Annual Results 2003

P R O C E E D I N G S at an **ANALYSTS CONFERENCE** of the Company held at 280 Bishopsgate London EC2 on Thursday 19th February 2004.

Top table:

SIR GEORGE MATHEWSON (Chairman)
MR. FRED GOODWIN (Group Chief Executive)
MR. FRED WATT (Group Finance Director)
MR. BENNY HIGGINS
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THE CHAIRMAN: Good morning, ladies and gentlemen, and welcome to the presentation of our results for 2003.

As you will have already seen from our Company Announcement, key features of our results include again strong growth in income and an improvement in our efficiency. We increased our Group operating profit by 11 per cent and our adjustment earnings per share by 11 per cent.

The Directors have recommended a final dividend of 35.7 pence per share which, when added to the interim dividend of 14.6 pence per share, makes a total of 50.3 pence per share for the full year, an increase of 15 per cent over the dividend of 43.7 pence per share for 2002. In addition to this, the third and final Additional Value Share dividend of 55 pence per share was paid in December. Adding ordinary dividends and AVS dividends we returned £3 billion to Shareholders in 2003.

This slide updates a chart which I have shown previously, many times in fact! Uniquely among our peer group we have increased our adjusted earnings per share in each of the last 10 years and we have increased our ordinary dividend per share each year. AVS dividends are excluded from this chart.

Today our agenda follows the usual pattern: Fred Watt will now review our Group results and the results from each of our Divisions, then Fred Goodwin will review our performance and look to the future. Fred!

MR. FRED WATT (Group Finance Director): Thank you, George, and good morning everyone from me also.

It is very pleasing to be able to stand up and talk about numbers that are very easy to look at year on year. As before, these numbers are pretty straightforward to compare one year with the next and we have no restatements of prior year numbers at Group level, no accounting changes to speak of to cloud any picture of year on year, and even acquisitions have a very minimal impact on profit and profit growth year on year this year.

Operating profit is up 11 per cent. You may recall at the half year we were up 10 per cent, so up even better than we were at the first half stage. As you will see in this slide, the gap between operating profit and profit before tax is now closing as we got to the end of the NatWest integration.

The NatWest integration was completed in the first half of 2003 and so restructuring costs and integration costs, you see there on the slide, are down from £957 million in the prior year to £229 million in 2003. Just over £140 million of that was the completion of the NatWest integration in the first half, the remaining, some £85/86 million, to do with Citizens' acquisitions over the last couple of years and the starting of the integration of Churchill.

Overall the gap between operating profit and PBT closing, but in this year in particular it causes the PBT to be up much more than operating profit, PBT up 29 per cent.

Just looking then at that 11 per cent operating profit growth, i.e., £700 million up on the previous year, again we see a very good gap between our income growth and our cost growth. We have maintained a 3 per cent gap between income cost even after acquisitions - 5 per cent headline, even after acquisitions we are up 3 per cent, income ahead of costs, the same as we were at the half year, so that gap is being maintained.

Various numbers on this slide are obviously distorted a bit by acquisitions, including income, and obviously insurance claims now reflect four months of Churchill. We will cover that as we look at each Division. Provisions overall again we will cover in a bit more detail, but overall on an improving trend.

Just looking then at income across all of the Divisions, as in previous years a very good spread of income growth across each. This year there have been some distortions in the income line which I will take you, notably we have clearly made some acquisitions in the year and that does have an effect particular in some of the divisional lines.

The US dollar decline year on year does have an effect on some of the Divisions, notably Citizens and CBFM, and also the Competition Commission impact. As you know, we implemented from 1st January 2003 the remedies of the Competition Commission which has an impact on our overall income.

I thought I would try and help you through that with just an explanation of the various factors that have affected the individual income growth numbers of each of the Divisions.

Starting with the slide you have just seen, overall income growth up 14 per cent, and is split by Division. The first thing to mention then is the dollar impact on income. The 10 per cent decline in dollar year on year has an impact on CBFM, which clearly has North American income and earnings, and more notably in Citizens which is a US bank, as you know. Citizens income has been impacted by about 10 per cent year on year by the dollar. Overall at the Group level less material but, nevertheless, about a 1 per cent impact of the dollar in the Group numbers.

