Annual Results 2016 CFO Round Table
Hosts: Ewen Stevenson, Katie Murray
28th February 2017

FORWARD-LOOKING STATEMENTS

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Session 1

Introduction

Ewen Stevenson, Chief Financial Officer
Well maybe I can kick off and talk for a couple of minutes and then I'm happy to go into Q&A. Michael and Sarah are from our IR team, Katie Murray is my number two in finance.

Look, I mean obviously a large headline loss on Friday; you know we would like to think that that large headline loss was actually a sign of very good progress. You know the fact that there were £10bn of one-offs in the results means that we did make significant progress from an accounting perspective in getting through legacy issues. Williams & Glyn, you know the proposal that we put in front of the European Commission we think is a very good proposal, a good proposal for competition in the SME marketplace, good outcome for Williams & Glyn, a good outcome for us relative to other alternatives.

On Capital Resolution, we're about a year away from being able to wind that up. So our intention is at the end of this year we will carve it up into various pieces, some will go into NatWest Markets, we'll probably report it separately I would think. A small piece will go into Commercial and we are looking at whether we put some other pieces into a vehicle that sort of sits away from NatWest Markets outside of the fence.

I would say the only part of that that may have sort of timetable issues around it really is the stake in what's now called Alawwal Bank in Saudi Arabia. My only hesitation really is I'm the fourth CFO who has been tasked with getting out of that stake. So it would be a big statement to say that I would confident that I would be the one to solve it, but we're certainly working towards that objective.

On the conduct side, you know when you go through the various issues - on PPI you may have now seen that we took an additional £200m odd in additional provisions. The thinking behind that was really the continued delay in the FCA coming out with guidance and our approach has always been - you know to be conservatively provided and to try and do end of life provisioning.

Having said that it was the final provision twice last year I was sort of reluctant to repeat it at full year results. But you know we've basically provided on the basis the claims period can run to the end of 2019 and we're running at about £100m of claims costs a quarter. So if that assumption proves to be wrong you can plus or minus from that date. But when we've looked at the other banks last week I guess we noted that we seemed to be alone in taking that position.

On the shareholder rights issues, we've obviously settled with four of the five claimants. There's one claimant, representing 22% of the original claim still outstanding. And to the extent, you know we've effectively provided in line with the settlement that we've made to the other claimants.

On RMBS we've obviously increased reserves there materially in January by another £3bn. On the litigation side apart from the FHFA you know it's down now to a small number of billion pounds of original principal balance litigation. So FHFA on the litigation side is by far and away the biggest single piece remaining. And DoJ discussions obviously continue.

There has obviously been some leadership changes at the DoJ, post the change of administration, you know that I think most plausibly that just delays things by a few months as the new DoJ leadership team beds down. But our assumption, I know we've made this assumption before, is that we will find a way to find resolution on that during this year.

On FX, really it still sits out there, nothing really new to report on FX and on GRG we provided £400m in Q4 last year, we still think that's a reasonable provision. So I would say really apart from RMBS and maybe a little bit of FX and a couple of other things there's not much to go now on conduct that we haven't financially provided for, that we haven't really seen. Although if you read in our Annual Report you'll still get 16 pages of various outstanding actions against us.

So on legacy I think you know if we were sitting here in a year's time most of those issues are then resolved. On the core bank again we're definitely more confident that we're developing a business model that can drive income growth faster than market growth rates. If you look at what's gone on in our mortgage franchise for umpteen years we've been growing faster than market and yet we constantly get challenged as to whether we can sustain the growth rate.

To me the biggest competitive threat is probably a change in the market dynamics where one or more of the larger mortgage writers who are currently choosing to protect back book profitability change their stance on that. But if they don't, we think it's highly credible that we should be able to grow mortgages faster than market growth rates. And it's not just mortgages, if you look underneath the results you see that we grew Business Banking by 6% following a new change of leadership in Business Banking about a year ago. The Reward Accounts helped drive a significant increase in current account balances as well.

Commercial, I think we are going through a bit of a transition, returns, particularly at the larger end are a bit challenged at the moment. I think while this interest rate environment persists it's hard to see parts of the larger end of Commercial earning above cost of capital returns. So our competitive response to that I think is to either reprice or withdraw capital from parts of Commercial, which is part of what sits behind that £20bn reduction in RWAs.

Private Banking is beginning to turn the corner now, the new CEO is doing a good job, we're quite confident that that business is on a path that we've consistently talked about to being above cost of capital returns.

Ireland is struggling a bit; I think will struggle for many years frankly. You've got 55% of the book is either a tracker mortgage book, or a NPL book, that's down from 62% a year ago, so it's coming down but as we said as part of the Investor Seminar in December that part of the book is very low ROE. If we were to sell it we would crystallise a very large mark to market loss. So it's just a pull that - most of it is performing so it's better to hold it and run it down.

But you've also got very low interest rates in a Eurozone economy which is impacting deposit spread, so you also see hedge income coming down a lot and at some point impairment write backs will come to an end. So its results at the moment are getting flattered by impairment write backs. But if you look at the sort of core business you know asset spreads there are better than the UK. So you've got a relatively small market, where we're the only large UK bank who are operating as an effective competitor in that market and costs are beginning to come down in the core bank.

So the 45% of it that really is a good core bank is actually going quite well, it's just the financial results get slightly overwhelmed by the 55% legacy.

RBSI in the Channel Islands doing well, it's got great franchise positions, again struggling a bit in this interest rate environment because it's a very deposit rich franchise. But the core fundamentals of that business are good and we think should be able to drive consistent returns comfortably above cost of capital.

And NatWest Markets as we said at the results, know the income now is comfortably ahead of the £1.3bn to £1.4bn range. But I worked in investment banking for 25 years, so I don't think we're going to plan on the basis of sustained customer activity at these sorts of levels and nor do we need to get back to cost of capital returns. It's mainly a cost take-out story, with part of our confidence in that cost take-out story is because we can see that we're heavily expensing investment spend fully through the P&L at the moment. And once that investment programme stops that just drops out.

And then in terms of the targets, look a couple of things, I mean firstly we think of them as floors, you think of them as targets, i.e. we've said 12 plus percent return on equity and sub 50% cost income ratio. I think you're all sceptical about our ability to deliver that. I guess we're a lot less sceptical than you are, hence the comments on floors versus targets.

You know every year we get progressively better at out cost planning. We've been at it for three years now and we've taken out £3.1bn of costs. I think we've done a better job on cost probably than almost any other bank in Europe. And so you take away from that that we have very, very good cost takeout skills in this organisation.

We don't put out targets lightly to the market; I think every year we've exceeded the targets that we've put out in the last three years. We're trying to take out a further £2bn plus of cost over four years of which we're pretty confident we'll take £750m out this year. So at that point we're really debating you know one and a quarter billion over three years, which doesn't really phase us, particularly knowing what we can still do in some of the franchises.

On the income side I think that's probably the difference of view is mainly around volumes. As I said we're more confident in our ability to consistently grow volumes and I think many of you want to normalise that volume to a very low growth rate in the outer years. I guess we just fundamentally don't agree that that normalisation would be that sharp and that sudden.

Impairments, I don't think you know - I mean who knows in four years' time, as I said the other day 30 to 40 basis points you know we're nowhere near those levels at the moment if you back out the Ulster Bank write-offs we're probably at about 10 basis points. So you know as and when and how long that takes to normalise who knows. Certainly there's nothing in 2017 year to date that would suggest that that normalisation is happening any time soon. And we're not exposed to things like we're not big in unsecured consumer.

But once you get out to 2018 with IRFS9, forecasting impairments will become a bit more challenging. So I think we intend to update the market on quantitative impacts, certainly day one impacts at the end of Q2. We'd like to go a bit further than that if we could in terms of variation and sensitivities around impairment trends. But we'll see how far we get.

But again, you know if you look at our book we're not big in highly cyclical credit sectors relative to others, so my assumption is that IFRS 9 should be less of an impact for us relative to come UK peers.

And on capital you know that £20bn of RWA reduction that we announced with 2.5% reduction on income I think is a big deal and yes there will be some RWA inflation and that RWA inflation is built in to our denominator in terms of the return targets in 2020. So that £20bn I think was not widely reflected in consensus numbers. So we think you know income up, costs down, impairments we can debate and less capital to drive that.

So maybe I can stop there and take questions.

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Questions and Answers

Question
Can I ask on costs because at the risk of - I mean you have done an amazing job collectively because it's - you know it's not just in the last three years it's been a long time before that. But for the next four - £2bn is obviously the net number and you're investing a lot, you know everybody is investing a lot, and in the past you've talked about on volume, particularly in mortgages you need more people - maybe that's changed now I don't know. But what's the gross cost takeout number?

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Ewen Stevenson, Chief Financial Officer

Well I mean if you just assume some type of inflation. I mean if you look at this year for example, we're putting through about a 2.5% wage increase through the sort of Retail and Commercial Banking network. We've got a bit more cost inflation in places like India where we have one of our sort of offshore costs. But - so 2, 3% inflation going through those numbers over four years so whatever that grosses up to, 10, 15, on the existing cost base less the reduction. So maybe it's £3bn gross.

Question
So nothing other than inflation?

Katie Murray, Director of Finance
No, there's not. I mean the thing that you'd keep coming back to is the view that by the time we get to those numbers we'll stop doing all of the adjusting items as well. So all the restructuring type costs will be dealt with, so they should be dealt with in the early part of the years. So I think it's very much to get to that run rate by the end in 2020, but no inflation is your main - I mean there's a wee bit of an FX story, but you can call that as well as I. I mean if we look at the shape of the expenses there is a significant portion that is non-sterling, so that take a bit of a hit in there - in those numbers. With sterling weakness I would kind of make assumptions on that.

Ewen Stevenson, Chief Financial Officer
I guess we tried to break it down the other day, I mean we've got very high confidence that we'll get out the cap res cost structure, we've done enormous amounts of work on NatWest markets, and had pretty high degrees of confidence about getting that cost structure from £1.3bn to £800m.

