortgages on residential property	711	5,070	13,578	19,359
Past due items	486	347	516	1,349
Securitisation positions	-	-	1,285	1,285
Other items (5)	178	520	1,489	2,187
	37,861	63,028	58,869	159,758
2010 (2,3,4)				
Central governments and central banks	19,056	6,662	9,136	34,854
Regional governments or local authorities	919	2,273	1,070	4,262
Administrative bodies and non-commercial undertakings	57	66	52	175
Multilateral development banks	-	31	-	31
Institutions	2,407	188	6	2,601
Corporates	17,173	30,975	12,490	60,638
Retail	4,366	13,308	20,376	38,050
Secured by real estate property	872	3,626	10,258	14,756
Past due items	404	771	626	1,801
Securitisation positions	-	-	1,888	1,888
Other items (5)	-	-	1,146	1,146
	45,254	57,900	57,048	160,202

Notes:

- (1) Revolving facilities are included in the within 1 year residual maturity band.
- (2) Exposure pre CRM is before taking into account the impact of on-balance sheet netting and financial collateral.
- (3) Excludes intra-group and non-customer assets along with OTC derivatives and repo products, which are shown separately in the counterparty credit risk disclosures.
- (4) Exposures are classified into maturity bandings in accordance with their residual contractual maturity.
- (5) Includes customer assets only.

Key points

- Reductions in exposure were concentrated in maturities within one year. These reductions were most notable within corporates, driven by the movement of new small and medium-sized enterprise loans from the within one year maturity bucket to the after one year but within five years maturity bucket.
- The introduction of the two new exposure classes, described on page 36, makes year-on-year comparisons by exposure class difficult.

For the standardised portfolio, the Group determines the appropriate risk-weight using a mapping system from the credit ratings of the main external credit assessment institutions used by the Group, to six credit quality steps (CQS), as shown in the following table. Where no external rating is available for use in the RWA calculation, exposures are allocated to an unrated CQS.

Table 29: Credit quality steps mapping to external credit gradings

Credit quality step	Standard & Poor's assessments	Moody's assessments	Fitch's assessments
Step 1	AAA to AA-	Aaa to Aa3	AAA to AA-
Step 2	A+ to A-	A1 to A3	A+ to A-
Step 3	BBB+ to BBB-	Baa1 to Baa3	BBB+ to BBB-
Step 4	BB+ to BB-	Ba1 to Ba3	BB+ to BB-
Step 5	B+ to B-	B1 to B3	B+ to B-
Step 6	CCC+ and below	Caa1 and below	CCC+ and below

Credit risk *continued*

The standardised portfolio exposure by CQS is detailed in the following table. EAD excludes exposures calculated under the counterparty credit risk approaches. It is also shown before and after the application of CRM, i.e. balance sheet netting and financial collateral.

Table 30: Standardised portfolio exposure for customer credit risk and counterparty credit risk by credit quality steps

Standardised exposure class	CQS						Unrated exposure £m	Total £m
	1 £m	2 £m	3 £m	4 £m	5 £m	6 £m		
2011 (1,2)								
Central governments and central banks (3)								
Exposure pre CRM	33,999	-	356	-	1	-	857	35,213
Exposure post CRM	33,999	-	356	-	1	-	857	35,213
Regional governments or local authorities								
Exposure pre CRM	3,287	52	-	94	-	-	40	3,473
Exposure post CRM	3,287	52	-	94	-	-	40	3,473
Administration bodies and non-commercial undertakings								
Exposure pre CRM	168	-	-	-	-	-	12	180
Exposure post CRM	168	-	-	-	-	-	12	180
Multilateral development banks								
Exposure pre CRM	30	-	-	-	-	-	-	30
Exposure post CRM	30	-	-	-	-	-	-	30
Institutions								
Exposure pre CRM	1,014	1,780	63	6	-	-	983	3,846
Exposure post CRM	1,014	1,780	63	6	-	-	983	3,846
Corporates								
Exposure pre CRM	10,223	753	1,863	1,363	968	166	37,637	52,973
Exposure post CRM	10,223	753	1,863	1,363	968	166	36,327	51,663
Retail								
Exposure pre CRM	-	-	-	-	-	-	31,321	31,321
Exposure post CRM	-	-	-	-	-	-	30,931	30,931
Secured by mortgages on commercial real estate								
Exposure pre CRM	-	-	-	-	-	-	8,542	8,542
Exposure post CRM	-	-	-	-	-	-	8,440	8,440
Secured by mortgages on residential property								
Exposure pre CRM	-	-	-	-	-	-	19,359	19,359
Exposure post CRM	-	-	-	-	-	-	19,359	19,359
Past due items								
Exposure pre CRM	-	-	-	-	-	-	1,349	1,349
Exposure post CRM	-	-	-	-	-	-	1,340	1,340
Securitisation positions								
Exposure pre CRM	401	38	10	86	750	-	-	1,285
Exposure post CRM	401	38	10	86	750	-	-	1,285
Other items (4)								
Exposure pre CRM	426	96	148	23	11	2	1,481	2,187
Exposure post CRM	426	96	148	23	11	2	1,480	2,186
Total exposure pre CRM	49,548	2,719	2,440	1,572	1,730	168	101,581	159,758
Total exposure post CRM	49,548	2,719	2,440	1,572	1,730	168	99,769	157,946

For the notes and key points relating to this table refer to page 43.

Credit risk *continued*

Table 30: Standardised portfolio exposure for customer credit risk and counterparty credit risk by credit quality steps *continued*

Standardised exposure class	CQS						Unrated exposure £m	Total £m
	1 £m	2 £m	3 £m	4 £m	5 £m	6 £m		
2010 (1,2)								
Central governments and central banks (3)								
Exposure pre CRM	34,124	1	449	-	14	-	266	34,854
Exposure post CRM	34,124	1	449	-	14	-	266	34,854
Regional governments or local authorities								
Exposure pre CRM	4,070	18	9	136	-	-	30	4,263
Exposure post CRM	4,070	18	9	136	-	-	30	4,263
Administration bodies and non-commercial undertakings								
Exposure pre CRM	132	20	-	22	-	-	1	175
Exposure post CRM	132	20	-	22	-	-	1	175
Multilateral development banks								
Exposure pre CRM	31	-	-	-	-	-	-	31
Exposure post CRM	31	-	-	-	-	-	-	31
Institutions								
Exposure pre CRM	1,101	702	38	4	3	-	753	2,601
Exposure post CRM	1,101	702	38	4	3	-	753	2,601
Corporates								
Exposure pre CRM	6,687	775	1,511	980	591	142	49,951	60,637
Exposure post CRM	6,687	775	1,511	980	591	142	48,446	59,132
Retail								
Exposure pre CRM	-	-	-	-	-	-	38,050	38,050
Exposure post CRM	-	-	-	-	-	-	37,656	37,656
Secured by real estate property								
Exposure pre CRM	-	-	-	-	-	-	14,756	14,756
Exposure post CRM	-	-	-	-	-	-	14,756	14,756
Past due items								
Exposure pre CRM	-	-	-	-	30	-	1,771	1,801
Exposure post CRM	-	-	-	-	30	-	1,761	1,791
Securitisation positions								
Exposure pre CRM	789	25	17	87	970	-	-	1,888
Exposure post CRM	789	25	17	87	970	-	-	1,888
Other items (4)								
Exposure pre CRM	464	2	-	-	-	-	680	1,146
Exposure post CRM	464	2	-	-	-	-	680	1,146
Total exposure pre CRM	47,398	1,543	2,024	1,229	1,608	142	106,258	160,202
Total exposure post CRM	47,398	1,543	2,024	1,229	1,608	142	104,349	158,293

Notes:

- (1) CQS are a combination of the counterparty exposure class and the external rating applied. Where no external rating is used in the RWA calculation, the exposure concerned is classified as unrated. For the mapping of CQS to external ratings, refer to table 29.
- (2) Excludes intra-group and non-customer assets.
- (3) A combination of all three agency ratings was used for central governments and central banks. Exposures where the obligor or issue was not rated, are classified as unrated. This predominantly relates to retail customers who do not have a rating. However, these exposures may still receive a zero risk-weight (CQS1), where BIPRU rules allow inference of risk-weight from an equivalent sovereign or issuer.
- (4) Includes customer assets only.

Key points

- The increase in corporates in CQS1 was driven by the purchase of Fannie Mae and Freddie Mac bonds. Reductions in the unrated bucket are a factor of two regulatory changes:
 - (1) Bringing the standardised treatment of lease exposures in line with the advanced IRB approach, where exposure is split into a credit portion and a residual value portion. The residual value exposure has been reclassified to other items.
 - (2) The FSA's creation of a new commercial real estate exposure class, which has resulted in some exposures being reclassified out of corporates into the new class.
- Retail reductions in the unrated bucket were a result of:
 - (1) The introduction of a new exposure class secured on residential property, which has resulted in some exposures being shifted from retail into the new exposure class.
 - (2) A decrease in business activity, which resulted in a £3.8 billion reduction.
 - (3) The FSA's introduction of new commercial real estate exposure class, which has resulted in the SME commercial real estate exposures being reclassified out of retail into the new class.

Credit risk *continued*

Table 31: Standardised exposures covered by eligible financial collateral

Standardised exposure class (1)	2011 £m	2010 £m
Corporates	1,241	2,315
Retail	402	408
Secured by mortgages on commercial real estate	102	-
	1,745	2,723

Note:

(1) Exposures covered by eligible financial collateral represent the value of financial collateral applied in the credit RWA calculation after volatility adjustments.

Key point

- As the Group transferred exposures from RBS N.V. to RBS plc, the Group also changed its calculation of the associated collateral from the Basel II standardised approach to the advanced IRB approach. This has resulted in a decrease in the value of collateral and, hence, the amount of corporate exposures covered by eligible financial collateral.

Table 32: Standardised exposures covered by guarantees and credit derivatives

Standardised exposure class (1)	2011 £m	2010 £m
Central governments and central banks	2,557	4,554
Regional governments or local authorities	-	6
Institutions	-	1
Corporates	12	43
Retail	655	743
Secured on real estate property	-	689
Secured by mortgages on residential property	496	-
Past due items	19	18
Securitisation positions	526	644
	4,265	6,698

Note:

(1) Exposures covered by guarantees and credit derivatives represent the value of the guarantees and credit derivatives applied in the credit RWA calculation.

Key point

- The reduction in exposure to central governments and central banks, was the result of a decrease in exposure to Government National Mortgage Association (Ginnie Mae) securities and, to a lesser extent, the maturity of US treasury bills. Investment in Ginnie Mae collateralised mortgage obligations decreased throughout 2011, reflecting a shift in investment strategy.

Counterparty credit risk

Counterparty credit risk (CCR) is the risk that a counterparty defaults prior to the maturity of a derivative contract. The risk may result from derivative transactions in either the trading or banking book and is covered by a credit risk framework consistent with other exposures. A number of specific policies govern how the Group manages such risk including documentation requirements, product-specific requirements (e.g. equity/futures and securities lending), counterparty-

specific requirements (e.g. hedge funds, pension funds), issuer risk policy, margin trading policy, collateral acceptability and custodians.

The following tables detail the total counterparty credit risk capital component and the current counterparty credit risk exposure, post credit risk mitigation by product type.

Table 33: Counterparty credit risk capital requirement

	Minimum capital requirement 2011 £m	Minimum capital requirement 2010 £m
Counterparty credit risk capital requirement	4,953	5,451

Table 34: Counterparty credit risk exposure

Product type	EAD post CRM 2011 £m	EAD post CRM 2010 £m
OTC derivatives	106,720	115,100
Repos	47,901	41,223
	154,621	156,323

Counterparty credit limit setting

Counterparty credit limits are established through the Group's credit approval framework. Limits are established based on the credit quality of the counterparty and the projected maximum potential future exposure of anticipated derivative transactions, based on 95th percentile assumptions. Credit limits are set by product and reflect documentation held for netting or collateral management purposes.

For external capital purposes, some counterparty risk is calculated using expected positive exposure methodology. It is expected that over time additional derivative exposures, not currently measured under the expected positive exposure methodology, will also be captured in this way. The Group uses 1.6 alpha, which forms part of the exposure calculation to convert the effective positive exposure to an exposure value.

Outstanding exposures are calculated as the mark-to-market position of outstanding contracts plus an additional potential future exposure based on transaction characteristics and governing documentation.

The following table details EAD by method.