The Competition Commission - this is the remedies implementation that we implemented 1st January - clearly the biggest impact is in our Retail Division where the majority of the SME customers sit. Quite a hard number to be absolutely accurate on given the movement in interest rates year on year, given that we are growing that business and therefore we have more customers to apply the remedy to, but approximately 3 per cent impact on Retail income and, again, overall at the Group level about a 1 per cent impact.

Looking then at the acquisition and disposal effects, a number of Divisions clearly made acquisitions and a couple of disposals during the year, the biggest impact by far is in RBS Insurance where the Churchill acquisition actually added 29 per cent to the income growth in Direct Line, now RBS Insurance.

Putting that all together, we end up with an underlying growth column which if you put last year's growth in income numbers for each of these Divisions side by side that number it shows remarkable consistency in underlying income growth year on year, so further growth in income along the same lines and same trend as in previous years. In fact, you may recall at the half year when I tried to do something similar with you, I was getting an underlying income growth of about 11 per cent - we said - clearly by the full year we are now moving ahead of that.

Has this income growth been achieved at the expense of margins? Well, no, absolutely not. And more importantly for those of you that were not able to calculate it to two decimal places before, we have in fact done so for you on this slide. We are reporting a net interest margin to two decimal places for the first time in 2003: 2.97 per cent achieved.

That is about 3 basis points ahead of the guidance that we were indicating at the half year, really better assets spread in the second half than we were anticipating partly to do with mix, and a small benefit from the uptake in interest rates in the UK. Clearly we are a net beneficiary from the movement upwards of interest rates in that way and, therefore, we have benefited a little way from that.

But to recap, from last year 3.13 per cent on this slide down to 2.97 per cent, there are two main impacts. One, the Competition Commission impact does have a big chunk of that difference, as we have seen on income and therefore on margin, and secondly, the lower interest rate environment which does have an impact on deposit margins, particularly non-interest bearing deposits.

These are the two chunks of movement downwards from 3.13 per cent to 2.97 per cent, noticeably no individual product margin pressure that we are noticing, all to do with other technical factors or the lower interest rate environment.

Looking forward without putting numbers on it, net interest margin, clearly the interest rate outlook is not unhelpful. We are predicting probably a couple more quarter point increases in interest rates in the UK this year. That is not unhelpful to margin but in the scheme of things does not make that much difference overall and, therefore, on existing businesses a broadly neutral margin is what we would expect.

Then you add in First Active, which I am sure some of you have already, and First Active clearly is operating at lower margin, being principally in mortgages, so the combined Group just by adding the two together will produce a lower margin for the Group overall but, importantly, not driven by competitive pressure.

Turning to expenses, as last year expense growth is volume related right across the Group. I have already said that the gap between income and expenses has been maintained and, as we go through each Division, adjusting for acquisitions, we will see that expense growth has been maintained at or below income in all Divisions.

That positive gap we have already mentioned a couple of times clearly produces an improved cost:income ratio for the Group. We are now operating at a 42 per cent cost:income ratio, down 2 percentage points in full from last year and an improvement even from the first half.

Unfortunately with the rule of percentages 2 per cent may not sound very much compared to the heady days of moving from 59 per cent with NatWest down very rapidly, but you have to remember with an income base of ours now at £19 billion 2 per cent of that income is actually £380 million and certainly worth having. So we are very pleased with the way this is going, and you hear more from Fred Goodwin on this later in terms of where we expect this to go in the future.

Provisions: as I said earlier, the provisions charge is now showing an improving trend and the earlier metrics that we spoke about of credit quality are now coming through in terms of provision charge. The basis point charge is slightly down on last year and really it is the second half story here. The first half was bang in line with last year, in the second half we are probably showing about a 57 basis point charge, so that trend is definitely coming through, improvement mainly through corporate as we will see as we look at CBFM.

This is borne out really when you start looking at some of the other risk metrics that we monitor. Risk elements in lending and potential problem loans, combined down 5 per cent from both the half year and last year, so on an improving basis. We are maintaining provisions at about the same level as last year, however, which gives us an overall coverage improvement on a combined basis, up to 68 per cent from 65 per cent last year.