You then get back into the core bank and I guess what you won't easily see is an enormous amount of just legacy cost complexity in almost everything we do. You know if we - if you just take the Finance team that I run, three years ago it was about 4,000 people and now it's down to 2,700 and we've got a plan to take that down by 50%. But even 50% smaller is still larger than Commonwealth Bank and Westpac today have as their finance teams. So we're not even trying to be world class, actually a lot of the stuff we're doing we're just catching up with people who are already there.

When we look at our like for like cost structures to UK peers, 50% sounds ambitious from where we start from but it's not a particularly ambitious total. You know all of our processes, as I said the other day about £3bn of the existing £6bn - £1.5bn relates to ten things customers do - like opening up an account and that just - you know the end to end complexity. We have 2,000 people in the bank doing KYC, involved in customer on-boarding. Now at some point you should be able to digitise most of that process and have very, very few people checking exceptions.

You know the amount of - and I think you hear the same message from the other banks too, there is a genuine sort of tipping point it feels like going on in terms of customer adoption of digital. So we think 95% of our commercial customers in a couple of years' time will be doing everything digitally. Branch visits have gone down 40% in the last three years. And even in the Wholesale bank, bond trading now is rapidly shifting electronically.

So wherever we look there's an enormous opportunity to strip our cost of distribution and the costs associated with providing that distribution. And then you get into things like - we were discussing this morning - white collar automation and what's the going to do to credit offices, finance people, you know your HR …

Question

So are you assuming that you keep that gain - i.e. the revenue margin stays the same in that? You know you gave lots of different examples there and if all the industry is maybe not moving at the same pace …

Ewen Stevenson, Chief Financial Officer
No, I think in Wholesale there's definitely a rate volume assumption in there. I think in Retail we are assuming we can keep much of the margin. In Commercial, as the number one commercial bank in the country if we cannot earn returns in the early teens then it's going to be a pretty tough sector for people to do business in. So again we're not that ambitious in terms of our return assumptions on this.

Question
On your Common Equity Tier 1 target, which I guess links into the return target to some extent as well, it's been 13% for quite a while now, it sounds like it's going to be 13% for quite a while longer and that's despite having thrown quite a lot of the numerator - the pension contribution, IFRS 9, the denominator, you're factoring Basel, PRA RWA, inflation to some extent, Pillar 2A has come down because of the contribution as well, so why are you holding it at 13%? I mean do you think that is just going to be the right number regardless of what comes on the top of …

Ewen Stevenson, Chief Financial Officer
No, you can imagine RWA inflationary scenarios at some point where you could reduce it, but it would be a big call today I think to confidently go out and say - 13 becomes 12. But it doesn't feel like it would be any better than 12 at any point in the foreseeable future. I think modelling 13 we feel comfortable with.

So far we went out early with 13 and we feel every other bank around us, after telling us we were wrong, have all sort of slowly slid up to where we were. So we see no reason at the moment.

I think until we really understand IFRS 9 and the implications of that at the moment we think for us it's probably more of an income volatility point. But until we really understand the stress testing implications of it and how far you get pushed down again we're going to be cautious I think.

Question
On IFRS 9 if I can just follow up, in the accounts you talk about the definition of a significant deterioration in the context of PDs I think it said anything more of a doubling of PD would be deemed significant. You're obviously going to give us more info on this in a few months, but right now can we look at the Pillar 3 and the buckets and see where PDs exceed what might be a starting state PD, twice that level and we've obviously got all the LGGs and PDs in those buckets and do a calculation on that basis? Would that get us kind of close to the answer?

Katie Murray, Director of Finance
So I guess we haven't given you an answer yet because we're not completely confident in terms of what the answer would be as we kind of pull through. And also as the book changes the behaviour of the numbers also change. But I think that would give you something that would give you the guidance as to what it might be. It's certainly the best that's available at the moment.

Question
Just in the terms of weird things, the equity issuance to neutralise pressures when does that stop?

Ewen Stevenson, Chief Financial Officer
When we pay dividends. Yeah. But just assume that we're going to continue to issue £300m of equity per annum, until such point as we have PRA approval to pay dividends - there's part immunisation on capital securities that are higher than that.

Question
Just really on pushing out the target by a year, I guess we always thought - or we were thinking to get to 12% in 2019 that you'd have £13bn of revenues and £6.5bn costs and now the cost target is £6.4bn, so about the same. Is there any material difference of the timing on the costs, is it much more about revenues …

Ewen Stevenson, Chief Financial Officer
I don't think you can correctly say that 6.4 is the same as 6.5, a couple of things, firstly we're assuming within that that residual bit of Williams & Glyn gets absorbed and we are saying that it's a sort of unadjusted bottom line cost number, if I could describe it as that. You know Lloyds last week talked about regular run rate conduct costs. I think we wouldn't disagree with them, that it's probably prudent to forecast on the basis of some ongoing costs. Some of what we call restructuring costs frankly we are going to restructure every time we take out a branch we call it a restructuring cost, but we will continue to take out branches. So I would say it's a high quality 6.4 than …

Question
Than the old 6.5.

Ewen Stevenson, Chief Financial Officer
It's a higher quality 6.4 than the old 6.5.

Question
You talk that the market is a bit pessimistic I guess on the volume growth, but I guess relative to what I was expecting the volume growth for some of the core franchises is less this year than what we might have thought. And generally speaking now you've got Williams & Glyn income which you didn't think you'd have …

Ewen Stevenson, Chief Financial Officer
Yes, so I don't think Williams & Glyn really is in there because remember it's not within our definition of PBB and CPB.

Question

But I'm just thinking in your long term to get to £13bn is surely far easier now Williams & Glyn, even if you assume a high attrition rate, so we don't have Williams & Glyn, you're telling us that growth is better, growth probably in 2016 was better than you thought it may have been …

Ewen Stevenson, Chief Financial Officer
Yeah and we told you we were going to lose £250m to £300m of income on the RWA reduction so we have to recoup that back. So I think 3% net lending growth when we told you we were going to shrink some books is much faster than the market.

Question
I just wonder what's worse now than it was when you set the - I know interest rates perhaps, but what's the magnitude of rate increase that you'd assumed in your original target them to get to 13, that's not compensated by the volumes and the Williams & Glyn?

Ewen Stevenson, Chief Financial Officer
Well look at where 2020 interest rates were pre Brexit versus today.

Question
So is that an order of magnitude of a billion say?

Ewen Stevenson, Chief Financial Officer
Yeah, probably. It's not an insignificant number.

Question
Why do you say Ulster struggles, because I mean - front book pricing is way higher than …

Ewen Stevenson, Chief Financial Officer
Well any bank that has 55% of its book either in an incredibly low ROE tracker book or 15% of the portfolio is NPLs is always going to be a struggle.

Question
But is the tracker not running off as fast as you'd like for example?

Ewen Stevenson, Chief Financial Officer
No, it will run off, I mean it reduced by - I think the RWA density reduced by about 30% in terms of capital usage last year. But you know it's earning a very low single digit return on equity on that part of the book. People have got no incentive to pay back their tracker books - tracker mortgages early unless they go through some lifestyle event, they want to move home, they get divorced, they die, otherwise they're just going to keep these things running to maturity.

When they were originated they were 30 year loans, so I mean you see that phenomena existing in other parts of Europe too, these long dated lending books that were priced at the wrong margin are just going to exist for a long period of time, unless you want to crystallise a very large mark to market loss, which we think is a poor use of capital currently.

But there is nothing we can do about it because it just is what we've inherited.

Question
I guess if you look at some of the Irish peers they still have these back books …?

Ewen Stevenson, Chief Financial Officer
Well their back book problems aren't as big as our problems. I mean we very successfully introduced the 100% LTV mortgage into Ireland in 2003 and took an enormous amount of market share on the back of that, you know we had a loan book at some point it was £50bn, so we've also got an infrastructure that was just built for a very different volume of business that we're trying to manage down too.

Question
Can you talk about costs in the markets business; I mean you keep referring to the investments that you're expensing. I mean if it's going to take you from £1.3bn to £800m that's a pretty sizable chunk of investment that's going in, particularly if you're doing it over kind of three years or so. So what exactly is that cost paying for.

Ewen Stevenson, Chief Financial Officer
There's probably £100m of remediation costs that we know will go out, there's probably £200m of investment spend that we know that will go out and we think that investment spend will enable us to take out £200m of our run rate cost.

Question
Why can't you capitalise that? What is it?

Ewen Stevenson, Chief Financial Officer
Well because you can't capitalise if you've got a business that's not earning a sufficient return to capitalise it. So at some point as the business recovers we will be able to capitalise on investment spend.

Question
Did you say last week that it would be a step down rather than an incline?

Katie Murray, Director of Finance

Yeah it will come down in chunks certainly as investment stops and remediation stops you'll see some quite chunky falls down through in that period.

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Question
Can I ask a question about NatWest Markets where you're clearly running a little bit ahead in terms of revenue? I find it quite difficult to sort of track how you're faring competitively against your peers and I was wondering whether you could just comment on market share as you would see it in the areas where you sort of wish to remain competitive?

And the second question I've got is that I seem to remember you had an 8% ROE target in NatWest Markets. Is that still the target you've got for that division?

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Ewen Stevenson, Chief Financial Officer
No I mean I think we'd like to get to cost of capital plus which we would describe as 10% plus returns. It's quite hard to unpick competitive data and we think in most areas that we're competing we're marginally growing share at the moment. Certainly sterling rates, euro rates, sterling FX we think we're building share. Competitively, it's definitely part of the business that benefits most from Brexit because you've got 40% of the income non-sterling and 20% of the costs so you get an automatic FX benefit and you've got more volatility around UK interest rates and currency. And in some ways the harder Brexit is, the better it will be for a domestic UK bank as it will make it harder for foreign banks to compete. So yeah it's probably that part of our business and obviously the equity value of Ulster Bank has gone up but where Brexit hurts us is UK because you've got a slower growth outlook, a weaker interest rate environment and probably a portion of its cost base which is sort of imported from previously very low cost jurisdictions that have become a bit higher cost.

But we're not trying to rebuild a big markets franchise. I think we're quite comfortable with the size and shape it is currently so.

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Question
So you don't want to be top five bulge bracket then?

Laughter

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Ewen Stevenson, Chief Financial Officer
Not an aspiration of ours, we're quite happy not being a G-SIB.