Table 35: Counterparty credit risk exposure at default by method

Method	EAD post CRM 2011 £m	EAD post CRM 2010 £m
CCR mark-to-market	110,676	105,160
Expected positive exposure (EPE)	38,302	40,317
Value-at-risk	5,643	10,846
	154,621	156,323

Key points

- The increase in CCR exposure was driven by an increase in repos, the result of an increase in trading activity with sovereign counterparties combined with the implementation of CRD III. The increase was also the result of a downward shift in interest rates and a corresponding rise in mark-to-market values of the derivatives affected. The increases were partly offset by a decrease in the value of OTC derivatives, driven by the active de-risking of the Non-Core portfolios.
- The decrease in EPE/EAD primarily seen within the Core business was driven by a reduction in trading activity attributable to numerous matured and settled trades compared to 2010. This reflects an exercise of early terminations of interest rate swaps (particular CDSs) in conjunction with other banks. Further reductions were attributable to the impact on interest rate contracts of the appreciation of sterling against the euro as a significant portion of these contracts are held in euros.
- The decline in EAD under the VaR method was mainly due to the maturity of repos.

Counterparty credit risk *continued*

Counterparty risk mitigation

To mitigate counterparty credit risk, it is Group policy to execute netting and collateral agreements where legally enforceable.

Additionally, dynamic credit risk reserving, as explained under credit valuation adjustments below, is used to manage counterparty credit risk. Counterparty Exposure Management (CEM) charges the trading desk a credit premium at trade inception in exchange for taking on the credit risk over the life of the transaction. CEM may then hedge the credit risk and default sensitivities using interest rate swaps, FX and other credit derivatives from third-party providers. The trading desks are thus 'insured' against some future credit events, including spread widening and default.

Netting and collateralisation

It is Group policy to ensure that appropriate swaps and derivative documentation is executed for clients prior to trading. Exceptions to this require specific approval from a senior risk officer. A formal documentation policy governs all derivative counterparties deemed suitable in terms of their legal and administrative capacity to enter into collateral agreements. Where netting and/or collateral enforceability criteria are not fulfilled, exposure is assumed to be uncollateralised. The policy framework establishes minimum documentation requirements and preferred credit terms under collateral agreements including: unsecured thresholds; minimum transfer amounts; independent amounts; minimum haircuts; collateral eligibility criteria, and collateral call frequency. The framework also includes a formal escalation process for counterparty collateral disputes and unpaid collateral calls.

The risk mitigating impact of netting and collateralisation on CCR for derivatives under the mark-to-market approach only is detailed in the following table.

Table 36: Netting and collateralisation impact on counterparty credit risk

Counterparty credit risk (1)	2011 £m	2010 £m
Gross positive fair value of contracts plus potential future credit exposure	252,760	260,695
Netting benefits	(163,565)	(168,013)
Net current credit exposure plus potential future credit exposure	89,195	92,682
Collateral held	(20,776)	(17,899)
Exposure at default post CRM	68,419	74,783

Note:

(1) Only shows OTC derivatives under the MTM approach.

Key point

- The decrease in EAD was driven by active de-risking of the Non-Core exotic credit derivatives portfolio, matured trades and early termination of interest rate swaps.

On a daily basis, for treasury and liquidity management purposes, the Group calculates what its additional requirements to post collateral, for each counterparty and in aggregate, would be in the event of the Group's credit ratings being downgraded by one or two notches. For further information refer to page 457 of the Group's 2011 Annual Report and Accounts.

Credit valuation adjustments

Credit valuation adjustments (CVAs) represent an estimate of the adjustment to the fair value of a derivative contract that a market participant would make to incorporate the additional credit (volatility or jump) risk inherent in counterparty derivative exposures. CVAs for monoline insurance companies are calculated on a trade-by-trade basis, using market observable credit spreads. The methodology used for credit derivative product companies is similar although, in the absence of market observable credit spreads, it estimates the cost of hedging expected default losses in excess of the capital available in each vehicle. For all other counterparties

CVA is calculated either on a trade-by-trade basis reflecting the estimated cost of hedging the risk through credit derivatives, or on a portfolio basis reflecting an estimate of the amount the third party would have to pay to assume the risk.

Credit derivatives

As part of its credit risk strategy to mitigate portfolio risk concentrations, the Group buys credit derivative products from market counterparties which incur counterparty credit risk. Such counterparties are subject to the Group's standard credit risk analysis. Over and above this, additional restrictions apply with respect to eligibility and suitability, (e.g. credit protection bought from the same corporate group as the reference entity is not considered eligible credit protection). A summary of notional credit derivative products is detailed in the following table, split between protection bought for portfolio management purposes and that relating to intermediation in the credit derivative markets.

Counterparty credit risk *continued*

Table 37: Credit derivative transactions (1)

	2011		2010	
	Credit default swaps £m	Total return swaps £m	Credit default swaps £m	Total return swaps £m
Notional principal amount of credit derivative transactions				
Used for own credit portfolio - protection bought	15,780	-	15,818	-
Used for intermediation activities - protection bought	466,153	457	572,171	820
Used for intermediation activities - protection sold	440,302	129	548,170	290
	922,235	586	1,136,159	1,110
APS - protection bought	131,800	-	195,800	-
	1,054,035	586	1,331,959	1,110

Notes:

- (1) Disclosures have been updated to reflect the impact of the APS protection on the Group's exposures.
- (2) The APS is accounted for as a credit derivative under IFRS (refer to page 356 of the Group's 2011 Annual Report and Accounts). The regulatory capital requirements are calculated using the securitisation framework under the FSA prudential rules (refer to page 115 of the Group's 2011 Annual Report and Accounts).
- (3) Disclosures on credit derivatives are included on pages 187 to 191 of the Group's 2011 Annual Report and Accounts.

Key points

- The slight reduction within the own credit portfolio was driven by the settlement of a CDS trade that had been protecting loans that were sold via a synthetic transaction. This was partially offset by an increase in CDS protection in the Core portfolio and by two new trades in the structured finance portfolio.
- The 18.5% (£106.0 billion) decrease in protection bought and the 19.7% (£107.9 billion) decrease in protection sold were driven by the de-risking of the Non-Core exotic credit portfolio. Total return swaps also declined due to a decrease in trading activities.

Management of negative risk correlations

The Group has a formal risk framework governing negative risk correlations or wrong-way risks. Wrong-way risks arise when the risk factors driving the exposure to a counterparty are adversely correlated with the credit quality of that counterparty. There is a tendency for the exposure to increase as the creditworthiness decreases.

This framework:

- defines the three different types of wrong-way risks, i.e. general, specific and induced;
- identifies scenarios whereby the Group may be exposed to this risk;
- establishes the credit treatment;
- defines a range of mechanisms to control and monitor these risks through reporting and escalation processes; and
- recommends risk mitigants.

Securitisation

Definitions

For the purpose of these disclosures:

Securitisation is the process where the risks and rewards of an asset or pool of assets are sold into a special purpose entity (SPE), which funds itself by issuing bonds. The riskiness of, and the return on, the bonds issued relies on the pool of underlying assets. The bonds are issued in different tranches, each receiving payments according to a defined schedule as cash becomes available to make payments of interest and principal.

For more information on SPEs, refer to Types of SPEs in use by the Group on page 50.

Traditional securitisations - Are securitisations in which an originating bank transfers legal ownership of a pool of assets to an arm's length SPE.

Synthetic securitisations - Are securitisations in which the originating bank retains legal ownership of the pool of assets but transfers the credit risk associated with them to an arm's length SPE through the use of credit linked notes or credit derivatives.

Re-securitisations - Are securitisations in which the underlying pools of assets are themselves bonds issued by securitisation SPEs.

The originator - Is the entity that has lent funds to a third party, in its normal line of business, thus creating the financial asset which can be securitised. Examples include a finance company that leases cars, or a bank that provides funds to a real estate company to facilitate the latter's purchase of an office building.

Objectives and roles

In participating in securitisation activity, the Group aims to achieve one or more of the following objectives:

- To gain access to diversified sources of funding, either for the Group or for customers;
- To facilitate prudential balance sheet management, either for the Group or for customers; and
- To earn fees for its provision of liquidity lines to customers' conduit assets.

The Group may play one or more of the following roles in securitisation transactions:

Originator - Detailed below is information on the types of securitisation transaction in which the Group may enter as originator. Some of the Group's exposures are originated for the specific purpose of securitisation, which is essentially a funding tool used by Group Treasury and remains a sizeable activity. Table 41 on page 54 discloses the portion of the Group's origination activity for which the securitisation bonds issued by the Group are fully retained by it.

Arranger - This role comprises the structuring of securitisation deals and the associated legal framework, as well as marketing and distribution of the securities to investors. The Group may perform this role for both its own and customers' transactions. In performing this role for customers (principally large corporates), the Group's objective is to offer them an efficient method to sell financial assets and fund specific portfolios of assets and to earn fees for the Group.

Sponsor - In this role, the Group establishes and manages asset-backed commercial paper (ABCP) programmes or other schemes that act as conduits through purchasing bonds or other financial assets from third parties. It may perform this role for its own or customers' transactions. During 2011, the Group reduced such activity for both its own assets and multi-seller conduits, in line with its wider approach to balance sheet management.

Investor - The Group may also act as investor holding a position in a securitisation transaction for which it is neither originator nor sponsor. This may include providing swaps and liquidity facilities to the transaction.

Underwriter - The Group may also act as an underwriter in securitisation transactions for both itself and customers.

Other administrative roles - The Group may also perform one or more administrative roles, in which function it is referred to as a 'contractual party'. These roles include acting as deposit account holder or manager of the securitisation (including monitoring of the underlying assets on behalf of investors) or providing reporting on the assets to investors. Other possible roles include providing the SPE with mortgage management and agency services. Typically, the Group performs such roles as an adjunct to its origination business.

Types of transactions

The types of securitisation transaction that the Group may enter into as originator are as follows:

Residential mortgage securitisations - The Group has securitised portfolios of residential mortgages originated by itself. The mortgages are equitably assigned to SPEs, which fund themselves principally through the issue of floating rate notes. On repayment of the financing, any further amounts generated by the mortgages will be paid to the Group.

Credit card securitisations - In the UK, the Group has securitised credit card receivables originated by itself by selling them to an SPE, which in turn has issued notes. The note holders have a proportionate interest in a pool of credit card receivables that have been equitably assigned by the Group to a receivables trust. The Group continues to receive the net interest margin after charge-offs and other costs.

Securitisation *continued*

Securitisations of other loan types - Other loans originated by the Group have been transferred to SPEs, which in turn has issued notes. Any proceeds from the loans in excess of the amounts required to service and repay the notes are payable to the Group after deduction of expenses.

In addition to securitisations of its own assets as described above, the Group may also participate in the following types of transaction:

Commercial paper conduits - The Group may participate in commercial paper conduits involving either its own or customers' assets. The assets are transferred to SPEs, which in turn issue notes to the conduit, which funds itself in the commercial paper market. The Group supplies certain services and contingent liquidity support to these SPEs on an arm's length basis as well as programme-wide credit enhancement.

Re-securitisations - The Group holds positions in re-securitisation bonds in both Core and Non-Core, which are analysed in depth by a specialist team of portfolio managers and the Group's third-party advisors. For the positions in Core, the strategy is to reduce exposure in line with the Group's risk appetite. The positions in Non-Core are being exited in accordance with the Group's Non-Core strategy.

Accounting and regulatory treatment of securitised assets

Securitisations may, depending on the individual arrangement, result in: continued recognition of the securitised assets on the balance sheet of the Group; continued recognition of the assets to the extent of the Group's continuing involvement in those assets (as defined within IFRS); or derecognition of the assets and the separate recognition, as assets or liabilities, of any rights and obligations created or retained in the transfer of assets to the SPE. The Group has securitisations in each of these categories.

The regulatory treatment may differ from the accounting treatment. The risk exposures of the original assets continue to be included in the Group's RWAs unless, by the Group's calculation, significant risk transfer (SRT) of the exposures to third parties has taken place.

Calculation of risk-weighted exposure amounts

The Group conducts SRT tests regularly through the year to ensure that, when appropriate, the risk associated with the original securitised assets is derecognised from the Group calculations and its exposures to the securitisation are recognised. SRT testing is undertaken by using a consistent set of metrics, the most severe of which is to review the RWAs prior to securitisation against the risk-weighting of all remaining exposures at 1,250%.

If the Group deems that SRT has not been achieved, the risks associated with the original assets are retained for the purposes of calculating RWAs in the determination of capital requirements and the exposure to the securitisation is ignored.