To recap before we look at each of the Divisions, we are seeing a strong and a consistent set of numbers here, and I think importantly we are seeing growth in operating profit before provisions, in other words, not distorted by movements up and down in provisions year on year. Operating profit before provisions is also up 11 per cent, operating profit after provisions is up 11 per cent, and our coverage of the provisions charge, i.e., profit before provisions still a very, very healthy 5.8 times - so profit before provisions some 5.8 times the provision charge!

Turning now to the individual Divisions. In CBFM the numbers are affected a little by acquisitions. You may recall that we acquired Dixon Motors in 2002 and Nordisk Renting in 2003. Just looking at them without acquisitions then, you see headline income growth up 10 per cent and expenses growth up 10 per cent, so expenses growing in line with income to support the strong volumes we have seen.

Again the problem here with the rule of numbers on percentages, it may look not that impressive to be growing income only at the same rate as expenses, however, if you are operating at a 28 per cent direct cost:income ratio, which we are in CBFM, that translates into income gap by more than £500 million for costs going up by some £160 million, so a very, very high level of gearing towards profitability from even 10 per cent income growing with 10 per cent expenses.

We are seeing good loan growth across CBFM, 9 per cent up on average year on year. The large corporates still subdued in terms of lending and borrowing from banks, and I will touch in a second on large corporate bond usage, but bank lending still pretty subdued in large corporate, but overall lending in the Division up 9 per cent on average.

The lendings margins have been maintained if not slightly improved; very good non-interest income growth; dealing revenues still very good in the second half, 10 per cent up on the previous year in the second half.

Capital market activity: this is the other side of the coin, if you like. We have very, very strong corporate customer relationships and we are now capable of offering them the alternative of bank borrowing in a way that we could not before. Traditional bank borrowing may be subdued, but we are now picking up rapidly our capital market business and from our corporate connections that we already have, so we are benefiting from our position in capital markets and from our strong customer relationships with them. Non-interest income is benefiting from that, that move in the last year.

Provisions: here we are seeing the improving trend coming through. The second half charge for provisions is £350 million against the first half of just over £400 million, so driving provision growth overall for the year only to be 4 per cent.

I would just like to pause for a second on the net interest income number. We are reporting here an actual 1 per cent decline in net interest income and I just wanted to highlight a couple of points for you on that.

Using this slide, a couple of things that you should be aware of within net interest income. First of all, it is improving. In the second half it was actually better than the first in terms of year on year growth, and I will come back to that in a second.

But, more importantly, what is in net interest income for us? Well, we actually have a very strong and growing operating lease and rental asset business. The funding cost of that appears in net interest income, the income from it is in Other income.

We pay the price for it in the net interest income line, so adjusting for that and also adjusting for the money market business which we indicated in the first half, given the interest rate environment, is less attractive year on year, in fact, the earnings from money markets is down slightly year on year, adjusting for just these two factors alone gets you to year on year NII growth of 3 per cent.

Remember, that is after some of the Competition Commission impact which does impact SME customers that do overlap to some extent into CBFM. You will remember from the earlier slide I said that the Competition Commission impact has about a 1 per cent hit on CBFM's total income, that is all in the net interest income line, so that is about a 2 per cent hit to the net interest income line.

Adjusting for all of these, you get back to a more understandable movement in net interest income and, more importantly, the trend in the second half as you look at that is showing an improving position.

Turning to Retail, again reminding you of the earlier slide, we did say that approximately 3 per cent impact of the Competition Commission impact on income. Here again it hits net interest income and total income for Retail, without which we would be seeing income growth of about 8 per cent, very similar to previous years, so a similar underlying trend of income growth. A very good lending growth, still average lending overall up 11 per cent, and deposits up on average about 6 per cent.

There has been good customer growth right across all the product areas and improving customer satisfaction. You will recall our rolling back the time in terms of putting telephony back into branches in NatWest - that has been very well received by customers - and we are receiving a lot of good credits for doing that. The Royal

Bank has always offered that; we are now the only bank to offer it right across the network.