When I mentioned the term the other day, Ross didn't even know what bulge bracket was.

Laughter

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Question
On UK mortgage market any comment around the income, are you being competitive here? I mean I suppose Lloyds seem to be talking about slightly repositioning some of their offerings. How big an impact do you think that could be and also the consultations in terms of making some of the challenger banks more competitive? What are your thoughts?

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Ewen Stevenson, Chief Financial Officer
Look the challenger banks have more than just capital reasons why they're not competitive at the moment. They have higher funding costs and from a scale perspective like Williams & Glyn is about a tenth of the size of our UK business so they're not scaled competitors at the moment. And capital just makes that - the advanced versus standardised modelling is just a further complication. In fact they were very competitive in parts of the space that we didn't want to compete in. And Lloyds, you've got a 25% market share player who's happy to write 16% or 17% flow share at the moment so that definitely helps us. So if they were to decide tomorrow to write 25% flow share that would definitely have an impact probably on our market share in mortgages.

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Question
Would you have an ability to change your cost of funding to maybe match more competitively in that environment or is that something that…?

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Ewen Stevenson, Chief Financial Officer
Yeah I mean we're, just structurally because we never bought a building society we've got far more of our funding as current account or on demand deposit funding. So our bigger competitive issue is the interest rate environment, not - I mean we've re-priced most of our deposits in Q4 to pretty de minimis levels so unless you're in a sort of special savings account you're typically at a sort of zero to ten basis points of deposit rates and you'd be lucky to be at the higher end of that. So the biggest influence on our deposit spread is really where interest rates are, not our ability to re-price back book term deposits.

And I think the other thing for us is we do have some very expensive legacy wholesale and capital securities costs that we're still unravelling. We don't have the issue that some others have called out too that MREL issuance is going to push up wholesale funding costs because it's going to get largely mitigated by the roll off of expensive back book wholesale and capital securities costs.

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Question
Can I ask on the prefs actually there's still a £260m charge I think in the 2016 accounts for prefs below the line? Where do you see that getting to by the time of your 2020 target?

Will it pretty much go and we'll just have the AT1 left?

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Ewen Stevenson, Chief Financial Officer
At some point we will yeah. I don't know whether we're - so I'm not entirely - completely clear what's in the pref line but we'll figure it out Jonathan. But overall by the time we get to the outer years we should have 200 basis points of AT1 and whatever the funding cost is on that. And hopefully by the time we get out to 2020 it's cheaper than what we're paying today. Because the other thing that if you look at our funding spreads because we're sub investment grade with Moody's and I think realistically Moody's is unlikely to upgrade us until they can see clear, tangible evidence of profitability funding spreads are substantially higher than we think they should be over the medium-term. Because we sort of look at the business model that we're building, particularly the business model inside the fence and think that should be a weak to single A credit.

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Question

Is there anything you can do about your IFRS volatility charge as well because that's aggregated up to about £1bn now over the last few years and I think it goes through capital am I right in saying because cash flow hedge treatment, so it's 40 basis points of …?

Katie Murray, Director of Finance
So if we look probably back to your IFRS 9 question a little bit that as you look at IFRS 9 there's two aspects of it, there's your credit piece which we talked about earlier and then there's also this fair value piece. So as we see IFRS 9 coming in what you will see is a lot of that volatility will disappear as we will convert it, it will just all be treated as fair value and so therefore we will no longer have the mismatch that we have coming through on our volatility side. So it's something you will see it won't disappear entirely because obviously volatility is part of what we do but you will see far less fluctuation in it by the time we get to 2018.

Question
And it's hedging local authority lending so.

Katie Murray, Director of Finance
It's the impact of the mismatch between how we recognise them at discounted value and then amortise value in …

Question
So to the extent it's depressing the equity Tier 1 ratio by about I don't know 40 basis points at the moment, will you get that back on the move to IFRS 9?

Ewen Stevenson, Chief Financial Officer
Yes. Probably not as much as 40 basis points but yes we'll get that back under IFRS 9.

Question
Is that partly why you think you'll be in a better position on IFRS 9 than some of the other banks? Because I think Lloyds and Barclays have got rid of volatility.

Katie Murray, Director of Finance
So they certainly did some of that on it but I think also the IFRS 9 you've also got to look at what books under IFR 9 are likely to be more volatile. Credit cards would be the obvious one to pick up on. We don't have a big credit card book, or as big as the other…

Ewen Stevenson, Chief Financial Officer
Emerging market books presumably are more volatile than developed market books.

Katie Murray, Director of Finance
Exactly. So we will see IFRS vol coming in quite significantly as we move forward.

Question
Okay thank you.

Question
On the ring-fenced and non-ring-fenced I think a while ago you set out the capital vision if you like of I think for the non-ring-fenced bank you said, the bit that's got the markets in you said about was it 14 or 15 core tier 1, is that still the case?

Ewen Stevenson, Chief Financial Officer
Well we're probably at 13.5, 14 today. We're still working it through because part of it depends on where we allocate pension risk.

Question
From the Pillar 2A point?

Katie Murray, Director of Finance
And ultimately there'll be a little bit of noise around you mentioned at the beginning the other entity which is interestingly called AA Holding and what ultimately things we pop into that entity which might make more sense because they're longer term run-off type vehicles which would impact it a little bit but it's in that range.

Question
Is there any reason to think that the big pension in Pillar 2A wouldn't just go into the ring-fenced bank?

Ewen Stevenson, Chief Financial Officer
Yeah it ultimately will it's just a question of the journey there and matching up capital buffers with that journey.

Question
You alluded to the risk of structural reform in the accounts, I presume that's to do with the covenants weakening as you look to segregate or split the scheme?

Ewen Stevenson, Chief Financial Officer
Yeah and look structural reform throws up all kinds of sort of interesting discussion points internally so I mean you've got tracked liquidity in different places, you've got tracked capital in different places,

you've got inconsistency between ICB, Brexit, European Intermediate Holding Company needing to plan on the basis that Scotland may choose to separate at some point and we're not quite sure whether it's going to go to Europe or somewhere else.

Question
But specifically in terms of the pension fund?

Ewen Stevenson, Chief Financial Officer
Yeah well on the pension fund ultimately I think ring-fencing ultimately will trigger the need for us to have a discussion with the trustee because at some point RBS Plc we're going to have to move the pension obligations into NatWest Holdings or NatWest which is obviously a different covenant to the covenant that they have today.

Question
Can I ask about your mortgage offering? And I guess we've had quite a lot of changes to the regulation around affordability and again for buy to let, so could you maybe comment on what you're seeing in terms of behaviour changes? I mean are you seeing more customers term out to five years, are you seeing individuals come want to go through limited companies and are you accommodating those?

Ewen Stevenson, Chief Financial Officer
It's a great question but I'm not sure I've got the answers for you. I think I'd do a disservice if I tried to answer that.

Question
On the ring fence [inaudible] non-ring fenced need to have 15% CT1 ratio [inaudible]

Ewen Stevenson, Chief Financial Officer
Yeah look I think we're confident we can probably run NatWest Markets at a lower level of capital than that and still get to the right rating. And remember effectively we're not asking for a rating until it's formed which is 1 January 2019. So we'll have improved the operating performance materially over the next two years by the time you get to a point of it needing to be rated.

Question
You touched on it a few moments ago, Scottish separation risk. What is on your core contingency planning list?

Ewen Stevenson, Chief Financial Officer
Well look I mean we're obviously incorporated in Scotland so we'd have to move the incorporation to England which is just requires an Act of Parliament, a private members bill. So that's not a huge issue. But it's simple stuff like what is called Williams & Glyn today, what largely is Williams & Glyn is

Royal Bank of Scotland branches in England and Wales. If Scotland was to go onto a new currency then the Royal Bank of Scotland system is not a dual currency system so we'd need to figure out how to get them off that system onto NatWest which is solvable.

You've got more prosaic issues like they don't have a banking regulator, they don't have a payments system, and some very practical issues with Scotland separating and choosing to go to its own currency.

As part of ring-fencing we're moving the Scottish retail and commercial customers out of RBS Plc which is going to become the non-ring-fenced bank for NatWest Markets because that's where all the derivative counterparties are today and we're taking those customers and we're putting them into a small Scottish bank we own today called Adam & Co which is a private bank up in Scotland. So unlike last time we'll have all the customers at least in a sort of ring-fenced Scottish bank but there's still about 40% of the systems, particularly the bank and middle office systems like accounting and finance, that are shared across the two organisations.

So I mean relative to two and a half years ago when, had the vote been to leave, they were leaving into the unknown really from a banking system point of view we're much better prepared and have thought through most of the issues. We are - in context we're the biggest I think private sector employer in Scotland so we have pretty regular conversations with them. You know Scotland is important for RBS. We will always have a big presence in Scotland with a lot of our employees up there but this notion that parts of Europe can disaggregate from countries that they were in is not straightforward when you apply it to banking systems because none of these regions within countries have regulators, payment systems, central banks, anything you need to run a banking system.

. . . .

Katie Murray, Director of Finance
Just on your prefs question - the line is a mixture of prefs and AT1s as it comes out there and it's been booked - we've obviously done some pref redemption but as we move forward it is a mixture of both of them.

. . . .

Ewen Stevenson, Chief Financial Officer
So where do you all think that we could do a better job at explaining the story to you? Throwing the question out to all of you given your scepticism. Or what is it that you're hearing from the buy side versus your own positions?

. . . .

Question
I guess part of the challenge is the cost database, a lot of the cost take out has come with huge a revenue cost base - a 100% cost income ratio effectively and then we've seen an improved position whereas from here you have to achieve a very different kind of cost takeout with very significant Jaws and it's just the magnitude of the Jaws. I think that's what people struggle with.

. . . .

Ewen Stevenson, Chief Financial Officer
A lot of that, because it's a popular debate that we have internally too, that the front office to the back and the middle office cost cutting has happened just because we've shut stuff. Just because you shut a branch doesn't mean that you take out any back or middle office cost.

. . . .

Question

I get that.

Ewen Stevenson, Chief Financial Officer
There's been an enormous amount of cost takeout going on in the organisation that's got nothing to do with exiting businesses.