If the Group deems that SRT has been achieved, it uses either the IRB approach or the standardised approach for calculating capital requirements on securitisation positions. Within the IRB approach, the Group applies the ratings-based approach to rated positions and the internal assessment approach to unrated ABCP programme positions where the Group is the sponsor. Further details are provided in the section on The use of external credit assessment institutions on page 51

Types of risks

The risks inherent within securitisation activity include those general to other types of financial instrument, but these may be heightened by the process of securitisation:

Credit risk - The risk of a financial loss to the Group as holder of the securitisation bonds owing to the failure of counterparties to settle outstanding amounts to the SPE. The performance of a securitisation bond is directly linked to that of the assets in the underlying pool, and to the seniority of that bond in the SPE cash waterfall, which determines whether available money is paid to a given bond as interest or principal. As fewer funds become available, the SPE is directed to make payments to the most senior bond holders until these have been repaid, in accordance with contractual terms. The creditworthiness of the securitisation bonds is also impacted by any other parties to the securitisation, such as the swap provider and the bank account provider.

Documentation risk - The risk that the securitisation structure does not function exactly as originally intended as a result of incorrectly drafted documentation. As each transaction is unique, the documentation must fully consider the potential impact of changes in the quality of the underlying assets on individual bond holdings.

This risk is heightened in the case of re-securitisations, as the Group needs to gather information surrounding each of the original transactions, together with an understanding of their interaction within the re-securitisation.

Economic risk - The risk that a sector-specific downturn will have a severe adverse impact on an undiversified asset type pool in a securitisation transaction.

Legal risk - The risk that the documentation that provides the rules for any decisions to be made within a securitisation has not been appropriately drafted to be effective in all relevant jurisdictions.

Liquidity risk - The risk that as individual loans are repaid by borrowers, the Group will fail to obtain replacement liquidity, in the form of new loans to customers, that dovetails with the predicted prepayment profile of the assets in the securitisation transaction.

Market risk - The risk that the value of the securitisation notes will change as a result of interest rate or currency volatility. This will depend on the structure of the bonds issued, as well as the type of assets in the pool. For example, if the bonds pay quarterly interest referenced against LIBOR but the pool assets, such as residential mortgages, are referenced against base rate, these may move differently.

Securitisation *continued*

Reputational risk - The risk of brand damage to the Group in the event that it does not pass on appropriate duty of care when assets are sold.

In addition, in cases where the Group retains servicing obligations, it must ensure that the securitised assets are legally and financially segregated whilst maintaining all conduct of business requirements.

Monitoring risks

The Group monitors the risks inherent in its securitisation activity on an ongoing basis, with a particular focus on complex historical transactions held in Non-Core. The simpler transactions undertaken for Group funding are managed and monitored by dedicated teams in Group Treasury.

Credit risks are particularly distinct to each transaction and, thus, managing them appropriately requires a comprehensive understanding of each underlying pool. The managers responsible for the Group's securitisation positions regularly review the credit risk inherent in each case with the Credit Officers. These reviews take into account the information provided by the relevant securitisation trustee on payment dates as well as information from rating agencies and third-party advisors.

The market risks in the Group's securitisation transactions are monitored primarily through reviewing daily value-at-risk calculations of bonds held on the Group's trading book. The prudential calculations are performed using the standardised market risk rules. An evaluation of pricing risk is performed regularly for bonds held on the Group's banking book (this is term used for the Group's non-trading book).

With a view to monitoring the liquidity risks in its securitisation transactions, the Group generates anticipated future cash flow reports. These reports are also produced for provision to the FSA.

The Group's internal controls are designed to help reduce the legal risks associated with its securitisation activity. Inter alia, these controls require the Group to:

Pre-close - follow established business processes to enable it to meet its obligations; and

Post-close - perform any continuing contractual roles as appropriate.

Hedging and unfunded protection

The Group has policies governing its use of hedging and unfunded protection to mitigate the risk of retained securitisation and re-securitisation positions for each type of transaction.

To mitigate the general market risk, the trading book has significant hedge positions in credit derivative swaps of asset-backed securities, most of which are with collateralised counterparties. Positions retained in originated securitisations are not customarily held on the trading book.

The retained securitisation positions used for funding purposes are incorporated into liquidity modelling and relevant interest rate risks are hedged where necessary.

The Group has legacy positions in the Non-Core division where minimal value is attributed to the majority of hedge providers. Non-Core also manages the historical re-securitisation positions. The Group also has significant historical exposures to monoline insurance companies, which are disclosed on page 188 of the Group's 2011 Annual Report and Accounts.

Types of SPEs in use by the Group

SPEs are vehicles set up for a specific, limited purpose. Typically, they do not carry out a business or trade or have any employees. SPEs, including those used for securitisation purposes, may take a variety of legal forms, e.g. trusts, partnerships and companies. Their share capital is typically held ultimately by charitable trusts.

The securitisation SPEs used by the Group hold either the securitised assets themselves or solely the rights to those assets.

The Group had seven commercial paper conduit programmes in use at 31 December 2011. For these programmes, the Group provides programme-wide enhancement and liquidity facilities, as disclosed in the conduit disclosures on page 125 of the Group's 2011 Annual Report and Accounts.

The Group's sponsored conduits are:

- TAGS
- Orchid
- Amsterdam
- Windmill
- George Street Finance
- Abel Tasman
- Churchill

At 31 December 2011, the Group had a single own-asset conduit in place for which the commercial paper issued by the conduit was fully retained by the Group. Another such own-asset conduit reported at 31 December 2010 was fully unwound in the first half of 2011.

The transactions in which the Group acts as swap counterparty and has originated all the assets and continues to administer those assets include those using the brand names listed below. This naming convention helps signal to market participants that transactions with the same brand name as each other share similarities in terms of the asset type securitised and the role or roles the Group plays in the transaction.

- Arran (cards master trust)
- Arran (UK residential mortgages)
- Artesian (UK water companies)
- Celtic (Irish residential mortgages)
- EPIC (commercial real estate)
- Greenock (UK residential mortgages)
- Talisman (commercial real estate)

Securitisation *continued*

The Group established Greenock to access the Bank of England's open market operations for contingent funding purposes.

Summary of accounting policies including derecognition Treatment of transactions as sales or financings and the recognition of gains on sales

A securitisation transaction is first assessed for any potential requirement to consolidate any of the various vehicles used. The assessment is made considering the requirements of International Accounting Standard (IAS) 27 'Consolidated and Separate Financial Statements' and Standing Interpretations Committee (SIC) 12 'Consolidation - Special Purpose Entities'. Both IAS 27 and SIC 12 require consolidation of entities where, on balance, the risks and rewards are retained by the Group.

Whether a securitisation transaction is treated as a sale or financing depends on whether the derecognition tests of IAS 39 'Financial Instruments: Recognition and Measurement', are met.

The Group's accounting policy on derecognition is as follows:

A financial asset is derecognised when the contractual right to receive cash flows from the asset has expired or when it has been transferred and the transfer qualifies for derecognition. A transfer requires that the Group either (a) transfers the contractual rights to receive the asset's cash flows; or (b) retains the right to the asset's cash flows but assumes a contractual obligation to pay those cash flows to a third party. After a transfer, the Group assesses the extent to which it has retained the risks and rewards of ownership of the transferred asset. The asset remains on the balance sheet if substantially all the risks and rewards have been retained. It is derecognised if substantially all the risks and rewards have been transferred. If substantially all the risks and rewards have been neither retained nor transferred, the Group assesses whether or not it has retained control of the asset. If it has not retained control, the asset is derecognised. Where the Group has retained control of the asset, it continues to recognise the asset to the extent of its continuing involvement.

A financial liability is removed from the balance sheet when the obligation is discharged, or cancelled, or expires. On the redemption or settlement of debt securities (including subordinated liabilities) issued by the Group, the Group derecognises the debt instrument and records a gain or loss being the difference between the debt's carrying amount and the cost of redemption or settlement. The same treatment applies where the debt is exchanged for a new debt issue that has terms substantially different from those of the existing debt. The assessment of whether the terms of the new debt instrument are substantially different takes into account qualitative and quantitative characteristics including a comparison of the present value of the cash flows under

the new terms with present value of the remaining cash flows of the original debt issue discounted at the effective interest rate of the original debt issue.

Key assumptions for valuing securitisation positions

Securitisation positions are valued by reference to external information, namely market data for recent transactions, and price information from third-party managers and third-party advisors, together with asset performance data provided to all bond holders at interest payment dates. There has been no change in the methodology used compared to previous reporting periods, market data inputs are updated to the year-end.

Treatment of synthetic securitisations

Synthetic securitisations are assessed in accordance with the same policies as non-synthetic securitisations. Any derivatives are treated in accordance with the requirements of IAS 39.

Assets awaiting securitisation

Assets are valued according to the normal methods appropriate to the asset class, until a securitisation is sufficiently certain for derecognition under IFRS to occur. At both 31 December 2011 and 31 December 2010, the Group had no assets considered to be categorised as awaiting securitisation.

The Group recognises all contractual commitments, such as liquidity lines, and applies the accounting policies as set out in the Group's 2011 Annual Report and Accounts. The Group provides support for securitisation transactions to the extent of those contractual obligations.

The use of external credit assessment institutions

The Group uses Standard & Poor's, Moody's or Fitch to rate deal structures in their entirety. For most transactions, the services of two or more of these rating agencies, formally classed as external credit assessment institutions for these purposes, are used.

As explained earlier, the Group uses the internal assessment approach (IAA), introduced by CRD II, for the commercial paper conduit programmes it sponsors.

In these programmes, each new pool of assets is subjected to a rating agency methodology and stress analysis, to confirm whether or not the programme can continue to issue paper with a public rating of A1/P-1 or A1+/P-1, but each pool does not itself receive a public rating.

The output of this process is an "inferred rating" or internal credit grade, which is also used to determine the capital requirement for the pool-specific liquidity facility exposures.

Securitisation *continued*

The key steps in deriving this internal credit grade are as follows:

- The relevant relationship manager produces a report proposing an internal credit grade and describing how this was calculated using the IAA.
- The credit risk manager is required to confirm and comment on the approach employed and the proposed credit grade.
- The relevant credit committee has ultimate authority to confirm the allocated credit grade.

Securitisation and re-securitisation exposures

Additional information is contained on pages 396 and 397 of the Group's 2011 Annual Report and Accounts.

An explanation of any material changes from 2010 is provided in the key points to each following table.

Detailed below are introductory notes in relation to tables 38 to 45:

- Data for 31 December 2010 are presented solely for the banking book. Trading book disclosures were a new requirement for the year ending 31 December 2011 under CRD III.
- Exposures presented in the tables reflect only those transactions that have passed the SRT test.
- Where the Group consolidates the exposure, values reflect the figures on the Group's balance sheet. Where the Group is the manager of the securitisation programme but does not consolidate the exposure, values reflect the figures on the SPE's balance sheet. In other cases, values reflect the Group's best reasonable estimate.
- For 2011, re-securitisation exposures were reported under the re-securitisations category as required under CRD III. For 2010, such exposures were allocated as appropriate to the relevant category of the original underlying asset.

Table 38: Exposures securitised, by transaction and exposure type

	Outstanding amounts of exposures securitised		
	Traditional		Synthetic
	Originator £m	Sponsor £m	Originator £m
Underlying portfolio			
2011 - trading book			
Re-securitisations	2,259	-	-
2011 - banking book			
Residential mortgages	-	2,999	-
Commercial mortgages	1,345	509	203
Credit card receivables	-	863	-
Leasing	-	344	-
Loans to corporates or SMEs	3,066	307	-
Consumer loans	-	1,850	-
Trade receivables	-	1,000	-
Auto receivables	-	4,055	-
Other assets	-	922	-
	4,411	12,849	203
2010 - banking book			
Residential mortgages	1,231	3,798	-
Commercial mortgages	456	660	2,255
Credit card receivables	29	2,087	-
Loans to corporates or SMEs	3,148	205	1,782
Consumer loans	-	2,644	-
Trade receivables	-	763	-
Auto receivables	-	5,291	-
Other assets	-	2,069	-
	4,864	17,517	4,037

Key points

- Volumes for those transactions on the Group's banking book where the Group acted as sponsor were muted due to unfavourable market conditions.
- As a result of the maturing of an own-asset residential mortgage transaction during 2011, the residential mortgage exposures on the Group's banking book for

traditional securitisations in which it was the originator declined from £1.2 billion at 31 December 2010 to nil at 31 December 2011.

- The year-on-year decline in synthetic transactions on the banking book reflects changes in the risk transfer status of certain transactions such that significant risk transfer is no longer deemed to have taken place.

Securitisation *continued*

Securitisation activity during the year

During 2010 and 2011, the Group participated as a sponsor in traditional securitisations as detailed in the following table.