In bancassurance, volume is getting better with improved market conditions, albeit still quite a small number for us so far. The provisions movement is entirely consistent with what we said at the first half and entirely consistent with what you would expect given the lending growth, particularly in NatWest over the last couple of years.

In Retail Direct, our other consumer-facing business, very strong income, similar to the first half, particularly so in supermarket banking through our joint venture with Tesco, extremely strong.

Mortgages: we have a very good position in mortgages with the One Account. Mortgages in the One Account are up 20 per cent year on year and we are now averaging over £7 billion in direct mortgages in this business, a very good improvement over the last couple of years. Other lending is pretty strong also and, of course, Cards going from strength to strength within all of that mix.

So another good story from the UK Retail Direct business and, of course, on top of that - Fred Goodwin will talk more later - we have added clearly a European dimension to this business, now more than we had before, and we have more recently added a United States dimension with the acquisition of the credit card business of People's Bank that we announced just a few weeks ago.

Turning to Manufacturing, those of you who remember the Manufacturing Conference we did in October will remember a couple of 'take-aways' probably from that conference. One, was that we do have an efficient manufacturing model that is scaleable and, secondly, that we are embarking and have already started on a programme of efficiency improvement driven through the manufacturing part of the Group but bringing improvements right across the Group.

Taking these two things, an efficient model is scaleable, absolutely, and in these numbers here, on the slide, an overall cost growth of 6 per cent, business as usual cost growth in manufacturing of about 3 per cent supporting double-digit volume and income growth right across the Group, so efficiency absolutely.

In terms of the efficiency programme, and again Fred Goodwin will talk more about this in terms of what we are aiming to do here, that is adding some costs to manufacturing in the next couple of years, certainly it started in 2003, and about 3 per cent of that cost growth is directly related to this specific programme. We are already getting benefits from it across the Group but the main driver of it, the main cost in improving it, is coming through the technology costs that you will see going up in the second half. As I say, Fred Goodwin will talk more on what is going to come from that, but it is absolutely the right thing to be doing.

In Wealth Management the underlying trends are much better than this slide would suggest. Remember we have exited a couple of businesses in this area in the last year, stockbroker-related, Miami-related. A good underlying performance coming through in the second half in particular with obviously the improved market conditions.

Just to demonstrate that a little clearer, just looking at the income line, headline income for the Division is down 3 per cent. If you take out the acquisitions and disposals and make it on a like-for-like basis we see a 1 per cent improvement in income now in that Division. But, more importantly, that splits really between two halves. In the first half we are still showing a decrease at that level given the stock market and market conditions in the first half. The second half income growth on a like-for-like basis is 6 per cent, so that is definitely showing an improving trend and one we are very happy with.

Turning to our Insurance businesses, clearly another very good year for Direct Line, on top of which we added Churchill on 1st September, so four months of Churchill in these numbers. Churchill clearly does distort the income line in particular and the claims line.

Looking at what was Direct Line without Churchill on this slide, excluding Churchill still a very good like-for-like performance from Direct Line. Continued good volume growth right across the various streams of business, good premium growth. Other income is only up 16 per cent, less impressive you may say, but that is still being affected by lower deposit rates. Other income is principally our investment income line and clearly the lower interest rate environment is less beneficial to that line but, nonetheless, there was a good overall income growth number of 25 per cent.

The costs are well under control and on the claims line the claim frequency is still very favourable and our overall claims management is still 'best in class' we think - claims management and claims inflation management still very much under control. Overall a very strong profit growth position, with the Churchill integration well underway and entirely on track.

Ulster Bank: there has been very good volume growth in Ulster Bank across mortgages in particular, loans and deposits. Right across the book we have seen strong growth, particularly in the second half. I think when we reported at the half year certainly the Republic of Ireland was still feeling a little bit slower than in prior years. That has come through stronger in the second half, so overall very, very good growth in income and very good growth in profits and ahead of where we were at the half year stage.

Turning to Citizens, another good year for Citizens. It is just a shame about the dollar in terms of looking at the Citizens numbers. Even with the dollar decline the sterling results are very impressive on their own, even in sterling our profits are up 12 per cent, however, it is much more relevant to look at the local currency performance of Citizens.