Question
In terms of the programme of cost takeout, for me in terms of the process efficiency it is plain and simple enough I think it relates to ten processes but maybe we need to see a bit more granular information about some examples within that - those ten processes to see where the costs are actually coming out in terms of the believability of the Jaws. I think that's what people struggle with, that's what I struggle with. It's a different nature in terms of the cost takeout from here than it has been historically.

We still have to believe you can do it on the same budget of roughly £1 for £1 of cost takeout which is much better than the rest. I know there's a scale difference but for instance Clydesdale is going through a very similar process of efficiency driven cost takeout programme and they're spending £2 per £1. I'm not saying that you need £2 per £1 but just staying the same as you have been historically and it's just sort of a step change I guess how I would see the nature of your cost programme. I'm not saying it hasn't been going well already but it's quite a different and to deal with that revenue consequence is quite challenging I guess. So that is where I struggle with it and maybe that's something you can supply us is more visibility on those processes you hope to re-engineer, what they look like now and what they're going to look like in the future.

Ewen Stevenson, Chief Financial Officer
Any more questions? You're all happy? Are we saying anything different on the sort of outlook compared to the other banks at the moment?

Question
I think you tend to always get the bad news in first in terms of things like structural hedges and thinking about the future regulation which is not necessarily a bad thing but no I think the commentary around the macro has been very similar across the board.

Ewen Stevenson, Chief Financial Officer
Yeah I'm quite sure we haven't said anything in the last few years that hasn't largely proved to be correct.

Question
No, exactly. I think you've just warned the market a bit earlier.

Ewen Stevenson, Chief Financial Officer
We view that as a good thing rather than a bad thing.

Question
And you've chosen to leave some money on the table in terms of your positioning on personal unsecured for good or bad.

Ewen Stevenson, Chief Financial Officer
Yes but equally we do just genuinely think it's a bad product and since we've taken that competitive position actually it's got worse. So now you can get 43 months of zero balance transfer. Most of the customers on that product have no idea what they're getting, what their interest rate is when they come off it. Well over 50% of the customers when they come off it cannot afford to pay back the zero balance that they've transferred into it. And we've been surprised and frankly a bit disappointed that there hasn't been a regulatory response to date against the product but we could well imagine at some point someone changes their mind and it's the next mis-selling issue.

But we just fundamentally think it's a bad product so we've explored whether we could come up with something that would force people to pay down their zero balance transfer amount during the term of the zero balance transfer and if we could come up with something that actually we thought worked from a customer perspective but yeah the focus on what's in the best interests for customers is pretty deep rooted here and you can see it in all kinds of things including the percentage of SVR book we have in mortgages. So we do think over the longer term that will be a winning strategy but certainly parts of it like unsecured credit cards hurt us but we're still pretty convinced that over the medium term we're in the right place.

Question
Do you think maybe the FPC would look at introducing affordability metrics for unsecured and would you be supportive of it?

Ewen Stevenson, Chief Financial Officer
Well look I sort of welcome the impact of IFRS 9 actually.

Katie Murray, Director of Finance
That will do it.

Ewen Stevenson, Chief Financial Officer
I think that will have a significant impact on the credit cards market.

Well thanks all for your time.

Katie Murray, Director of Finance
Thank you.

Ewen Stevenson, Chief Financial Officer

We'll try and follow up with some answers on mortgages, buy to let mortgages.

. . . .

END

Session 2

Introduction

Ewen Stevenson, Chief Financial Officer
So if it's okay with you I was going to kick off with a few comments and then I'm happy to go into whatever Q&A you want to go into. Michael and Sarah are from our IR team, Katie is my number two in Finance, also runs the cost programme and all the work on IFRS 9 as well if you want to get into that.

. . . .

Katie Murray, Director of Finance
And ICB if you'd like to talk about that - I don't know whether I'm ready.

Laughter

. . . .

Ewen Stevenson, Chief Financial Officer
I guess just reflecting on Friday, we were trying to at least convey a more positive tone, despite the £7bn loss. The fact that the loss was £7bn I think is a sign that there was a lot of one-off costs to get us there, which is a sign of progress on getting through the past.

So on conduct now I think when we look at all the various items in conduct we feel reasonably well provided against, some we feel very well provided against relative to others. I guess the pieces that still sit out there is FX; you know bits and pieces that are in the 16 pages of disclosure we give you on litigation and regulatory investigations. But the big piece is really US RMBS. And on the litigation side of RMBS what you won't have seen is we've been progressively whittling down cases. So apart from FHFA now, FHFA is probably 19% plus of the outstanding principal balance of litigation remaining.

And then on DoJ, really nothing new to say. There has obviously been a little bit of a hiatus because the senior officials at the Department of Justice have changed, so when they settle into their new jobs, I assume we'll be able to make more progress. And the fact that three of the European banks had discussions and got to a point before Christmas is positive news in terms of them working through the issues.

Then on CapRes, I guess the only piece of CapRes that I would be more cautious on our ability to execute against is just the stake in what's now called Alawwal Bank, the Saudi Arabian bank. It's just we've been wanting to get out of that stake for ten years, so I'm the fourth CFO who has been trying to get out of the stake. So I would hope to be the fourth and successful CFO, but I think for the other bits it's reasonably on a path to just run off over time. And then at the end of this year we plan to effectively dissolve Capital Resolution. A little bit will go and things like the shipping loans would go into Commercial at that point, anything markets related the bulk of that would go into NatWest Markets, but we have another company called AA Holdings, which sits outside the ring fence and we may choose to put stuff in there, or to separately report it within NatWest Markets, we're still working through that. And part of that is tied into getting to the right ratings in NatWest Markets, will drive some of the thinking around that.

Williams & Glyn we think the solution that is in front of the European Commission is good - when you go through the sort of remedies that the CMA wanted in the SME marketplace, this ticks a lot of those boxes. So we think it's a good outcome and treasury agrees with us for SME competition, good for Williams & Glyn and it's a much better solution than going through a very complex M&A process, which would have frankly taken us years to execute, before the customers had migrated. But we'll see where we'll get to, but we would hope that the European Commission is supportive.

And we've got - we obviously said £2bn of restructuring charges; we'd take £1bn of that this year. But when you get through it, absent US RMBS slipping in to 2018, it's just very, very difficult to see that we would be doing anything other than making profits at that point.

The core business, particularly Retail, to a lesser extent Private doing very, very well, you know we do genuinely think - we probably have a slightly different view to you - but do genuinely think that we can continue to take share for a sustained period of time. And if you look through the results it's not just mortgages, you can see Business Banking grew, current accounts grew well, you know we feel that whatever segment we want to grow in, Commercial we can grow, Private is growing again, RBSI is growing again. The parts of the Ulster book we want to grow are growing again. Compared to when I joined just under three years ago when large parts of that franchise, apart from parts of Retail, were stagnated it's sort of night and day in terms of the performance of the business now.

You still see the impact of the interest rate environment across particularly the deposit rich franchises, parts of Commercial. But you know we think we can grow income, cut costs, remember the core bank had a cost income ratio of 62%, so that provides an awful lot of operating leverage just getting that cost structure in line.

Impairments inevitably will go up; I mean if you add back Ulster Bank write-backs you're at about 10 basis points in core in 2016, so I don't know - I mean we really don't I think have a good sense of where normalised is, but we would probably argue 30 to 40 basis points and we're sort of miles away from seeing trends that would get us to the low end of that range. But at some point they'll normalise and I guess we have a lot less forecasting ability from 2018 until we have more work done on IFRS 9 and have a better sense of the likely volatility that we'll see, there will be more volatility.

I guess just quickly on IFRS 9 my assumption is that we'll suffer less than others because of our business mix. Developed markets is obviously better than emerging markets, and secured is obviously better than unsecured. So - our hope is to provide you as much numerical analysis as we can give you in Q2.

And then looking at our targets, or floors as I call them, we think of them as floors, the 12% plus for return on equity, sub 50% cost income ratio, they're not targets they're floors. I know some people have said look the cost takeout hasn't really changed. Actually in our minds it has. It incorporates Williams & Glyn; it is a good clean, all in cost number. Not dissimilar to Lloyds we do think it's sensible to model on some level of ongoing mis-selling charge in the future. And there will be some regular run rate restructuring charge. But all of that is within the £6.4bn.

We are definitely more optimistic I think than consensus on income. I think a lot of the headwinds in terms of mix changes, decline in the credit card book, interchange fees running off, have all largely been played through now. So yeah more of the volume growth should translate into income growth.

Sitting here today and I know we've moved our targets around a bit, but based on everything we can see we have a reasonable degree of confidence in hitting those targets in 2020. Even if you flex impairments a bit - there is a bit of fat in those numbers in order to get to those numbers.

So maybe I can stop there.

Questions and Answers

Question
If I can kick off on impairments and you talked about this impairment level of 30 to 40 basis points, I think the last time you and Ross presented your plan it was 40 to 60 …?

. . . .

Ewen Stevenson, Chief Financial Officer
Yes so the 40 to 60 number sort of predated I think both of us and was a sort of - which I've never seen, but I was told a piece of analysis that said pre-crisis if you went back it was sort of 40 to 60 basis points of losses over 20 years. That was obviously in a very, very different interest rate environment. And yeah, today the equivalent of 40 to 60 would be 30 to 40 I guess is our best judgement.

. . . .

Question
And also I think there was some press commentary in the last couple of weeks saying that you were going to re-enter some of the unsecured areas that Ross had sort of stepped away from because he was concerned about …

. . . .

Ewen Stevenson, Chief Financial Officer
Maybe I'll come in - so we had a pretty strong and visceral view that zero balance transfer credit cards were a bad product. And yeah so what we've been exploring is just whether or not all the things we hate about the product from a customer perspective we could change, which is figure out why they're on zero balance. We force them to amortise the debt, because what you see is well over 50% of them don't amortise. They get to the end of the 43 months now and then they get whacked with a massive interest rate and they can't pay it back. And that's how we're convinced that the product works and we think it's a bad product for customers. And I guess we're disappointed to date with the regulatory response - it hasn't violently agreed with us.

So if Ross said look - if someone can come up with a product for us that makes me feel good that it's a good product for customers then I'm happy to look at it. But if we can't we won't.

. . . .