Table 39: New securitisation activity during the year

Underlying portfolio	Originator		Sponsor	
	Exposures securitised traditional sponsor £m	Recognised gain or loss on sale £m	Exposures securitised traditional sponsor £m	Recognised gain or loss on sale £m
2011 - trading book				
Re-securitisations	2,259	-	-	-
2011 - banking book				
Commercial mortgages	1,351	41	-	-
Leasing	-	-	286	-
Consumer loans	-	-	271	-
Trade receivables	-	-	361	-
Auto receivables	-	-	1,253	-
	1,351	41	2,171	-
2010 - banking book				
Residential mortgages	-	-	391	-
Credit card receivables	-	-	920	-
Consumer loans	-	-	657	-
Trade receivables	-	-	49	-
Auto receivables	-	-	1,972	-
	-	-	3,989	-

Key point

- Securitisation activity continues to be a source of diversified funding for the Group and customers, but is only entered into where economic.

Table 40: Impaired and past due exposures securitised, by exposure type and losses

	Outstanding amounts of exposures securitised	
	Impaired/past due Originator £m	Losses Originator £m
2011 - banking book		
Loans to corporates or SMEs	12	-
2010 - banking book		
Residential mortgages	133	24
Loans to corporates or SMEs	28	-
	161	24

Key points

- The maturing of an own-asset residential mortgage transaction during 2011 accounts for the reduction in the impaired and past due residential mortgage exposures on the banking book from £133 million at 31 December 2010 to nil at 31 December 2011.
- For own-asset securitised exposures on the trading book, the Group is no longer the lender of record and does not perform any management or administrative function. Hence, impaired/past due and loss data on these exposures are not readily available.

Securitisation *continued*

Table 41: Securitisation positions, retained or purchased, by exposure type on and off-balance sheet

Underlying portfolio	Aggregate amount of securitisation positions retained or purchased				2010 Banking book (1) £m
	2011				
	On-balance sheet		Off-balance sheet		
Trading book £m	Banking book £m	Trading book £m	Banking book £m		
Residential mortgages	824	10,521	74	4,567	20,937
Commercial mortgages	761	2,474	41	285	5,355
Credit card receivables	115	168	-	1,636	4,094
Leasing	-	115	-	532	1,566
Loans to corporates or SMEs	-	469	-	17	5,441
Consumer loans	-	23	-	1,640	3,757
Trade receivables	-	441	-	1,640	7,749
Re-securitisations	1,269	7,615	249	523	758
Auto receivables	53	1,221	-	7,212	8,593
Other assets	978	3,768	170	4,362	4,221
	4,000	26,815	534	22,414	62,471

Note:

(1) Data for 31 December 2010 present on-balance sheet and off-balance sheet securitisation positions combined. Separate disclosure of off-balance sheet positions is a new requirement for 31 December 2011 under CRD III.

Key points

- Securitisation positions in the banking book, for on and off-balance sheet exposures combined, declined from £62.5 billion to £49.2 billion, reflecting increased risk aversion in both the Group and the wider market. For geographic breakdowns of banking book securitisation positions (excluding deductions and counterparty credit risk), refer to Credit risk on page 38.
- The large year-on-year rise in re-securitisation positions in the banking book primarily reflects the change in allocation of such positions to the re-securitisation category in 2011 under CRD III. At 31 December 2011, the vast majority of such positions comprise conduit exposures to pools of trade receivables.

Table 42: Securitisation positions, retained or purchased, by risk-weightings

Risk-weight bands	2011 - trading book		
	Aggregate amount of securitisation positions retained or purchased		
	Exposure amount £m	Capital charges, standardised approach £m	Capital charges IRB approach £m
≤ 10%	228	-	1
> 10% ≤ 20%	195	-	3
> 20% ≤ 50%	1,233	13	16
> 50% ≤ 100%	236	3	9
> 100% ≤ 650%	885	45	116
> 650% ≤ 1,250%	79	10	34
1,250%/deduction	1,678	821	871
	4,534	892	1,050

Securitisation *continued*

Table 42: Securitisation positions, retained or purchased, by risk-weightings *continued*

2011 - banking book			
Aggregate amount of securitisation positions retained or purchased			
Risk-weight bands	Exposure amount £m	Capital charges, standardised approach £m	Capital charges IRB approach £m
≤ 10%	28,088	-	174
> 10% ≤ 20%	6,372	6	59
> 20% ≤ 50%	7,625	2	190
> 50% ≤ 100%	1,416	1	72
> 100% ≤ 650%	2,764	16	419
> 650% ≤ 1,250%	24	-	13
1,250%/deduction	2,940	157	2,191
	49,229	182	3,118

2010 - banking book			
Aggregate amount of securitisation positions retained or purchased			
Risk-weight bands	Exposure amount £m	Capital charges, standardised approach £m	Capital charges IRB approach £m
≤ 10%	33,343	-	209
> 10% ≤ 20%	15,763	13	184
> 20% ≤ 50%	5,616	1	182
> 50% ≤ 100%	3,092	1	228
> 100% ≤ 650%	679	24	112
1,250%/deduction	3,978	970	3,008
	62,471	1,009	3,923

Key points

- The reduction in securitisation positions exposure reflects a number of factors: (i) the allocation of re-securitisation positions to the re-securitisation category as at 31 December 2011 (now captured in the following table); (ii) the reclassification of diversified payment rights as loans as at 31 December 2011 from securitisation positions as at 31 December 2010); and (iii) increased risk aversion in both the Group and the wider market.
- However, despite this reduction in exposure, capital charges in total for securitisation and re-securitisation positions combined have decreased only marginally, reflecting increased capital requirements for existing measures as well as new capital charges required under CRD III.

Securitisation *continued*

Table 43: Re-securitisation positions, retained or purchased, by risk-weightings

Risk-weight bands	2011 - trading book		
	Aggregate amount of re-securitisation positions retained or purchased		
	Exposure amount £m	Capital charges, standardised approach £m	Capital charges IRB approach £m
> 10% ≤ 20%	27	-	1
> 20% ≤ 50%	462	6	8
> 50% ≤ 100%	26	-	1
> 100% ≤ 650%	367	5	60
> 650% ≤ 1,250%	40	10	13
1,250%/deduction	596	291	310
	1,518	312	393

Risk-weight bands	2011 - banking book		
	Aggregate amount of re-securitisation positions retained or purchased		
	Exposure amount £m	Capital charges, standardised approach £m	Capital charges IRB approach £m
> 20% ≤ 50%	4,736	-	102
> 50% ≤ 100%	858	-	41
> 100% ≤ 650%	1,245	-	167
1,250%/deduction	1,299	-	1,299
	8,138	-	1,609

Table 44: Exposures to securitisations of revolving assets

2010 - banking book	Aggregate outstanding amounts	
	Originators' interest £m	Investors' interest £m
Retail committed	3,917	29

Key point

- There were no exposures to own-asset securitisations of revolving assets at 31 December 2011, following the early maturity of a credit card securitisation transaction during the year.

Table 45: Total trading book outstanding exposures securitised and subject to a market risk capital requirement

Underlying portfolio	Total outstanding exposures securitised - traditional £m
2011 - trading book	
Residential mortgages	24
Commercial mortgages	50
Credit card receivables	3
Auto receivables	5
Other assets	168
	250

Key point

- There were no synthetic transactions subject to a market risk capital requirement at 31 December 2011.

Market risk

Market risk arises from changes in interest rates, foreign currency, credit spreads, equity prices and risk related factors such as market volatilities.

The Group has exposure to market risk through both its trading and non-trading portfolios.

Governance and risk management

For information on the business and organisation structures governing the Group's management of market risk as well as key market risk management principles, quantitative risk appetite and stress testing, refer to pages 229 to 231 of the Group's 2011 Annual Report and Accounts.

Risk models

The Group's market risk models are described below. These include three new models for calculating stressed VaR, incremental risk charge and all price risk, as required under CRD III. These new models have been approved by the FSA for calculating market risk capital and are within the scope of the Group's VaR waiver.

VaR - The VaR model has been approved by the FSA to calculate regulatory capital for the trading book, for those legal entities under its regulatory jurisdiction. These legal entities are currently The Royal Bank of Scotland plc; National Westminster Bank plc; and RBS Financial Products Inc. Regulatory VaR differs from the internal VaR as it is based on a 10-day holding period. The approval covers general market risk in interest rate, foreign exchange, equity and limited commodity products and specific risk in interest rate and equity products.

For more information on the VaR model, refer to page 230 of the Group's 2011 Annual Report and Accounts.

Stressed VaR (SVaR) - SVaR is applied to the trading portfolio and utilises data from a specific one year period of continuous stress. As with VaR, the technique produces estimates of the potential change in the market value of a portfolio over a specified time horizon at given confidence level. For the purposes of calculating regulatory SVaR, a time horizon of ten trading days is assumed at a confidence level of 99%.

Risks not in VaR (RNIV) - The RNIV framework has been developed to quantify those market risks not adequately captured by VaR and SVaR methodologies. Where risks are not included in the model, various non-VaR controls (for example, portfolio size limits, sensitivity limits, triggers or stress limits) are in place.

Incremental risk charge (IRC) - The IRC model aims to quantify the impact of defaults and rating changes on the value of bonds, credit derivatives, and other related positions held in the trading book. It is calculated over a one year horizon to a 99.9% confidence level, and therefore represents a 1-in-1,000 loss over the following year. The

modelling framework differentiates between the liquidity of different underlying instruments, with a minimum liquidity horizon of three months. It also captures basis risks between different products referencing the same underlying credit (e.g. bonds and CDS), and between similar products with different contractual terms (e.g. CDS in different currencies). The portfolio impact of correlated defaults and rating changes is assessed with reference to the resulting market value change of positions, which is determined using stressed recovery rates and modelled credit spread changes. The average liquidity horizon at the year end was 4.5 months.

All price risk (APR) - The APR model is applied to the corporate credit correlation trading portfolio, subject to certain eligibility constraints (principally that the underlying names are liquid corporate CDS positions). The measure is calibrated to a 99.9% confidence level over a one year time horizon. All material price risks, including defaults and credit rating changes, are within the scope of the model. Of these, the most significant are credit spread risk, credit (base) correlation risk, index basis risk, default risk, and recovery rate risk. In addition, losses due to both hedging costs and hedge slippage are modelled. The overall APR capital charge is floored at 8% of the corresponding standard rules charge for the same portfolio. The average liquidity horizon at the year end was 12 months.

Product control and valuation

For information on pricing model ownership, review and developments during 2011, refer to page 231 of the Group's 2011 Annual Report and Accounts.

Marking to market

To ensure that the risks associated with dealing activity are reflected in the financial and management statements, assets and liabilities in the trading book are measured at their fair value. Any profits or losses on the revaluation of positions are recognised in the income statement on a daily basis.

Fair value is the amount at which the instrument could be exchanged in a current transaction between willing parties. The fair values are determined following IAS 39 guidance, which requires banks to use quoted market prices or valuation techniques (models) that make the maximum use of observable inputs.

When marking-to-market using a model, the market risk function reviews and approves the valuation methodologies.

Traders are responsible for marking-to-market their trading book positions on a daily basis. Traders can either:

- directly mark a position with a price (e.g. spot FX); or
- indirectly mark a position through the marking of inputs to an approved model, which will in turn generate a price

Market risk *continued*

Independent price verification

Independent price verification is a key additional control over front office marking of positions.

Key elements of the independent price verification framework include:

Appropriate financial controls - business unit controllers are responsible for ensuring that independent price verification processes are in place covering all trading book positions held by their business. The independent pricing verification policy requires that daily independent price verification is performed for positions where prices/model inputs are readily available on a daily basis. For positions where prices/model inputs are available on a less regular basis, verification may occur on a frequency that is less than daily. Where practical, verification is performed to a frequency that matches the availability of this independent price information.

Compliance statements - business unit control is required to prepare and maintain compliance statements that benchmark price verification procedures against the independent pricing policy. Each compliance statement requires review and sign-off from the relevant financial controller, market risk manager and front office management every six months at least.

For more information on independent price verification, refer to page 345 of the Group's 2011 Annual Report and Accounts.

The following table analyses the market risk minimum capital requirement. The 2011 figures have been calculated in accordance with Basel 2.5. The 2010 figures have been calculated in accordance with Basel 2.