Here we have it on this slide, which is all in dollars. We have income growth up 16 per cent, contribution up 22 per cent in local currency. I will show you a slide in a second on acquisitions, but not much this year by way of acquisition impact. We are getting it from very strong volume growth in all of our areas, in New

England, in Mid-Atlantic and in supermarket banking. The low interest rate environment is clearly helping borrowing growth and lending growth.

The other side of that coin is that margin from the low interest rate is lower but overall net/net a very, very strong net interest and total income position, so volumes more than offsetting any margin decline as a result of lower interest rates in the United States.

It is still a very conservative lender. You will see the provisions line, on this slide, hardly moving year on year, still ‘best in class’ as far as US banks are concerned in terms of provision charge and provision coverage, so lending growth we are achieving is principally secured lending, very low charge off.

Just so that you have it, on this slide we have excluded the acquisitions from Citizens. You will still see profits in dollars up 16 per cent, excluding acquisitions.

As with the income slide the overall split of profit is very well spread across the Group. As you go down each Division, very good numbers even after some of the effects that we have seen, particularly the Competition Commission impact on Retail. We have now got five out of our seven customer-facing Divisions reporting double-digit income growth and profit growth - a very, very, strong spread right across the Group.

Earnings per share: as with profit before tax, some of the adjustments you have to make to get to our adjusted earnings per share are declining, that is the integration costs as a factor is much lower than the prior year.

In 2003, however, the AVS was a bigger payment than the previous year so net/net adjusted earnings per share up 11 per cent versus a basic of 15 per cent. The two are moving much more closer together now given the decline in integration costs and the final AVS payment in 2003 will make that even more clearer going forward.

The dividend cover is still a very strong 3.1 times, down a little bit from last year given that dividend growth is slightly ahead of adjusted earnings growth.

Turning lastly to capital, in a year that we have made many acquisitions, and indeed returned £1.5 billion to Shareholders by way of the Additional Value Share payment, we have actually improved our capital ratios overall thanks to the strong capital generation of the Group.

Tier 1 at the end of 2003 was 7.4 per cent, the equity element of that 5 per cent and total capital 11.8 per cent. To help you do the numbers in terms of the acquisitions that we have recently announced, the First Active and People's Bank credit card business would take the year end number to 7.1 per cent and 11.5 per cent.

That is all from me. I will now hand you over to Fred Goodwin!

MR. FRED GOODWIN (Group Chief Executive): Thank you, Fred, and good morning everyone. I would like to use my time with you this morning just to touch on a couple of particular features of our results and go into them in a bit more detail and then at the end come on to talk a little bit about the outlook. To avoid any unnecessary build up of suspense I will touch on acquisitions and capital at the end, just in case anyone is thinking of leaving! (Laughter)

The most obvious number it seems to me to talk about, and one of the most important numbers in our results, is obviously income and income growth. Behind the headline figure there is a story to tell and I would like to take some time this morning to take you through some of that story because I think it is very important that everyone understands and has a view as to the quality of the income we are generating and the quality of that growth.

That figure, on this slide, is either very impressive or could be very unimpressive if last year's figures were poor. As it happens, last year's figures were not poor so I would put it to you that this is good income growth. But, let me take you through some of the features of it and try and woo you round to that opinion.

This is an old slide, and I am not recycling old slides here but I think it did seem to bring some light to the subject when I put it up last year. I put it up again just to remind people that, yes, we got transaction benefits from NatWest and, yes, that process completed. I mentioned to you at the equivalent meeting to this last year that the integration benefits had all been delivered, but in the overall scheme of what had been going on in the Group they were but a small part of the income growth that we had achieved - over 70 per cent or £4 billion of the growth during that period was organic.

Taking those two figures and saying, ‘okay, what was our batting average during that three year period in terms of income growth? How much did we generate organically and how much did we generate in total?’ You will see the resulting figures on the slide. It struck me as one of the first things to do, was to say, ‘okay, how are we doing against that batting average? How do the 2003 results shape up?’

Well, they do shape up. The growth rate, the organic growth, is actually greater than the average during that period. That is what you would expect but it is worth just reconfirming that to ourselves. Of course, the income growth in total is markedly more than the average during the previous three years.