Question
So you're not going to go back into zero percent balance transfer is that the conclusion?

. . . .

Ewen Stevenson, Chief Financial Officer
I think unless we can find some product development that we like, no.

. . . .

Question
The three percent UK PBB growth - when you think about that in 2017 what drives that - then it's purely Business Banking and mortgages?

. . . .

Ewen Stevenson, Chief Financial Officer

Yeah, I mean I think you should assume that Commercial will be a lot lower than that 3%, because you also have got some of the RWA coming off, some of which is Commercial lending. And yeah it will be - well we are growing unsecured, personal loans, we're just not doing it in the zero balance credit card market. We are growing nicely our credit cards book, which is the bit where customers pay us interest on credit cards.

Question
Could you comment a little bit more on your optimism for income, we had a couple of - in this earnings season some of your competitors were fairly bearish on the outlook for long growth margin from here, what makes you more positive, the excess deposit based on the mortgages or more ability to optimise on maybe the liability sides, I think you called …?

Ewen Stevenson, Chief Financial Officer
Well on the liability side most of our deposit customers now get zero to ten basis points and probably at the lower end of that. You know unless you're on a special savings rate where maybe you get a bit more than that, you know we still have quite a bit of legacy expensive funding cost, so on the wholesale side and capital security side. But that will get offset by, or partially - largely offset by MREL issuance over time. But we certainly don't have the phenomena that one of the banks called out of getting whacked with higher MREL cost because it gets offset for us with the benefit of running off wholesale - other wholesale funding.

And then on the asset side, again you go back to our customer philosophy, which is offer your customers the most attractive rates and we've self-cannibalised ourselves, so we're not sitting with a large SVR book trying to protect that profitability. You know our SVR book is now down to 12% and has been there for the last couple of quarters, it can probably drift a couple of basis points lower than that but not a lot more. So we just think a lot of the volume growth that we'll now put on will go much more towards income growth.

You know we had over £100m of reduction in non-interest income from interchange fees, that's now all played through.

Question
And I guess also the Williams & Glyn portion is going to come …

Ewen Stevenson, Chief Financial Officer
Williams & Glyn will come through.

Question
Excluding Ewen the Williams & Glyn part if you look at the core margin of the Group, what's your sense in terms of as you progress to 2017 the shape of that margin?

Ewen Stevenson, Chief Financial Officer
So there's a whole bunch of stuff going on I guess, you know there's some of the Q4 repricing of deposits, you know there'll be a marginal benefit from that. There will be less pressure on mix change because the credit card book has largely seen the decline that it's had because we stepped out of the

zero balance market, the SVR book has stabilised, you've got the structural hedge that will roll off a bit in Commercial, we're basically exiting lower ROE lending for higher ROE lending.

So you've got less benefit coming through this year because capital resolution is a lot smaller. So you know the benefit that we've been getting from running that down, so the overall Group NIM has gone up even though core NIM has gone down, you'll see less benefit of that. So I think overall there will be some modest reduction in NIM this year.

. . . .

Question
But every pound you said you put onto the core balance sheet has got to be value to the NIM given your starting point in core. So can you maybe talk a little bit about the split of the 3%, how much mortgages would be a part of that?

. . . .

Question
How much of that is buy to let, what's the pipeline like?

. . . .

Ewen Stevenson, Chief Financial Officer
I mean we're taking about the same share, I mean you can see in the Annual Report, we break out how much of the new business is buy to let, but it's not disproportionate to market and our flow share is slightly ahead of our stock share, but our stock share is well behind market stock share in buy to let.

. . . .

Question
How are you seeing the pipeline today with PRA changes?

. . . .

Ewen Stevenson, Chief Financial Officer
Well look I mean we obviously stood up last week and talked about that fact that we expect PBB income to go up for the year, so that was obviously coloured by the first two months of the year.

. . . .

Question
Have you changed your criteria for buy to let new business already - you had a September deadline I believe?

. . . .

Ewen Stevenson, Chief Financial Officer
We constantly look at valuation; I don't think we have particularly tightened up criteria.

. . . .

Question
But is portfolio landlord something that you would target?

. . . .

Ewen Stevenson, Chief Financial Officer

Pardon?

Question
Portfolio landlord, buy to let, the four plus properties, is that something that you guys will actively target when complex rules come in in September?

Ewen Stevenson, Chief Financial Officer
Sorry I can't tell you.

Question
So obviously the challenger banks are saying that the large banks have not adjusted underwriting criteria in buy to let for the rules that will come in in September this year. And that is why there is still growth in the large banks which will tail off from September. That's the story being talked about.

Ewen Stevenson, Chief Financial Officer
I'm sure we can all tell stories.

Question
As you can see you don't believe everything they say.

Question
Just moving onto Ulster, about £3.5bn in NPLs there now, coverage has gone down a lot, 34% coverage can you just give us some colour on what's in the book and how do you plan to sweat that?

Ewen Stevenson, Chief Financial Officer
55% of the book is either NPLs or trackers. And say 15% of that is non-performing and 40% is performing, but you count de minimis returns and you've got 45% of the book which is a good core book, growing nicely you know the returns, the front book returns are above the UK. But it's 45% of the book. So I think it's a sort of multiyear journey in Ireland. If you were to crystallise the 40% that's performing in legacy because it's got a low ROE you would crystallise a very substantive mark to market loss. So we don't plan to do that.

Question
Any further transactions on the NPL book, the 3.5 …?

Ewen Stevenson, Chief Financial Officer
Yeah look, I mean we're constantly looking on the NPL book whether we can run it down and sell it.

Question
The NPL book is mostly corporate still - both …?

Ewen Stevenson, Chief Financial Officer
No, no it's a bit of everything. But you know in Ireland on top of that you've got impairment write backs that will decline over time. We've got a lot of benefit of structural hedging income which did roll off a bit last year it will roll off some more this year.

You know if you carved out the 45% we're sort of pleased with the trends, i.e. it's growing, it's good margin, we're cutting costs, it just continues to be overwhelmed a bit by the 55% - a year ago the 55% was 62% so it's getting smaller, but it will take many years before - you know if you were to rollout five years you're probably at an 80/20 ratio or something, but it's that sort of period.

Question
On litigation you've got a nice fat kind of RMBS provision now, £6.7bn …

Ewen Stevenson, Chief Financial Officer
Fat is your word not mine.

Question
Not far away from my expectation, but does that cover a lot of these various items that are there, I mean you've dealt with NCUA but you know FHLB, DoJ, state attorney generals rules you know securitisation, CDOs, so it cover all that or are there specific things that are not covered by that 6.7bn?

Ewen Stevenson, Chief Financial Officer
It doesn't cover some of the state attorney's, it doesn't cover bits and pieces of litigation, almost by definition if it was enough the FHFA would have settled and the Department of Justice probably. But I mean it's very …

Question
You're not advanced to that stage was the previous message, so …

Ewen Stevenson, Chief Financial Officer
I mean FHFA we talk to regularly but Nomura are still sort of ahead of us. DoJ nothing to the degree of substance say where the Europeans were pre-Christmas.

Question
And this provision is based on the settlements we saw, like is that …

Ewen Stevenson, Chief Financial Officer
Based on the Board's judgement of what a reasonable provision would be.

Question
So under accounting rules you need to justify the calculation, so how as that been justified?

Katie Murray, Director of Finance
Yes so I guess I mean when you're trying to derive what a number might be you look to see what others have settled at, but each of them have got their own unique settlements. And then the other important thing under the accounting provision is that if there is a number that the Board would settle at that is a number that you can fairly provide. So this would be a view that this is a number that you could look elsewhere and derive some comfort and also the Board would be willing to settle at.

Question
And if you go back to the core trajectory …

Ewen Stevenson, Chief Financial Officer
And when you look at the settlements I mean it's just - there could be a four times delta if you try to do a quantitative basis …

Question
Just a follow up, given your guidance about the statutory loss, Ross confirmed that the balancing item for 2017 is further litigation charges …

Ewen Stevenson, Chief Financial Officer
Well you could deduce that there are incremental one off costs that we haven't guided to.

Question
Okay, so when we trend back into that number it looks a lot larger than where consensus currently is. But if we think about your big litigation items you've largely resolved the rights issue investigation, you settled with four of the five, you've taken this big provision on RMBS, what are we missing, what are the thing big key items out there?

Ewen Stevenson, Chief Financial Officer
Well there's things like FX, there's various things that exist at the back of our Annual Report that you can read about, but as I say we're confident in our ability to project the same degree of confidence in 2017 profitability is not there relative to 2018. And it wouldn't - I guess it's unsurprising from a sort of capital planning perspective that we would be more conservative than consensus on something like that, but more optimistic on the core business, so.

Question
When you look at the trajectory of the core income through the quarters, obviously the core PBB and Commercial bank have been relatively stable in terms of the progression through the quarters. But clearly it's been that this market, which has been flitting around …

Ewen Stevenson, Chief Financial Officer
Well the core PBB and CBP grew by 2% last week and NatWest Markets was up 16%.

Question
I was more talking about the quarterly progression. If you look at the Q3 and Q4 for example NatWest Markets took obviously the seasonal step down and I think on the call you talked about potentially higher revenues as well?

Ewen Stevenson, Chief Financial Officer
Remember for all of us the first six weeks of last year were not stellar, so it would be better than the first six weeks of last year.

Question
So what's driving - I mean what do you think the - I think you said £1.4bn plus?

Ewen Stevenson, Chief Financial Officer
Well I've worked in an investment bank for 25 years and one of the things it was extremely difficult to do was forecast investment banking revenues quarter on quarter. But look we've basically built a business model that we think if it can make £1.4bn of income, have an £800m cost structure it will be able to get to 10% returns. So you know based on the income trends that we're seeing at the moment, they're above the £1.4bn run rate, but we've told Chris Marks just plan on the basis that your cost structure needs to be £800m because we don't want to build a business that's reliant on significantly higher income flows.

Question
So the £1.4bn is not the growth story it's purely - because I'm trying to see if I'm missing something on PBB and CMB?

Ewen Stevenson, Chief Financial Officer
The income story is not out of NatWest Markets.