Table 46: Market risk minimum capital requirement

	2011 (1) £m	2010 £m
Interest rate position risk requirement	1,107	405
Equity position risk requirement	3	-
Option position risk requirement	26	-
Other position risk requirement	-	955
Commodity position risk requirement	2	-
Foreign currency position risk requirement	10	-
Specific interest rate risk of securitisation positions (1)	250	n/a
Total (standard method)	1,398	1,360
Capital requirement for aggregation entities	n/a	873
Pillar 1 model based position risk requirement	3,725	4,175
Total position risk requirement	5,123	6,408

The principal contributors to the Pillar 1 model based position risk requirement are:

	2011	2010
VaR	887	1,913
Stressed VaR (1,2)	1,682	n/a
Incremental risk charge (1)	469	n/a
All price risk (1)	297	n/a
Incremental default risk charge	n/a	751

Notes:

(1) As the new capital charges for Basel 2.5 have been implemented for 2011, the average, minimum and maximum are not available for stressed VaR, IRC or APR.

(2) The year end stressed VaR for RBS plc, before application of the capital multiplier, was £485 million.

Market risk *continued*

Key points

- *Basel 2.5 market risk capital requirements* - These new requirements, which came into effect on 31 December 2011, included stressed VaR, all price risk and the incremental risk charge (which replaced the incremental default risk charge). The rules also require a specific interest rate risk capital charge under standardised rules for those securitisation positions that are not deemed part of the correlation trading portfolio.
- *Capital requirement for aggregation entities* - The non-European Economic Area rules which allowed the Group to consolidate market risk capital for some legal entities using local regulatory rules expired at the end of 2011. The capital requirements for these legal entities are now calculated using FSA standardised rules and incorporated in the standard method position risk requirements. The interest rate position risk requirement increased materially as a result of the rule change.
- *Total position risk requirement* - Despite the increased requirements under Basel 2.5, the total position risk requirement decreased year-on-year, primarily driven by factors affecting the following two risk requirements:
 - Other position risk requirement: The trades transferred from RBS N.V. to RBS plc in 2009 and reported under standardised rules in RBS plc were reclassified from the trading book to the banking book in March 2011. This reclassification was approved by the FSA.
 - VaR risk requirement: In line with the Group's overall business strategy to reduce risk exposures, the VaR risk requirement was significantly lower in 2011 than in 2010. The VaR also declined further as the volatility experienced during the 2009 financial crisis dropped out of the two year time series used in the VaR calculation. For more information on the management of market risk exposures refer to pages 229 and 230 of the Group's 2011 Annual Report and Accounts.

Market risk traded VaR

For information on market risk trading VaR, refer to page 233 of the Group's 2011 Annual Report and Accounts.

Operational risk

Operational risk

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. It is an integral and unavoidable part of the Group's business as it is inherent in the processes it operates to provide services to customers and meet strategic objectives.

Operational risk management

The objective of operational risk management is not to remove operational risk altogether, but to manage it to an acceptable level, taking into account the cost of minimising the risk against the resultant reduction in exposure. Strategies to manage operational risk include avoidance, transfer, acceptance and mitigation by controls.

Structure and governance

Group Operational Risk (GOR) is an independent function reporting to the Deputy Group Chief Risk Officer. GOR is responsible for the design and maintenance of the Operational Risk Policy Standards.

The Operational Risk Executive Committee is a sub-committee of the Group Risk Committee. It oversees the operational risk framework and profile of the Group in line with the agreed risk appetite. It provides guidance, oversight and advice. It also escalates and reports any issues or areas of concern to the Board Risk Committee and to other senior committees (refer to the Governance section on pages 268 to 271 of the Group's 2011 Annual Report and Accounts).

Operational risk roles, responsibilities and accountabilities operate in accordance with the Group's three lines of defence model.

Risk appetite

The Group's operational risk appetite statement is agreed by the Group Board. It comprises a number of specific measures of risk, such as:

- The maximum operational risk losses the Group is prepared to accept. This is expressed as a percentage of the Group's estimated gross income for the year ahead; or
- The value of a single extreme but plausible operational impact. These are identified and assessed through the scenario analysis programme (refer to Scenario analysis).

To ensure the Group operates within the set risk appetite, the high level statements are supplemented by specific tolerances for different types of operational risk. The Group Policy Framework sets out how to manage risk within acceptable limits, which in turn enables the Group to operate within the overall risk appetite and the specific tolerances. The Group has a zero tolerance for risks such as breaches of laws and regulations.

Group Policy Framework (GPF)

The GPF is owned and managed by GOR. It consolidates a large number of individual policy standards under a consistent and structured overarching framework for conduct, control and governance. It is a core component of the Group's risk appetite framework, it supports the risk appetite setting process and also underpins the control environment.

Operational Risk Policy Standards (ORPS)

ORPS are incorporated in the GPF. They provide the direction for delivering effective operational risk management and are designed to allow the consistent identification, assessment, management, monitoring and reporting of operational risk across the Group. The key operational risk processes covered by ORPS are as follows:

Risk and control assessments

Business units identify and assess operational risks to ensure that they are effectively managed, prioritised and documented.

Group new product approval process

This process ensures that all new products or significant variations to existing products are subject to a comprehensive risk assessment. Products are evaluated and approved by specialist areas and are subject to executive approval prior to launch.

Scenario analysis

Scenarios for operational risk are used to assess the possible impact and likelihood of extreme but plausible operational risk loss events. Scenario assessments provide a forward-looking basis for managing exposures that are beyond the Group's risk appetite.

Issues management

This ensures a consistent approach to the capture and classification of operational risk issues, and robust governance covering their closure and acceptance in accordance with the Group's three lines of defence model.

Event and loss data management

Each business unit captures its operational risk events and losses above certain minimum thresholds. The data is used to enhance control adequacy and effectiveness, identify opportunities to prevent or reduce recurrence and inform risk and control assessments and scenario analysis. Events exceeding specified customer, financial or reputational criteria are quickly escalated to senior management to ensure appropriate action is taken.

Control environment certification

The control environment certification process requires management to monitor and report regularly on the internal control framework for which they are responsible, confirming its adequacy and effectiveness. This includes certifying compliance with the requirements of the GPF.

Operational risk *continued*

Scope and nature of reporting and measurement systems

Reporting forms an integral part of operational risk management. The Group's risk management processes are designed to ensure that operational risk issues are identified quickly and then escalated and managed on a timely basis.

Exposures for each division are reported through monthly risk and control reports, which provide detail on the risk exposures and action plans. Events that have a material, actual or potential impact on the Group's finances, reputation or customers, are escalated and reported to divisional and Group executive.

Policies for hedging and mitigating

ORPS require each business unit to determine appropriate mitigation techniques to reduce its risk exposure to an acceptable level, and confirm that the adequacy and effectiveness of controls and other risk mitigants (e.g. insurance) are tested regularly and the results documented. Where unacceptable control weaknesses are identified, action plans must be produced and tracked to completion.

The Group purchases insurance to provide the business with financial protection against specific losses and to comply with statutory or contractual requirements. Insurance is primarily used as an additional risk mitigation tool in controlling the Group's exposures. However, insurance only provides protection against financial loss once a risk has occurred.

Capital

The Group calculates the capital requirement for operational risk using the standardised approach (TSA). The capital requirements are as follows:

Table 47: Operational risk minimum capital requirement

	2011 £m	2010 £m
Operational risk capital requirement (TSA)	3,034	2,968

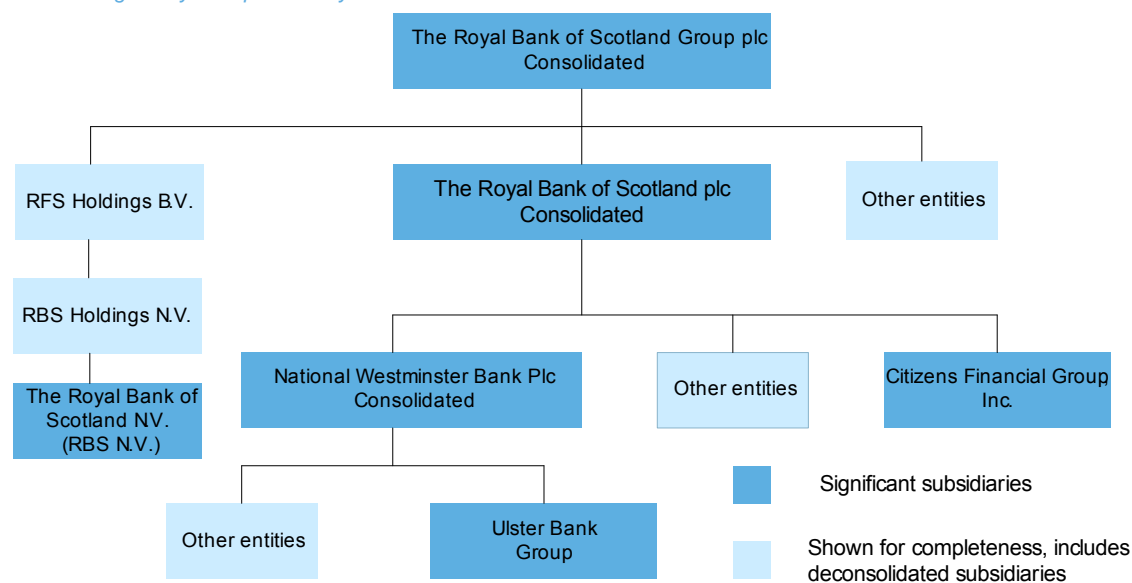
For further information on the Group's operational risk framework refer to pages 236 to 239 of the Group's 2011 Annual Report and Accounts.

Additional disclosures

Significant subsidiaries

Chart 3 represents a simplified regulatory hierarchy of the Group, specifically highlighting those subsidiaries and regions which are of significance. The Group has considered the requirements of the significant subsidiary disclosures and concluded that the following entities are within scope; The Royal Bank of Scotland plc Consolidated, National Westminster Bank Plc Consolidated, Ulster Bank Group, RBS N.V. and Citizens Financial Group, Inc.

Chart 3: Regulatory Group hierarchy



As highlighted by the diagram, data for these five significant subsidiaries does not aggregate to the overall Group position.

Subsidiaries deconsolidated for regulatory reporting purposes include RBS Insurance Group Limited, RBS Group Insurance Services Limited (excluding Lombard Direct Home Insurance Services Limited) and RBS Life Holdings Limited.

Table 48: Significant subsidiaries minimum capital requirement

Risk type	RBS Consolidated £m	NatWest Consolidated £m	Ulster Bank Group £m	RBS N.V. £m	Citizens Financial Group £m
2011					
Credit risk	29,507	8,335	3,158	3,138	4,707
Market risk	4,752	1,044	21	369	-
Operational risk	2,958	1,230	178	13	435
	37,217	10,609	3,357	3,520	5,142
2010					
Credit risk	30,628	8,671	3,065	6,047	4,802
Market risk	6,314	676	11	90	-
Operational risk	2,871	1,156	186	85	432
Concentration risk (1)	147	-	-	-	-
	39,960	10,503	3,262	6,222	5,234

Note:

(1) The concentration risk charge is calculated on intra-group large exposure balances and arose mainly due to increased trading book derivative exposures with RBS N.V.

Additional disclosures *continued*

Table 49: Significant subsidiaries RWAs

Risk type	RBS Consolidated £m	NatWest Consolidated £m	Ulster Bank Group £m	RBS N.V. £m	Citizens Financial Group £m
2011					
Credit risk	368,837	104,191	39,476	39,221	58,836
Market risk	59,400	13,053	260	4,614	-
Operational risk	36,971	15,362	2,225	167	5,432
	465,208	132,606	41,961	44,002	64,268
2010					
Credit risk	382,855	108,396	38,312	75,586	60,025
Market risk	78,928	8,447	135	1,127	-
Operational risk	35,888	14,454	2,325	1,057	5,404
Concentration risk	1,838	-	-	-	-
	499,509	131,297	40,772	77,770	65,429

Table 50: Significant subsidiaries credit risk minimum capital requirement

Credit risk approach	RBS Consolidated £m	NatWest Consolidated £m	Ulster Bank Group £m	RBS N.V. £m	Citizens Financial Group £m
2011					
Advanced IRB	17,004	6,628	3,044	2,296	-
Standardised	7,729	1,146	22	563	4,629
Counterparty credit risk	4,774	561	92	279	78
	29,507	8,335	3,158	3,138	4,707
2010					
Advanced IRB	18,503	7,263	2,951	3,106	-
Standardised	8,034	1,163	28	1,317	4,730
Counterparty credit risk	4,091	245	86	1,624	72
	30,628	8,671	3,065	6,047	4,802

Note:

(1) Credit risk capital requirements include both intra-group and non-customer assets.

Additional disclosures *continued*

Table 51: Significant subsidiaries credit risk advanced IRB minimum capital requirement

Advanced IRB exposure class and sub-class	RBS Consolidated £m	NatWest Consolidated £m	Ulster Bank Group £m	RBS N.V. £m
2011				
Central governments and central banks	97	8	8	80
Institutions	231	48	3	364
Corporates	9,825	3,258	1,342	1,640
Retail	5,030	2,941	1,590	-
Retail SME	765	602	164	-
Retail secured by real estate collateral	2,831	1,330	1,330	-
Qualifying revolving retail exposures	836	575	64	-
Other retail exposures	598	434	32	-
Equities	213	41	1	123
Exchange traded exposures	69	16	-	9
Private equity exposures	20	10	1	77
Other exposures	124	15	-	37
Securitisation positions	614	-	-	89
Non-credit obligation assets	994	332	100	-
	17,004	6,628	3,044	2,296
2010				
Central governments and central banks	102	9	4	173
Institutions	179	52	4	521
Corporates	11,405	3,904	1,664	2,133
Retail	5,238	2,969	1,197	-
Retail SME	1,023	827	180	-
Retail secured by real estate collateral	2,449	910	910	-
Qualifying revolving retail exposures	1,074	727	68	-
Other retail exposures	692	505	39	-
Equities	200	25	1	194
Exchange traded exposures	59	-	-	24
Private equity exposures	17	10	1	118
Other exposures	124	15	-	52
Securitisation positions	699	-	1	91
Non-credit obligation assets	680	304	80	(6)
	18,503	7,263	2,951	3,106

Notes:

- (1) Excludes counterparty credit risk assets.
- (2) Citizens Financial Group is not included as it is wholly on the Basel II standardised approach.

Additional disclosures *continued*

Table 52: Significant subsidiaries credit risk standardised minimum capital requirement

Standardised exposure class	RBS Consolidated £m	NatWest Consolidated £m	Ulster Bank Group £m	RBS N.V. £m	Citizens Financial Group £m
2011					
Central governments and central banks	-	-	-	12	-
Regional governments or local authorities	2	-	-	9	2
Administrative bodies and non-commercial undertakings	3	-	-	-	3
Institutions	346	66	-	14	22
Corporates	3,461	341	2	192	2,199
Retail	1,676	199	2	46	1,254
Secured by mortgages on commercial real estate	664	108	-	11	430
Secured by mortgages on residential property	532	147	-	13	276
Past due items	130	31	17	13	47
Securitisation positions	192	-	-	-	192
Other items	723	254	1	253	204
	7,729	1,146	22	563	4,629
2010					
Central governments and central banks	11	10	-	16	-
Regional governments or local authorities	2	-	-	15	1
Administrative bodies and non-commercial undertakings	4	-	-	-	4
Institutions	225	42	-	8	9
Corporates	4,149	539	3	478	2,431
Retail	1,923	197	2	60	1,464
Secured by real estate property	388	131	-	18	158
Past due items	180	36	22	16	64
Securitisation positions	425	-	-	-	425
Other items	727	208	1	706	174
	8,034	1,163	28	1,317	4,730

Table 53: Significant subsidiaries counterparty credit risk and concentration requirement

	RBS Consolidated £m	NatWest Consolidated £m	Ulster Bank Group £m	RBS N.V. £m	Citizens Financial Group £m
2011					
Counterparty credit risk	4,774	561	92	279	78
2010					
Counterparty credit risk	4,091	245	86	1,624	72
Concentration risk capital component	147	-	-	-	-

Additional disclosures *continued*

Table 54: Significant subsidiaries market risk trading book and other business

2011 (1)	RBS Consolidated £m	NatWest Consolidated £m	Ulster Bank Group £m	RBS N.V. £m
Trading book business				
Interest rate position risk requirement	1,106	902	14	-
Equity position risk requirement	3	3	-	-
Option position risk requirement	26	26	-	-
Specific interest-rate risk of securitisation positions	250	71	-	-
Commodity position risk requirement	2	2	-	-
Foreign exchange position risk requirement	8	8	7	1
Total (standard method)	1,395	1,012	21	1
Pillar 1 model based position risk requirement	3,357	32	-	368
Total position risk requirement	4,752	1,044	21	369

The principal contributors to the Pillar 1 model based position risk requirement are:

VaR	815	9	-	72
Stressed VaR	1,526	23	-	156
Incremental risk charge	329	-	-	140
All price risk	297	-	-	-

2010

Trading book business				
- Interest rate position risk requirement	403	21	-	1
- Any other position risk requirement	955	-	-	-
Foreign exchange position risk requirement	-	-	1	1
Total (standard method)	1,358	21	1	2
Capital requirement for aggregation entities	781	643	10	88
VaR model based position risk requirement	4,175	12	-	-
Total position risk requirement	6,314	676	11	90

Note:

(1) As the new capital charges for Basel 2.5 have been implemented for 2011, the average, minimum and maximum are not available for stressed VaR, IRC or APR.

Additional disclosures *continued*

Table 55: Significant subsidiaries capital resources

	2011				
	RBS Consolidated £m	NatWest Consolidated £m	Ulster Bank Group £m	RBS N.V.(1) £m	Citizens Financial Group (2) £m
Shareholders' equity (excluding non-controlling interests)					
Shareholders' equity per balance sheet	61,726	16,135	6,301	2,775	15,117
Preference shares - equity	-	-	(959)	-	-
Other equity instruments	(1,421)	-	-	-	-
	60,305	16,135	5,342	2,775	15,117
Non-controlling interests					
Non-controlling interests per balance sheet	128	1,272	512	18	-
Non-controlling preference shares	-	(1,177)	-	-	-
Other adjustments to non-controlling interests for regulatory purposes	-	-	(489)	-	-
	128	95	23	18	-
Regulatory adjustments and deductions					
Own credit	(1,157)	-	-	(759)	-
Unrealised (gains)/losses on AFS debt securities	(2,114)	(1)	-	2,565	(162)
Unrealised gains on AFS equity shares	(106)	(4)	-	(124)	-
Cash flow hedging reserve	(1,018)	14	-	18	503
Other adjustments for regulatory purposes	(230)	11	(134)	(149)	(11)
Goodwill and other intangible assets	(12,365)	(812)	-	(8)	(6,938)
50% excess of expected losses over impairment provisions (net of tax)	(2,553)	(1,773)	(1,217)	(95)	-
50% of securitisation positions	(1,605)	(424)	-	(39)	-
50% of APS first loss	(2,763)	-	-	-	-
	(23,911)	(2,989)	(1,351)	1,409	(6,608)
Core Tier 1 capital	36,522	13,241	4,014	4,202	8,509
Other Tier 1 capital					
Preference shares - equity	-	-	1,448	2,100	327
Preference shares - debt	2,857	293	-	-	-
Non-controlling preference shares	-	1,177	-	-	-
Innovative/hybrid Tier 1 securities	3,645	-	-	-	-
	6,502	1,470	1,448	2,100	327
Tier 1 deductions					
50% of material holdings	(235)	(339)	-	(355)	-
Tax on excess of expected losses over impairment provisions	920	640	439	-	-
Other adjustments for regulatory purposes	-	-	(492)	-	-
	685	301	(53)	(355)	-
Total Tier 1 capital	43,709	15,012	5,409	5,947	8,836

For the notes relating to this table refer to page 70.

Additional disclosures *continued*

Table 55: Significant subsidiaries capital resources *continued*

	2011				
	RBS Consolidated £m	NatWest Consolidated £m	Ulster Bank Group £m	RBS N.V.(1) £m	Citizens Financial Group (2) £m
Qualifying Tier 2 capital					
Undated subordinated debt	4,916	2,290	100	3,094	-
Dated subordinated debt - net of amortisation	17,272	4,989	1,060	-	-
Unrealised gains on AFS equity shares	106	4	-	124	1
Collectively assessed impairment provisions	584	5	4	-	801
Non-controlling Tier 2 capital	11	-	-	-	-
	22,889	7,288	1,164	3,218	802
Tier 2 deductions					
50% of securitisation positions	(1,605)	(424)	-	(39)	-
50% excess of expected losses over impairment provisions	(3,473)	(2,413)	(1,656)	(95)	-
50% of material holdings	(235)	(339)	-	(355)	-
50% of APS first loss	(2,763)	-	-	-	-
Other adjustments for regulatory purposes	-	-	492	-	-
	(8,076)	(3,176)	(1,164)	(489)	-
Total Tier 2 capital	14,813	4,112	-	2,729	802
Supervisory deductions					
Unconsolidated investments	(111)	(111)	-	-	-
Other deductions	(184)	(177)	-	(4)	-
	(295)	(288)	-	(4)	-
Total regulatory capital	58,227	18,836	5,409	8,672	9,638

For the notes relating to this table refer to page 70.

Additional disclosures *continued*

Table 55: Significant subsidiaries capital resources *continued*

	2010				
	RBS Consolidated £m	NatWest Consolidated £m	Ulster Bank Group £m	RBS N.V.(1) £m	Citizens Financial Group (2) £m
Shareholders' equity (excluding non-controlling interests)					
Shareholders' equity per balance sheet	57,010	15,054	4,697	4,267	14,619
Preference shares - equity	-	-	(959)	-	-
Other equity instruments	(1,421)	-	-	-	-
	55,589	15,054	3,738	4,267	14,619
Non-controlling interests					
Non-controlling interests per balance sheet	597	1,315	558	21	-
Non-controlling preference shares	-	(1,192)	-	-	-
Other adjustments to non-controlling interests for regulatory purposes	-	-	(504)	-	-
	597	123	54	21	-
Regulatory adjustments and deductions					
Own credit	(622)	-	-	(883)	-
Unrealised (gains)/losses on AFS debt securities	(843)	(9)	1	2,181	(105)
Unrealised gains on AFS equity shares	(74)	-	-	(97)	-
Cash flow hedging reserve	81	15	-	24	550
Other adjustments for regulatory purposes	(277)	3	(69)	(191)	(12)
Goodwill and other intangible assets	(11,832)	(683)	-	(22)	(7,310)
50% excess of expected losses over impairment provisions (net of tax)	(1,998)	(1,254)	(781)	(338)	-
50% of securitisation positions	(1,916)	(829)	(12)	(103)	-
50% of APS first loss	(4,225)	-	-	-	-
	(21,706)	(2,757)	(861)	571	(6,877)
Core Tier 1 capital	34,480	12,420	2,931	4,859	7,742
Other Tier 1 capital					
Preference shares - equity	-	-	1,463	2,087	326
Preference shares - debt	2,890	292	-	-	-
Non-controlling preference shares	-	1,192	-	-	-
Innovative/hybrid Tier 1 securities	3,638	-	-	-	-
	6,528	1,484	1,463	2,087	326
Tier 1 deductions					
50% of material holdings	(242)	(333)	-	(215)	-
Tax on excess of expected losses over impairment provisions	797	500	312	-	-
	555	167	312	(215)	-
Total Tier 1 capital	41,563	14,071	4,706	6,731	8,068

For the notes relating to this table refer to page 70.

Additional disclosures *continued*

Table 55: Significant subsidiaries capital resources *continued*

	2010				
	RBS Consolidated £m	NatWest Consolidated £m	Ulster Bank Group £m	RBS N.V.(1) £m	Citizens Financial Group (2) £m
Qualifying Tier 2 capital					
Undated subordinated debt	4,925	1,597	103	3,539	-
Dated subordinated debt - net of amortisation	18,067	4,931	1,097	-	52
Unrealised gains on AFS equity shares	74	-	-	97	-
Collectively assessed impairment provisions	672	4	4	-	780
Non-controlling Tier 2 capital	11	-	-	-	-
	23,749	6,532	1,204	3,636	832
Tier 2 deductions					
50% of securitisation positions	(1,916)	(829)	(12)	(103)	-
50% excess of expected losses over impairment provisions	(2,795)	(1,754)	(1,093)	(338)	-
50% of material holdings	(242)	(333)	-	(215)	-
50% of APS first loss	(4,225)	-	-	-	-
Other adjustments for regulatory purposes	-	-	-	-	-
	(9,178)	(2,916)	(1,105)	(656)	-
Total Tier 2 capital	14,571	3,616	99	2,980	832
Supervisory deductions					
Unconsolidated investments	(116)	(116)	-	-	-
Other deductions	(267)	(177)	-	(133)	-
	(383)	(293)	-	(133)	-
Total regulatory capital	55,751	17,394	4,805	9,578	8,900

Notes:

(1) RBS N.V. disclosure is driven off the De Nederlandsche Bank (DNB) disclosure; with specific national discretions applied by DNB.