Question

It's purely out of PBB and CMB - but then perhaps - sorry just to finish off on Commercial banking, in terms of the core business now as you reintegrate Williams & Glyn back in, obviously it looks like under the new agreement you would be funding challenger banks or whoever, you know it gets the benefit through dowries to take your customers away. Is that agreement limited to the customers inside Williams & Glyn, or once you've reintegrated Williams & Glyn that becomes then open to the entire Commercial bank?

Ewen Stevenson, Chief Financial Officer
We haven't said what it applies to - but yeah the provision that we took for £750m includes all of the economic value that we think that we will lose out of what we disclosed.

Question
But do you see the £750m is a one off impact and losing customers …

Ewen Stevenson, Chief Financial Officer
No, no, no it's an NPV impact.

Question
Right, okay so there's a negative income drag implied by the £750m for the Commercial bank plus Williams & Glyn, which is what I was trying to think about.

Ewen Stevenson, Chief Financial Officer
Yeah, but remember there are other parts of that proposal so I wouldn't focus on the customer piece as a huge piece actually.

Question
As it relates to the £750m.

Ewen Stevenson, Chief Financial Officer
And if you look at the income over 50% of the income is retail. So we get to keep almost all of that, plus a proportion of the Commercial, so.

Question
But that's assuming that it suits Williams & Glyn …?

Ewen Stevenson, Chief Financial Officer
Look that way it's structured that's the right way to think about it.

Question
Can I just come back to your comment on NatWest Markets. So you talked about the £1.4bn, I think you said on Friday £1.5bn to £1.6bn for this year?

. . . .

Ewen Stevenson, Chief Financial Officer
I didn't say that no, I said above £1.4bn.

. . . .

Question
Okay, some growth for this year, but based on the kind of reiteration of the £1.4bn and £0.8bn and the 10% ROE that sounds like a comment on kind of current year market conditions and trading rather than anything sustainably changing …?

. . . .

Ewen Stevenson, Chief Financial Officer
No, more comment on five or six good quarters. I mean anyone who has a macro franchise at the moment is doing well. And yeah I don't think anyone is yet saying that that is a secular trend as opposed to a cyclical trend, so we're quite happy that it's going well at the moment, but we're not trying to build a business based on current income flows.

. . . .

Question
But there are things that you've been changing in the business that give you more optimism on the medium term?

. . . .

Ewen Stevenson, Chief Financial Officer
Well we can see the underlying day by day, month by month customer flows that are coming through and they're pretty consistent and reliable and good. You know you've obviously got risk flows - risk hits that go up and down on any given month. But you know we can see the underlying customer trends and I guess it's validation of the assumption supporting our business plan.

. . . .

Question
A quick one on rate sensitivity to sterling, just on the half year the sterling has gone up significantly, it's gone from 390 to run about 440, 100 basis points, what changed in the half year - this is clearly the second half of the year?

. . . .

Ewen Stevenson, Chief Financial Officer
I'm not sure - it could be we've hedged conduct assumptions in US dollars, it could be that.

. . . .

Question
25 basis fall, is that what you're looking at?

. . . .

Question
100 basis raise so if you look at that …

All talking together

Question
Well it goes from 385 to 436; I will double check this specific one.

Question
The IFRS volatility in the central items is quite big actually - to forecast, what's driving that quarter on quarter …?

Ewen Stevenson, Chief Financial Officer
So a long time ago we did some very long dated lending to local authorities in the UK. The loans are held at book value but the hedge is mark to market. So as interest rates move, as interest rates go down we suffer IFRS volatility losses.

Question
And that impacts capital as well?

Ewen Stevenson, Chief Financial Officer
Yes. We're not currently marking to market the loans, but we are marking to market the derivative, so it should be relatively neutral for capital if you were marking to market the loans and we don't mark to market the loans.

Question
Is this similar to ESHLA that Barclays had in terms of …?

Ewen Stevenson, Chief Financial Officer
Yeah, so Barclays I think unravelled or changed this to take the capital benefit. We would get a lot of that capital benefit naturally under IFRS 9, if we - so either we …

Question
So you've basically reclassified …

Ewen Stevenson, Chief Financial Officer
Well we can wait until the end of the year and get capital benefit from just waiting, or we can choose to change it and accelerate that capital benefit.

Question
The obvious question is how much is the capital benefit?

Ewen Stevenson, Chief Financial Officer
Well I mean just look at the IFRS volatility sensitivity …

Katie Murray, Director of Finance
Seeing that will give you some guidance.

Ewen Stevenson, Chief Financial Officer
And take it the other way.

Question
So basically the IFRS volatility so far has been the negative - is a negative drag on capital, but what you're saying is that effectively that's unrealised loss because you've not closed the hedge yet, so?

Ewen Stevenson, Chief Financial Officer
And we've got an unrealised capital mark to market gain on the loans.

Question
Well clearly the loans will be the loans unless there's a current loss you're get part less interest back, so effectively the mark to market hedge accounting would reverse when you change the treatment on the hedge?

Katie Murray, Director of Finance
Yes, so as we re-designate the loan to fair value, which we'll do as we do the transition to IFRS 9, you'll then see the hedge and the underlying asset matching.

Question
Okay, so we just add all the negatives and mark it up?

Ewen Stevenson, Chief Financial Officer
Someone estimated 40 basis points a few days ago and I don't think - it's not as high as that.

Question

Could you just remind me of the - sort of the latest in terms of your Williams & Glyn thinking in terms of timing, what we should basically see both in terms of the deal, but also in terms of …?

. . . .

Ewen Stevenson, Chief Financial Officer
So this year you probably won't see much. You know it has to go through quite an elongated both Treasury and European Commission process to turn the proposal into something where they're prepared to support it and then they need to renegotiate between themselves a new state aid agreement. That may well take all of this year and possibly into next year to get to that new signed state aid agreement. Putting money into a tech fund or putting money into an SME fund at that point can happen almost instantaneously, migrating customers may take a bit longer. Then when we sort of reabsorb the residual remember that it sits today on the Royal Bank of Scotland systems so we could just reabsorb it instantaneously without any implementation cost to reabsorb. We could strip out presumably a lot of the back and the middle office costs at that point and then decide what we want to do over time with the physical distribution network. But the 300 branches almost entirely overlap with our existing distribution network.

. . . .

Question
Do you crack on with setting up the structure for the fund and all this or do you wait until the European Union…?

. . . .

Ewen Stevenson, Chief Financial Officer
It's not our fund, it's the Treasury's fund so I guess it's up to them as to whether they crack on or don't crack on but we could certainly give them the money tomorrow if - but I think presumably we will usefully use the time between now and when there would be a new state aid agreement signed to figure out what we have to do to incentivise customers to migrate and how to set that up properly so that's a good customer experience presumably.

. . . .

Question
Is there a danger that with all else that's going on around Europe that's actually it's all rather irrelevant? I mean in the sense that in two years we're out of Europe anyway so…

. . . .

Ewen Stevenson, Chief Financial Officer
No I don't think, I think we have to operate under the assumption that European law is going to survive so there's certainly no one operating under an assumption that if we just waited that eventually this would disappear.

. . . .

Question
Given the timeframe on this presumably the reintegration charges that you flagged are not going to flow through until 2018 so you have to weigh up the sign off for the alternative proposal.

. . . .

Ewen Stevenson, Chief Financial Officer
I was careful what I say about reintegration because we could just take it back tomorrow and there'd be no reintegration charge.

Question
So the reintegration charge - ?

Ewen Stevenson, Chief Financial Officer
Reintegration is really restructuring.

Question
So that in what you flagged in the RNS should have an offsetting cost benefit in your…?

Ewen Stevenson, Chief Financial Officer
I mean we run it today off the RBS systems so there is no reintegration required. And it's branded Royal Bank of Scotland today in England and Wales and branded NatWest in …

Question
But the £6.4bn cost target is predicated on the existing strategic plan.

Ewen Stevenson, Chief Financial Officer
Yeah some degree of cost synergy yes.

Question
How quickly can you move the NatWest products over to the existing Williams & Glyn retail, things like the Reward Account?

Ewen Stevenson, Chief Financial Officer
They're on different systems so reward is offered to Royal Bank of Scotland customers.

Question
Only in Scotland right?

Ewen Stevenson, Chief Financial Officer
No, so it could be I think pretty quickly rolled over to Williams & Glyn customers.

Question
But in terms of trying to get some sort of idea of where we would see an EPS, sort of sustainable EPS.

Ewen Stevenson, Chief Financial Officer
2020.

Question
There's a one off payment that you're going to make which is going to be one off I guess and then there are going to be a transfer of some customers to sundry challenger banks, is that - so there'd be revenue from those, but other than that …

Ewen Stevenson, Chief Financial Officer
Well so over 50% of the income today is retail so assume that we keep most of that and assume that off the residual commercial income that we keep a portion of that and you're not going to be miles away, we keep the £400m of costs and then we rationalise the cost structure and RWAs, you're not going to be miles out with your estimates on RWAs. There may be some incremental restructuring costs we just don't know what those numbers are today. And all of that should be able to happen quite quickly so by the time we get to 2020 you're back to a sort of clean cost and income number.

Question
Is that the same for the dividend then as well? Just to be absolutely clear in terms of the dividend. I mean as of today you can't pay a dividend until Williams & Glyn is sorted.

Ewen Stevenson, Chief Financial Officer
It's got nothing to do with Williams & Glyn. So in that sense. I mean look there's four things that we need to do to pay a dividend which is we need to solve Williams & Glyn but it's the definition of what's solved. I mean I would assume, without having had this conversation with the PRA that getting to a signed state aid agreement the Treasury, the European Commission and everyone was happy with is enough of an answer. We have to solve US RMBS and that I think largely means FHFA and DOJ. We have to pass a stress test and we have to make profits. So I mean normal banks make profits and pay dividends so it's not a conversation we spend huge amounts of time discussing with the PRA at the moment.

Question
So just on Williams & Glyn my understanding was you will need to sell some of the assets, some of the loan books will go away. But you are saying the current loan book RWAs won't be a million miles - I'm just trying to square the circle here, what are you expecting will go away of the current preliminary loan book?

Ewen Stevenson, Chief Financial Officer
Well take all of retail, keep it.

Question

Keep all the retail and?