(2) Citizens disclosure is driven by FED Band 1 which does not incorporate a Core Tier 1 definition. The above amount shows value for Core Tier 1.

Past due and impaired assets

A credit exposure is past due when its contractual repayment is overdue by 90 days or more.

A loan is impaired and an impairment loss incurred when there is objective evidence that events since the loan was granted have adversely affected expected cash flows from the loan. The impairment loss is the difference between the carrying value of the loan and the present value of estimated future cash flows discounted at the loan's original effective interest rate.

Impairment loss provision methodology

Provisions for impairment losses are assessed under three categories:

- **Individually assessed provisions** - Provisions required for individually significant impaired assets which are assessed on a case-by-case basis, taking into account the financial condition of the counterparty and any guarantor and collateral held after being stressed for downside risk. This incorporates an estimate of the discounted value of any recoveries and realisation of security or collateral. The asset continues to be assessed on an individual basis until it is repaid in full, transferred to the performing portfolio or written-off.

- **Collectively assessed provisions** - Provisions on impaired credits below an agreed threshold which are assessed on a portfolio basis to reflect the homogeneous nature of the assets, such as credit cards or personal loans. The provision is determined based on a quantitative review of the relevant portfolio, taking account of the level of arrears, the value of any security and average loss experience over the recovery period.

Latent loss provisions - Provisions held against impairments in the performing portfolio that have been incurred as a result of events occurring before the balance sheet date but which have not been identified at the balance sheet date. The Group has developed methodologies to estimate latent loss provisions that reflect:

- the probability that the customer will default;
- historical loss experience adjusted where appropriate, in the light of current economic and credit conditions; and
- the period between an impairment event occurring and a loan being identified and reported as impaired.

Additional disclosures *continued*

Provision analysis

The Group's consumer portfolios, which consist of high volume, small value credits, have highly efficient largely automated processes for identifying problem credits and very short timescales, typically three months, before resolution or adoption of various recovery methods. Corporate portfolios consist of higher value, lower volume credits, which tend to be structured to meet individual customer requirements. Provisions are assessed on a case-by-case basis by experienced specialists with input from professional valuers and accountants. The Group operates a transparent provisions governance framework which sets thresholds whereby suitable oversight and challenge is undertaken and

significant cases will be presented to a committee chaired by the Group Chief Executive or the Group Finance Director.

The Group's accounting policy on impairments and impairment loss provision methodology are set out on pages 319, 202 and 203 respectively of the Group's 2011 Annual Report and Accounts.

Disclosure basis

The following tables detailing past due and impaired assets and provisions are presented on an IFRS basis rather than on a regulatory basis.

Table 56: Past due exposures, impaired exposures and provisions by industry sector

Industry sector	Impaired assets (1) £m	Past due assets £m	Individually and collectively assessed provisions £m	Latent provisions £m	Charge to income statement (2) £m
2011					
Agriculture and fisheries	136	9	63		(7)
Building and construction	1,644	118	703		139
Business services	1,609	106	881		677
Financial services	1,915	65	1,350		201
Manufacturing	871	170	535		229
Individuals	7,382	439	3,534		1,858
Power and water	88	-	23		3
Property	20,655	1,000	8,862		3,670
Public sector and quasi-government	996	81	458		304
Technology, media and telecommunications	528	-	183		120
Tourism and leisure	1,391	46	643		334
Transport and storage	574	15	146		78
Wholesale and retail trade	958	49	516		180
Latent				1,986	(545)
	38,747	2,098	17,897	1,986	7,241
2010					
Agriculture and fisheries	136	16	86		31
Building and construction	2,114	350	875		530
Business services	763	145	447		334
Financial services	1,963	157	1,276		437
Manufacturing	1,272	66	552		(190)
Individuals	7,409	412	3,771		2,384
Power and water	90	2	23		14
Property	18,284	1,300	6,736		4,682
Public sector and quasi-government	786	269	319		159
Technology, media and telecommunications	392	-	253		142
Tourism and leisure	1,187	84	504		321
Transport and storage	240	7	118		87
Wholesale and retail trade	1,065	89	572		334
Latent				2,650	(121)
	35,701	2,897	15,532	2,650	9,144

Notes:

(1) Excludes debt securities and equity shares totalling £3,174 million (2010 - £1,915 million).

(2) Excludes impairment losses on debt securities and equity shares totalling £1,468 million (2010 - £112 million).

Additional disclosures *continued*

Table 57: Past due exposures, impaired exposures and provisions by geographic area

Geographic area (1)	Impaired assets (2) £m	Past due assets £m	Individually and collectively assessed provisions £m	Latent provisions £m	Total provisions £m	Charge to income statement (3) £m
2011						
UK	15,575	1,700	7,583		7,583	3,364
Europe	20,349	330	9,240		9,240	3,993
North America	1,898	-	589		589	482
Rest of World	925	68	485		485	(53)
Latent				1,986	1,986	(545)
	38,747	2,098	17,897	1,986	19,883	7,241
2010						
UK	15,738	2,373	7,483		7,483	3,949
Europe	16,080	356	6,643		6,643	3,747
North America	2,243	87	785		785	1,190
Rest of World	1,640	81	621		621	379
Latent				2,650	2,650	(121)
	35,701	2,897	15,532	2,650	18,182	9,144

Notes:

- (1) The analysis by geographic area is based on the location of the lender. This analysis is used for financial reporting and differs from the disclosure in the credit risk section of this document which is based on the country of incorporation of the counterparty.
(2) Excludes debt securities and equity shares totalling £3,174 million (2010 - £1,915 million).
(3) Excludes impairment losses on debt securities and equity shares totalling £1,468 million (2010 - £112 million).

Table 58: Loan impairment provisions movement

	Individually assessed provisions (1) £m	Collectively assessed provisions £m	Latent provisions £m	Total £m
At 1 January 2010	8,953	5,254	3,076	17,283
Transfer to disposal groups	(72)	-	-	(72)
Currency translation and other adjustments	(15)	27	31	43
Disposals	(1,344)	(526)	(302)	(2,172)
Amounts written-off	(3,323)	(2,719)	-	(6,042)
Recovery of amounts previously written-off	90	321	-	411
Charged to income statement - continuing (2)	6,195	3,070	(121)	9,144
Charged to income statement - discontinued	35	41	(34)	42
Unwind of discount	(283)	(172)	-	(455)
Balance at 31 December 2010	10,236	5,296	2,650	18,182
Transfers to disposal groups	(158)	(536)	(79)	(773)
Currency translation and other adjustments	(244)	1	(40)	(283)
Disposals	8	-	-	8
Amounts written-off	(2,205)	(2,322)	-	(4,527)
Recovery of amounts previously written off	275	252	-	527
Charged to income statement - continuing (2)	5,195	2,591	(545)	7,241
Charged to income statement - discontinued	(8)	-	-	(8)
Unwind of discount	(342)	(142)	-	(484)
At 31 December 2011	12,757	5,140	1,986	19,883

Notes:

- (1) Includes provisions against loans and advances to banks.
(2) Excludes impairment losses on securities totalling £1,468 million (2010 - £112 million).

Additional disclosures *continued*

Non-trading book equity risk

Non-trading book equity risk is the potential variation in the Group's non-trading income and reserves arising from changes in equity valuations.

Objective

Equity positions in the non-trading book are held to support strategic objectives and venture capital transactions, or in respect of customer restructuring arrangements.

Risk control framework

The commercial decision to take or hold equity positions in the non-trading book, including customer restructurings, is taken by authorised persons with delegated authority under the Group credit approval framework. Investments or disposals of a strategic nature are referred to the Group Acquisitions and Disposals Committee (ADCo), Group Executive Committee (ExCo), and where appropriate the Board for approval. Those involving the purchase or sale by the Group of subsidiary companies require Board approval, after consideration by ExCo and/or ADCo.

The risk arising from these holdings is mitigated by proper controls and identification of risk prior to investing.

Valuation

At Group level, positions are monitored by and reported quarterly to GALCO.

Equity positions are measured at fair value. Fair value calculations are based on available market prices where possible. In the event that market prices are not available, fair value is based on appropriate valuation techniques or management estimates.

The following table shows the balance sheet value and fair value of the Group's non-trading book equity positions at 31 December 2011.

All quantitative disclosures below exclude the Group's insurance business.

Table 59: Non-trading book equity at balance sheet value

	Balance sheet value 2011 £m	Fair value 2011 £m	Balance sheet value 2010 £m	Fair value 2010 £m
Exchange-traded equity	576	576	535	535
Private equity	674	674	953	953
Other	1,094	1,094	1,128	1,128
	2,344	2,344	2,616	2,616

The exposures may take the form of listed and unlisted equity shares, linked equity fund investments, private equity and venture capital investments, preference shares classified as equity or Federal Home Loan Bank stock. The following table shows the net realised and unrealised gains from these positions:

Table 60: Net realised and unrealised gains from non-trading book equity

	2011 £m	2010 £m
Net realised gains arising from disposals	150	19
Unrealised gains included in Tier 1, 2 or 3 capital	235	132

Note:

(1) Includes gains or losses on available-for-sale instruments only.

Cumulative gains on equity shares designated as at fair value through profit or loss but not held for trading purposes were £230 million at 31 December 2011 (2010 - £216 million).

Additional disclosures *continued*

Interest rate risk

The banking book consists of interest bearing assets, liabilities and derivative instruments used to mitigate risks which are accounted for on an accrual basis, as well as non-interest bearing balance sheet items which are not subject to fair value accounting.

The Group provides financial products to satisfy a variety of customer requirements. Loans and deposits are designed to meet customer objectives with regard to repricing frequency, tenor, index, prepayment, optionality and other features. When aggregated, they form portfolios of assets and liabilities with varying degrees of sensitivity to changes in market rates.

However, mismatches in these sensitivities give rise to net interest income (NII) volatility as interest rates rise and fall. For example, a bank with a floating rate loan portfolio and largely fixed rate deposits will see its NII rise as interest rates rise and fall as rates decline. Due to the long-term nature of many banking book portfolios, varied interest rate repricing characteristics and maturities, it is likely the NII will vary from period to period, even if interest rates remain the same. New business volumes originated in any period will alter the interest rate sensitivity of a bank if the resulting portfolio differs from portfolios originated in prior periods.

The Group assesses interest rate risk in the banking book (IRRBB) using a set of standards to define, measure and report the market risk. These standards incorporate, inter alia, the expected divergence between contractual terms and actual behaviour of commercial and personal fixed rate loan portfolios due to refinancing incentives. The standards also take into account the risk associated with structural hedges of interest rate insensitive current account portfolios, which relates primarily to the stability in the size of the underlying current account portfolios.

It is the Group's policy to minimise interest rate sensitivity in banking book portfolios and where interest rate risk is retained to ensure that appropriate measures and limits are applied. Key measures used to evaluate IRRBB are subjected to approval of divisional ALCOs and GALCO. Limits on IRRBB are proposed by the Group Treasurer for approval by the Executive Risk Forum annually.

The Group uses a variety of approaches to quantify its interest rate risk. IRRBB is measured using a version of the same VaR methodology that is used for the Group's trading portfolios. NII exposures are measured in terms of sensitivity over time to movements in interest rates. Additionally, Citizens measures the sensitivity of the market value of equity to changes in forward interest rates.

VaR metrics are derived from interest rate repricing gap reports based on monthly balance sheet positions. In addition to customer products, this incorporates non-financial assets and liabilities such as property, equipment, capital and reserves. As discussed above, behavioural assumptions are applied as appropriate. The gap report also includes hedging transactions.

The VaR does not provide a dynamic measurement of interest rate risk since static underlying repricing gap positions are assumed. Changes in customer behaviour under varying interest rate scenarios are captured via earnings risk measures.

In relation to earnings, sensitivity to rate movements is derived from a central forecast over a 12 month period. Market implied forward rates and new business volume, mix and pricing consistent with the plan are used to generate a base case earnings forecast. This is shifted up and down by 100 basis points and the earnings impact recalculated. New business assumptions and the behavioural maturity profile of existing business may vary under the different rate scenarios.

With the exception of Citizens and GBM, divisions are required to manage IRRBB through internal transactions with Group Treasury, to the greatest extent possible. Residual risks in divisions must be measured and reported as described below.

Group Treasury aggregates exposures arising from its own external activities and positions transferred to it from divisions. Where appropriate, Group Treasury nets off-setting risk exposures to determine a residual exposure to interest rate movements. Hedging transactions using cash and derivative instruments, primarily interest rate swaps, are executed to manage IRRBB exposures, within the GALCO approved VaR limits.

Citizens and GBM manage their own IRRBB exposures within approved limits to satisfy their business objectives.

Residual risk positions are routinely reported to divisional ALCOs and monthly to the Group Balance Sheet Management Committee, GALCO, the Group Board and the Executive Risk Forum.

Additional disclosures *continued*

Table 61: IRRBB VaR for retail and commercial banking activities at a 99% confidence level

	Average £m	Period end £m	Maximum £m	Minimum £m
31 December 2011	63	51	80	44
31 December 2010	58	96	96	30

Table 62: IRRBB VaR by currency

	2011 £m	2010 £m
Euro	26	33
Sterling	57	79
US dollar	61	121
Other	5	10

Key points

- Interest rate exposure at 31 December 2011 was considerably lower than at 31 December 2010 but average exposure was 9% higher in 2011 than in 2010.
- The reduction in US dollar VaR reflects, in part, changes in holding period assumptions following changes in Non-Core assets.

Sensitivity of net interest income

The Group seeks to mitigate the effect of prospective interest rate movements, which could reduce future net interest income in the Group's businesses, whilst balancing the cost of such activities on the current net revenue stream. Hedging activities also consider the impact on market value sensitivity under stress.

The following table shows the sensitivity of net interest income, over the next twelve months, to an immediate upward or downward change of 100 basis points to all interest rates. In addition, the table includes the impact of a gradual 400 basis point steepening and a gradual 300 basis point flattening of the yield curve at tenors greater than a year. This scenario differs from that applied in the previous year in both the severity of the rate shift and the tenors to which this is applied.

Table 63: Sensitivity of net interest income

Potential favourable/(adverse) impact on net interest income	2011 £m	2010 £m
+ 100 basis points shift in yield curves	244	232
- 100 basis points shift in yield curves	(183)	(352)
Bear steepener	443	
Bull flattener	(146)	

Key points

- The Group's interest rate exposure remains slightly asset sensitive, driven in part by changes to underlying business assumptions as rates rise. The impact of the steepening and flattening scenarios is largely driven by the investment of net free reserves.
- The reported sensitivity will vary over time due to a number of factors such as market conditions and strategic changes to the balance sheet mix and should not therefore be considered predictive of future performance.

Table 64: Sensitivity of net interest income by currency

	GBP £m	USD £m	EUR £m	Other £m	Total £m
+100 basis points shift in yield curves	190	59	(19)	14	244
- 100 basis points shift in yield curves	(188)	(4)	25	(16)	(183)

Appendix 1

Glossary of acronyms

ABCP	Asset-backed commercial paper
ADCo	Acquisitions and Disposals Committee
AFS	Available-for-sale
APR	All price risk
APS	Asset Protection Scheme
AQ	Asset quality
BBSW	Bank Bill Swap Reference Rate (Australia)
BEEL	Best estimate of expected loss
BIPRU	The Prudential Sourcebook for Banks, Building Societies and Investment Firms
CCF	Credit conversion factor
CCR	Counterparty credit risk
CDOR	Canadian Dollar Offered Rate
CDS	Credit default swaps
CEE	Central and Eastern Europe
CQS	Credit quality steps
CRD	Capital Requirements Directive
CRM	Credit risk mitigation
CVA	Credit valuation adjustments
EAD	Exposure at default
EPE	Expected positive exposure
EU	European Union
EURIBOR	Euro Interbank Offered Rate
ExCo	Executive Committee
FSA	Financial Services Authority
GALCO	Group Asset and Liability Management Committee
GCR	Group Credit Risk
GOR	Group Operational Risk
GPF	Group Policy Framework
IAA	Internal assessment approach
IAS	International Accounting Standard
ICAAP	Individual capital adequacy assessment process
IFRS	International Financial Reporting Standard
IMV	Independent model validation
IRB	Internal ratings based approach
IRC	Incremental risk charge
IRRBB	Interest rate risk in the banking book
LGD	Loss given default
LIBOR	London Interbank Offered Rate
ORPS	Operational Risk Policy Standards
OTC	Over-the-counter
PD	Probability of default

Appendix 1 continued

Glossary of acronyms continued

RAR	Risk asset ratio
RNIV	Risks not in VaR
RWAs	Risk-weighted assets
SIC	Standard Industrial Classification
SME	Small and medium-sized enterprises
SPE	Special purpose entity
SRT	Significant risk transfer
SRW	Supervisory risk-weights
STMF	Short-term markets financing
SVaR	Stressed value-at-risk
The Group	The Royal Bank of Scotland Group plc and its subsidiaries
TSA	The standardised approach
VaR	Value-at-risk

Appendix 1 *continued*

Glossary of key terms

- *Advanced measurement approach* - in the most advanced approach to operational risk, the use of internal models is permitted to calculate the operational risk minimum capital requirement.
- *Asset quality (AQ) band* - probability of default banding for all counterparties on a scale of 1 to 10.
- *Bear Steepener* - a widening of the yield curve caused by long-term rates increasing at a faster rate than short-term rates. This causes a larger spread between the two rates as the long-term rate moves further away from the short-term rate.
- *Bull Flattener* - a yield-rate environment in which long-term rates are decreasing at a rate faster than short-term rates. This causes the yield curve to flatten as the short-term and long-term rates start to converge.
- *Contingents* - a potential obligation that becomes an actual obligation upon a defined event occurring e.g. where conditions set out in a guarantee that require the guarantor to make payment are met.
- *Counterparty credit risk (CCR)* - counterparty credit risk is the risk that a counterparty defaults prior to the maturity of a derivative contract. The risk may result from derivative transactions in either the trading or banking book and is subject to credit limit setting like other credit exposures.
- *Credit grade* - the rating that is linked to the probability of default of a customer. Credit grades represent points of a grading scale.
- *Credit risk* - the risk that the Group will incur losses owing to the failure of customers to meet their financial obligations to the Group.
- *Credit risk mitigation (CRM)* - techniques such as the taking of collateral or obtaining a guarantee or other form of credit protection from a related or third party that reduce the credit risk associated with an exposure.
- *Equity risk* - the risk of changes in the market price of the equities or equity instruments arising from positions, either long or short, in equities or equity-based financial instruments.
- *Expected loss (EL)* - the product of PD, LGD and EAD.
- *Exposure at default (EAD)* - an estimate of the expected level of utilisation of a credit facility at the time of a borrower's default. The EAD may be higher than the current utilisation (e.g. in the case where further drawings may be made under a revolving credit facility prior to default) but will not typically exceed the total facility limit.
- *E** - the comprehensive (own estimates) approach used to measure adjusted exposure for cases where financial collateral is used for qualifying exposures.
- *Guarantees* - an agreement by a third party to cover the potential loss to a credit institution should a specified counterparty default on their commitments.
- *Interest rate risk (IRR)* - interest rate risk is the exposure of a bank's financial condition to adverse movements in interest rates. Accepting this risk is a normal part of banking and can be an important source of profitability and shareholder value.
- *Internal ratings based approach (IRB)* - approach to credit risk under which a bank may use internal estimates to generate risk components for use in their credit risk regulatory capital requirements. There are two approaches: foundation and advanced (including retail).
- *Latent loss provision* - loan impairment provisions held against impairments in the performing loan portfolio that have been incurred as a result of events occurring before the balance sheet date but which have not been identified as impaired at the balance sheet date. The Group has developed methodologies to estimate latent loss provisions that reflect historical loss experience (adjusted for current economic and credit conditions) and the period between an impairment occurring and a loan being identified and reported as impaired.
- *Loss given default (LGD)* - the economic loss that may occur in the event of default i.e. the actual loss - that part of the exposure that is not expected to be recovered - plus any costs of recovery.

Appendix 1 *continued*

Glossary of key terms *continued*

- *Market risk* - the risk that the value of an asset or liability may change as a result of a change in market factors such as foreign exchange rates and commodity prices, interest rates, credit spreads and equity prices.
- *Mark-to-market* - the daily adjustment of an account to reflect profits and losses.
- *Maturity* - the remaining time in years that a borrower is permitted to take to fully discharge their contractual obligation (principal, interest and fees) under the terms of a loan agreement.
- *Minimum capital requirement* - the minimum amount of regulatory capital that a financial institution must hold to meet the Pillar 1 requirements for credit, market and operational risk.
- *Model validation* - the process of assessing how well a credit risk model performs using a predefined set of criteria including the discriminatory power of the model, the appropriateness of the inputs and expert opinion.
- *Netting* - the ability of a bank to reduce its credit risk exposures, by offsetting the value of any deposits against loans to the same counterparty.
- *On-balance sheet* - items that appear on the bank's balance sheet e.g. loans which have actually been made.
- *Operational risk* - the risk of loss resulting from inadequate or failed processes, people, systems or from external events.
- *Pillar 1* - minimum capital requirements - the part of the Basel Accord, which sets out the calculations of regulatory capital requirements for credit, market and operational risk.
- *Pillar 2* - the supervisory review process - the part of the Basel Accord which sets out the process by which a bank should review its overall capital adequacy and the processes under which the supervisors evaluate how well financial institutions are assessing their risks and take appropriate actions in response to the assessments.
- *Pillar 3* - market discipline - the part of the Basel Accord, which sets out the disclosure requirements for banks to publish certain details of their risks, capital and risk management, with the aim of strengthening market discipline.
- *Probability of default (PD)* - the likelihood that a customer will fail to make full and timely repayment of credit obligations over a one year time horizon.
- *Project finance supervisory slotting approach* - project finance is a method of funding in which the lender looks primarily to the revenues generated by a single project, both as the source of repayment and as security for the exposure. The FSA has introduced the supervisory slotting approach to recognise this fact and requires banks to slot these exposures and derive a risk-weight based on the credit characteristics of the contract.
- *Provision* - a liability where the company is uncertain as to the amount or timing of the expected future costs.
- *Qualifying revolving retail exposure* - facilities to retail customers that provide a revolving facility i.e. credit cards.
- *Repo* - repurchase agreements are agreements whereby one party to the transaction agrees to sell securities to the other and at the same time agrees to repurchase the securities at a future date for a specified price. The repurchase price will be fixed at the outset, usually being the original sale price plus an amount representing interest for the period from the sale to the repurchase.
- *Risk-weighted assets (RWAs)* - assets adjusted for their associated risks using weightings established in accordance with the Basel Capital Accord as implemented by the FSA. Certain assets are not weighted but deducted from capital.
- *Securitisation* - a process by which assets or cash flows are transformed into transferable securities. The underlying assets or cash flows are transferred by the originator or an intermediary, typically an investment bank, to a special purpose entity which issues securities to investors. Asset securitisations involve issuing debt securities (asset-backed securities) that are backed by the cash flows of income-generating assets (ranging from credit card receivables to residential mortgage loans). Liability securitisations typically involve issuing bonds that assume the risk of a potential insurance liability (ranging from a catastrophic natural event to an unexpected claims level on a certain product type).

Appendix 1 *continued*

Glossary of key terms *continued*

- *Special purpose entity (SPE)* - an entity created by a sponsor, typically a major bank, finance company, investment bank or insurance company. An SPE can take the form of a corporation, trust, partnership, or a limited liability company. Its operations are typically limited for example in a securitisation to the acquisition and financing of specific assets or liabilities.
- *Standard industrial classification (SIC)* - a classification of businesses by type of economic activity.
- *Standardised approach* - the standard method used to calculate credit risk capital requirements under Pillar 1 of Basel II. In this approach the risk-weights used in the capital calculation are determined by regulators.
- *Stress testing* - term describing various techniques used to gauge the potential vulnerability to exceptional but plausible events.
- *The standardised approach (TSA)* - the standardised approach to operational risk, calculated using three year historical gross income multiplied by a factor of between 12-18%, depending on the underlying business being considered.
- *Trading book* - a trading book consists of positions in financial instruments and commodities held either with intent to trade, or in order to hedge other elements of the trading book. To be eligible for trading book capital treatment, financial instruments must either be free of any restrictive covenants on their tradability, or able to be hedged completely.
- *Value-at-risk (VaR)* - is a technique that produces estimates of the potential change in the market value of a portfolio over a specified time horizon at given confidence levels.
- *Undrawn commitments* - assets/liabilities that have been committed but not yet transacted. In terms of credit risk, these are obligations to make loans or other payments in the future.
- *Wrong-way risks (WWR)* - the risk of loss when the risk factors driving the exposure to a counterparty or customer are positively correlated with the creditworthiness of that counterparty i.e. the size of the exposure increases at the same time as the risk of the counterparty or customer being unable to meet that obligation, increases.