Ewen Stevenson, Chief Financial Officer
And then commercial just make an assumption, you're not going to be miles off.

Question
Okay fine. And we take the - okay fine. Just on the £20bn RWAs that will go from core you gave some guidance on pre-tax on the call, can I get the split of that £20bn, so how much of that is the Ulster legacy, what is commercial, some different pots? What are these assets that are going away and how difficult will they be to - off?

Ewen Stevenson, Chief Financial Officer
We haven't broken it out but a decent chunk of it is commercial but we've told you where we're trending in NatWest Markets, you can figure out some of the runoff in Ulster but it's not part of the natural runoff. This is incremental new and some of it's improved risk models, some of it's just improved risk metrics that lower the RWAs. Ongoing work, we've got a lot of work going on in cleaning up data in the bank which is leading to improved RWA outcomes.

Question
So against the £20bn of RWAs how much loan book is going away, just so that we can understand what is real and what is model change?

Ewen Stevenson, Chief Financial Officer
Well you can make assumptions based on the £250m to £300m income and gross out for that can't you?

Question
Ulster's RWA would be subject to analysis that ECB is doing, part of the internal models. Does that lead to a positive for you potentially?

Ewen Stevenson, Chief Financial Officer
I have to say I don't think Ulster is really a sort of earnings growth story. It's an improving quality of earnings story. But it's going to be a long time I think before it becomes an earnings growth story.

Question
Coming back to the European Commission what's your expectation around the potential other terms that may be attached to this and I'm talking about price leadership, M&A, the inability to be able to do certain things?

Ewen Stevenson, Chief Financial Officer
Don't know.

Question
The decision to carry a 2.9% illustrative headroom or I don't know how you think about the management buffering in the new framework. Can you talk just a little bit about why you need such a great headroom?

Ewen Stevenson, Chief Financial Officer
So I would observe that we were the first to go to 13% and I think since we've gone there despite all the other banks saying we were being far too conservative they have chased us up towards that number. We don't know where we are on RWA inflation and what impact that has.

Question
So you don't believe the Bank of England's doing offset commentary? Because they say you shouldn't worry about RWA inflation because you're going to do it before.

Ewen Stevenson, Chief Financial Officer
Yeah so they've introduced the concept of a significant increase for us in mortgage risk weights and haven't said you're going to get an offset in anything, so we should sort of take that with a grain of salt in places. We don't know the impact of IFRS 9 and how that should impact our buffers. So I mean 13 - I have to say longer term I would say the debate is probably between 12% and 13% but 13% feels like a pretty good, conservative place to ground ourselves for now until we know more. And I don't think we'd win any fans with the - remember we failed a stress test last year - we would win any fans with the PRA who are keen to say that we're changing our long term capital targets at the moment.

Question
Has the pension deficit fully washed through the Pillar 2A now or is there more to come?

Ewen Stevenson, Chief Financial Officer
There's still more ...

Katie Murray, Director of Finance
There is still some pending.

Ewen Stevenson, Chief Financial Officer
There's still some in there.

Question

Can I ask on the cost reduction plan if you strip out your guidance on Capital Resolution you said £25m per quarter is the exit rate. You've got another £0.5bn coming from NatWest Markets so you're still talking about £0.8bn is the balance to get to the £6.4bn. You've flagged the digitalisation simplification for the commercial and retail but could you elaborate a bit more on that £0.8bn, exactly where does that come from?

. . . .

Katie Murray, Director of Finance
I guess the thing for me is we talked about the ten journeys and we'll go through them and kind of strip them out but I guess I obviously look after the finance department and that's normally one of - it's a good way to extrapolate it so we're not a huge part of that £0.8bn but we're more than mentionable kind of thing within that number. And it's just the constant removal of the duplication of effort, the multiple filings you need to do, the multiple reconciliations, the very manual processes that we originally we operate today and how they will evolve over the next four to five years. And I guess for me speaking personally I'm still relatively new to the bank and it is an unbelievably complicated system that we file. We talk about the number of - you saw our publication last week, with three sets of annual reports that came out in that piece. I'm not sure if you all printed it all out but if you did it would have been about 2,000 pages on your desk. So just actually automating a huge amount of that production, making it all happen simultaneously is significant. You know in a couple of weeks we'll post you a few 20Fs to add to your reading so how do we take all of that stuff out -

. . . .

Ewen Stevenson, Chief Financial Officer
Finance headcount we think we can halve it in the next three or four years.

. . . .

Question
So then you have the automation, we'd get sent one report instead of three, I'm sure that won't be the case but how much is then IT cost saves versus headcount reduction versus consolidation of office space? Just trying to …

. . . .

Ewen Stevenson, Chief Financial Officer
You can see what headcount is as a percentage of our cost base. About two thirds of our cost base is headcount related so we don't talk about headcount numbers externally but we took out 15% of our workforce last year which again is probably more than any other bank in Europe. We took out 13,400 heads. We don't talk about it publicly; we just get on and do it. So you can cut - like in Finance - Katie and I sat down and went through the top 300 people in Finance and took out 60% of them.

. . . .

Question
I guess the reason I ask is the headcount is quite binary, it's either there or it's not. The thing that's taking longer is the [IT].

. . . .

Ewen Stevenson, Chief Financial Officer
You need the technology solution, you need the simple process, at that point - you know we're spending over a billion pounds a year in investment spend at the moment. As you simplify that process and get it end to end you can then strip out an enormous amount of cost. We've got 2,000 people involved in customer on boarding in KYC. Now that is a process that you could probably get down to a few hundred with the right technology solution.

Once you get the right technology in place usually you can then cut the heads. That's what I'm saying, that is a cost saving. Over time.

Question
Over time. But where banks have traditionally fallen down is the cost saves that are attached to decommissioning some of the legacy IT systems because they go to turn them off and then they find actually it's attached to X, Y, Z and you can't decommission it. So that's what I'm just trying to get a feel for of the end millions how much is headcount versus systems?

Katie Murray, Director of Finance
I think it's on the system piece you're absolutely right it takes far too long to decommission things and we have far too many old systems. What you will find today is the old systems aren't costing us a lot of money other than just the keeping them from dying rather than actually maintaining them or developing. So they are things that are all completely written off. You don't get them free because there is the ancillary costs of just keeping them alive. But actually once you make the investment for them to go it's then the people that are attached to those systems that then go because today they don't cost us.

Ewen Stevenson, Chief Financial Officer
But I mean most would just - I mean we do think we're pretty good at cost cutting. We've taken a 26% nominal reduction in costs out of this bank in the last three years which is probably more than almost any other bank in Europe. Other banks announce a few thousand headcount reduction over multiple years and make a big press announcement about it. We took 13,400 people out of this organisation last year. But it is just old fashioned brutality and having to get on and do it. We've got five mortgage platforms in the UK and Ireland that we can get down to one mortgage platform. We've got a new general ledger coming into finance that will be able to take out 200 to 300 people the day that we get it installed.

Question
How much do you spend on IT each year and how much of that is BAU versus investment?

Ewen Stevenson, Chief Financial Officer
Well we're spending over £1bn in each of the last three years on investment spend.

Question
And that's IT investment or that's more broadly?

Ewen Stevenson, Chief Financial Officer
A mix of stuff.

Question
Do you have an idea of what the digital cost …?

Ewen Stevenson, Chief Financial Officer
And also if you go through the heavy restructuring charges as we said the other day 40% of that, of the £2bn relates to property so as you reduce the property footprint and we've got some very expensive owned real estate that we're exiting.

Katie Murray, Director of Finance
But one could assume the rest of the office is not as spacious as this room, so as you reduce the property footprint you're reducing your headcount dramatically to match that.

Ewen Stevenson, Chief Financial Officer
We announced last week, two weeks ago, there's a building over there that we have 2,700 people in that we're coming out of at the end of this year. That will require us to get rid of 2,300 people in London in order to get out of that building. The other 400 will share desks, not my desk, but will share some other desks elsewhere in London.

Katie Murray, Director of Finance
Because they do occasionally share my desk so …

Laughter

Question
Can I ask you about your 2020 targets?

Ewen Stevenson, Chief Financial Officer
Floors.

Question
Floors sorry, your 2020 floors. And in particular what are you assuming about the profitability of the core banking business, the UK PBB? Because I guess one of the things that worries me is that everybody, all of you - if I speak to you, if I speak to Barclays, Lloyds, you all tell me how impossibly difficult it is to make returns in a low interest rate environment and mortgages and you can only pay depositors ten basis points etc. And yet when I look at your profitability you're knocking out 27% in UK PBB which sounds to me like a fantastic environment, doesn't sound it's tough at all. I wonder how are you writing this each year …

Ewen Stevenson, Chief Financial Officer
Remember that we've got a 100 to 1 times levered mortgage business in the UK because we've got a 7% risk weighting against advanced UK mortgages, put leverage on. So it's no wonder we're

recording very high returns at the moment because we expect the capital usage on that to double as we've talked about.

Question
So that will come down?

Ewen Stevenson, Chief Financial Officer
I think on deposits the fact is that if you've got a free current account and we've got a lot of those, 80% of our current accounts are free, we are losing money on them because you can't earn any spread on the balance, we don't charge for the service and we provide them with access to all of our branch network, ATM network, everything for free. That undoubtedly is a loss leading proposition for us.

So yeah the whole narrative in the UK is wrong. Everyone says poor savers, it's actually asset side customers where the excess spread is at the moment and then you say well what's going to disrupt that. It doesn't feel like the challenger banks are going to disrupt it because they can't afford to get competitive funding in order to disrupt it. There's no active securitisation market at the moment. The largest mortgage writer in the country is prepared to take a flow market share about eight percentage points lower than their current - than their stock share, so the biggest mortgage writer in the country is not competing. So I mean there are odd competitive dynamics at the moment that allow us to earn an excess return on our - and we've got no capital against it largely.

Question
But say if you're going to look at it by products than the sort of mortgages and credit cards which is where you're knocking the -

Ewen Stevenson, Chief Financial Officer
Well we're not big in credit cards but for others obviously they're getting a big return in credit cards. I mean if you're charging an 18% APR and you're getting a deposit at 1% you're obviously making a decent return on that for the time being.

Question
Maybe to ask the same question in a different way I don't know if we can figure it out, I haven't tried I have to apologise. But the 12% ROE tangible what is the denominator here that you mean on that?

Ewen Stevenson, Chief Financial Officer
So I mean you take what's in the call, you take off the £20bn, you assume some growth, you add in most of Williams & Glyn, you add in the mortgage floors that we've given you, you add in some assumptions around Basel IV, add in some assumptions around IFRS 16 and add in a bit of legacy capital resolution. That's the equation.

Question
And then the capital ratio against that is still 13?

Ewen Stevenson, Chief Financial Officer
The 13.

Question
And a bit of Ulster model change as well? Ulster models rolling off.

Ewen Stevenson, Chief Financial Officer
No but that's all in that core growth.

Question
Because I thought you said on the call that there was more to come.

Ewen Stevenson, Chief Financial Officer
Remember we talked about growing PBB income right, that's a mix of some parts of PBB that are shrinking and other parts that are growing.

Question
In terms of timing of the floors so you've talked about it in the past as well like the whole thing around say the denominator problem is what you're alluding to right now in terms of high returns. When do we see it just in terms of the pass through of higher risk density on mod gauges I mean …?

Ewen Stevenson, Chief Financial Officer
I mean Q1 2019 is when we're supposed to see and it will impact us differently to others I think because of we've got much lower point in time RWA density rather than some through the cycle. I mean some people are much closer to sort of 15ish % risk weighted density. And if you look at our RWA, if you look at the amount of capital we have more capital allocated to Irish IRB mortgages than we do UK mortgages today.

Question
How should we think about the runoff of £15bn to £20bn RWAs left in cap res?

Ewen Stevenson, Chief Financial Officer
It will be gradual and multiyear. I mean there's some very long dated stuff in there that will take a long time to wind down.

Question

So is ten a reasonable assumption for 2020?

. . . .

Ewen Stevenson, Chief Financial Officer
Yeah it's probably not wildly out provided we're out of the other Alawwal stake at that point.

. . . .

Question
Just maybe switching gears, if there is a Scottish referendum by 2019 and there is a decision to leave how do you think the group will be positioned for that outcome and do you have a contingency plan?

. . . .

Ewen Stevenson, Chief Financial Officer
Yeah so a lot better than last time. So I mean if you start with Scotland, Scotland doesn't have a banking system, they don't have a banking regulator, they don't have a payments system, they don't have a central bank. So they definitely have more problems than we have in terms of responding to a vote to leave. So my assumption is there has to be a very elongated transition period because they can't cope today. We don't know what currency they're going to. Depending on what currency they're going to the Royal Bank of Scotland system is not a dual currency system so we would have to get the Williams & Glyn customers in England and Wales off the Royal Bank's systems at that point to put them onto our NatWest systems which presumably we could do. The head office just needs an Act of Parliament to move and we would get support to do that.

. . . .

Question
Royal Bank will stay in Scotland?

. . . .

Ewen Stevenson, Chief Financial Officer
Yeah. RBS Plc where the Scottish retail and commercial customers, that's going to become NatWest Markets. So the customers that are in Scotland are going to go into our Scottish private bank Adam & Co so it will have all the Scottish retail and commercial customers in a legal entity. That entity is not separable today, there's about 40% of the systems are either shared or co-mingled.

. . . .

Question
How big is the balance sheet?

. . . .

Ewen Stevenson, Chief Financial Officer
£20bn, £25bn I think pre Williams & Glyn.

. . . .

Question
Does that include large corporate as well?

. . . .

Ewen Stevenson, Chief Financial Officer

No. So it also depends how many of the large corporates stay there versus choose to go to NatWest as part of ring-fencing.

. . . .

Question
So is that £20bn to £25bn then consistent with the postcode lending data that you get which is mortgages plus SME?

. . . .

Katie Murray, Director of Finance
It should be yeah.

. . . .

Question
So that's everything except the large corporate?

. . . .

Katie Murray, Director of Finance
Yeah.

. . . .

Ewen Stevenson, Chief Financial Officer
So the large corporate it sort of depends, yeah the large corporate that sit in RBS Plc today if they want to go and be serviced out of Royal Bank they can be, if they want to go to NatWest we'll facilitate that. Williams & Glyn would go there but then would come back out again under that scenario.

. . . .

Question
Do you still think that you could meet your ROE target if Scotland were to become independent?

. . . .

Ewen Stevenson, Chief Financial Officer
Yeah I don't think Scotland is going as I said, I mean they can't. It's not like unravelling from Europe, I mean it's the same as any region of Europe trying to separate. None of them have the banking infrastructure to separate into. If Catalonia decided tomorrow to leave Spain there's no payment system, no regulator, no central bank. That problem exists; there's 300 years of integration. We're the largest private sector employer in Scotland so we have a very good dialogue with the Scottish government. And I think relative to last time they certainly understand the issue a lot better than they did a few years ago.

And I guess the other thing around structural reform obviously is European IHC legislation adds a new dimension of complexity to everyone.

. . . .

Question
Somebody said it's de minimis costs, one of the other CFOs.

. . . .

Ewen Stevenson, Chief Financial Officer
Well it's more - it's incompatible with ICB in some places. So for example Ireland for us it's inside the fence for ring-fencing, under European IHC it may need to sit outside the fence and just issues like that. Our Western European corporate business sits inside the fence and would have to sit in a European IHC.

Question
We haven't asked the Brexit question yet.

Ewen Stevenson, Chief Financial Officer
What's the question? Do we like it?

Laughter

Would we vote again for it?

Question
I feel like we're missing something. If the Article gets triggered in two weeks' time or something like that -

Ewen Stevenson, Chief Financial Officer
When it gets triggered.

Question
When, yes. Which pockets of your loan book would you be most worried about? Is it the SME book, is it the unsecured?

Ewen Stevenson, Chief Financial Officer
If you look at the sort of Bank of England stress tests it's not mortgages, it's not really commercial real estate. And we don't have a huge unsecured book in the UK so probably we're the biggest business lender in the UK so if it's bad for business it will be bad for us. But again there will be - my assumption is it will be quite varied. I mean remember until tariff free access stops any exporter to Europe has got a 15% to 20% devaluation and is doing great. There'll be pockets of the economy who will be better off and pockets of the economy who will be worse off. That currency devaluation I think provides a huge shock buffer.

Question
Some of the development book in commercial real estate which is concerning you or anything there?

Ewen Stevenson, Chief Financial Officer

I don't think any of the big banks - all the big banks have stepped back substantially from some of the more problematic commercial real estate sectors and that lending has been led by others in the last few years.

Question
Has IFRS 9 impacted the state of the bank? Because when you reported the second quarter you obviously had different macro inputs that you put in and you had that slide saying GDP unemployment was in a different place in terms of 2018. I guess when you've rerun those models now with the current projections presumably that day one hit is a lot lower?

Ewen Stevenson, Chief Financial Officer
I mean the day one hit is not huge for us relative to what we think it will be. Again we don't have portfolios that - we don't have a very, very big credit card book, we don't have significant emerging market exposure, we don't have the type of exposure that should cause undue day one impact. We talked about LOBOs before that would be a day one benefit so it's - I think what we're trying to figure out more is what earnings volatility does it introduce.

Katie Murray, Director of Finance
And what stress boundaries does it produce.

Ewen Stevenson, Chief Financial Officer
And what does that do to the way that you all think about cost of capital, what does it do for your stress testing, probably means that you have much sharper Vs on the way down and what does that mean for your capital buffers. We don't have a good sense of that at that moment until we do more modelling.

Question
Has there been discussion on that volatility issue with the regulators? Is the PRA engaging on that?

Ewen Stevenson, Chief Financial Officer
Yeah they've asked us to run special IFRS 9 stress tests this year later in the year.

Katie Murray, Director of Finance
A significant amount.

Question
Because most of the regulatory focuses tend to be on the day one impact rather than -

Ewen Stevenson, Chief Financial Officer

Well no I would say they are definitely focused on the other thing more than the first thing; it's just none of us have got good enough analysis yet to show them. I mean we'd all love to know what the volatility is.

Katie Murray, Director of Finance
Yes we submitted a QIS in February but that was much more concerned with the day one piece. We then have another thing, the stress test work that we'll do in June I believe which will confirm much more of the volatility and the stressed impacts for the net.

Question
Are you assuming any transitional impact, transitional phasing for the day one impact?

Ewen Stevenson, Chief Financial Officer
No current assumptions.

Katie Murray, Director of Finance
Certainly not from an accounting perspective.

Question
So your confidence around the impact being manageable is even after assuming the whole impact upfront and not including the 40 bps from LOBOs?

Ewen Stevenson, Chief Financial Officer
Yeah.

Facilitator
Apologies but we'll need to be slowly wrapping up.

Ewen Stevenson, Chief Financial Officer
Remember that we've got lots of other things that we worry about so.

Facilitator
Maybe one final question.

Question
Just one, in your stress test modelling if you kind of back out, take out all the stuff that you are thinking of getting rid of, remove the litigation, what kind of stress test loss, i.e. PRA buffer requirement are you thinking about?

Ewen Stevenson, Chief Financial Officer
I mean our assumption is longer term. We want to run the bank plus or minus and this sort of predates an IFRS 9 view I guess but the assumption had been that we want to run the bank within a sort of 400 basis point extreme stress buffer.

Question
400 yeah.

Ewen Stevenson, Chief Financial Officer
So under a stress test you would be no worse than nine and that -

Question
Is that feasible by 2020 or it might take a little longer?

Ewen Stevenson, Chief Financial Officer
Well I was talking to our risk guys today saying look I mean again if you roll forward another year so you're on the '17 balance sheet all the stuff we've talked about I'm intrigued how we look at that point. Because if we're not approaching that sort of stress buffer then there's something else that we've missed. And that therefore you're then 200 basis points above seven so you're at no risk of triggering AT1. And that's why it gets back to if you wanted to go down to 12 that nine is - it will be driven by the nine.

Question
So the stress test is the nine -

Ewen Stevenson, Chief Financial Officer
And how much stress you have. So if it's 12 then you have to be confident of 300 basis points, if it's 13 it's 400. But I think nine is the more hard barrier than the starting point.

Thanks a lot.

END