Another way to look at income growth and its quality is to compare it with others and to compare it with our peers. I do not propose today to go into the merits or demerits of individual competitors, there are significant events missing from some of the figures in this slide, not least the 2003 results in many cases. The Household acquisition clearly will make a big difference to HSBC. I put this slide up though to indicate that our income growth is of a different nature and of a different character to our competition and the stability and consistency of income growth puts us in a different category from our peers.

Looking at this another way, we fired the starting gun in 1999 and looked to just how income growth developed during that period. On this slide, that is how the income growth looks in pounds. Sometimes we get confused because Organisation A will grow by 10 per cent and we only grow by 10 per cent so they have done as well as us, but when it comes to actually growing income out in the High Street or out there in the big bad world it has got to be won pound by pound by pound, so I think it is valid to look at income growth by pounds.

I think it is world noting that during that period since 1999 we have grown our income by more than others who are on the slides, total income.

Looking at some of the diversity aspects, the income is quite widely based. I know some of you have attempted to work this slide out before - I grant you it is not easy from the published information - but to give you a sense of the split: Corporate Banking, predominantly UK but not exclusively UK, is 36 per cent; UK Personal 27 per cent; Insurance 16 per cent, and Overseas 21 per cent. Perhaps a different degree of diversity than many people thought!

This slide you have seen before but obviously the numbers have changed again. The proportion of non-interest income has grown again this year, the mix between deposits and assets roughly similar.

Looking inside that net interest income to get a sense of some of the components, I think again you start to see quite a diverse and quite a well balanced picture emerging. We do have a good spread of where we generate our interest income from: from personal deposits, from personal lending, business deposits and business lending, a fairly even split.

Looking within that, into I guess the hot topic at the moment, 'is personal lending in a bad place in the UK?' Incidentally, I don't think it is! But we will probably come back to that later in questions. If you look at the proportion of our income which is derived from consumer finance in the UK it is only 7 per cent, only 3 per cent of our income came from mortgages in the UK, so we are not particularly exposed even if you do think the outlook for personal lending is not benign which, as I say, is not our prognosis.

Looking at that non-interest income again, this slide shows a quick comparison with the peers. We do have a much bigger proportion of non-interest income than our peers.

Looking within it and giving you some insight into some of the components of that non-interest income, I did not think the net fees and commissions would be a particularly helpful topic or heading for you, so I thought I would break it out a little bit and give you a sense for the principal drivers there.

Money transmission, the day-to-day business of moving money around the place, which often gets overlooked as a business that we are pre-eminent in, in the United Kingdom, is 12 per cent of our income; cards-related income is only 4 per cent, another sort of 'hot potato' out there; and a variety of other things adding up to 7 per cent. Insurance we have touched on already.

Dealing profits: I am going to say quite a bit more about dealing profits, but it just worth reminding ourselves that dealing profits are only about 9 per cent of our total income.

Looking at them in more detail I think there was some concern at the Interims, or a degree of confusion around dealing profits at the Interims. Remember, when we are talking about dealing profits here we are talking about dealing profits before the associated costs, it is a statutory definition so we cannot change it, but dealing profits are not actually dealing profits, it is dealing income.

Point number one, and the overriding point, is that we do not particularly trade proprietarily, we trade for our customers and our business is driven by activity conducted for our customers. It leads to the shape you see on this slide there: foreign exchange, interest rate products, securities trading about 6 per cent; Greenwich Capital - I will talk quite a bit more about Greenwich Capital in a moment

- and the asset backed business that we talked about at the half year is 2 per cent of our total income, and the remainder of their business about 1 per cent. So 9 per cent of our total income is all that is derived from dealing profits.

This slide gives you a picture of dealing profits and I think it underscores the fact, or underscores two things really. One, this is related to the business of our customers. We are not in the market trading in a proprietary basis, this is business we do for our customers and as our customer base has grown so, general speaking, has the level of dealing profits.

Half One 2003 stands out, as we said it did, as a consequence of the particular circumstances which existed in the United States with regard to the mortgage backed securities trading which Greenwich is a major player in.

Again, with this slide, just reminding ourselves of the consistency of the proportion of dealing profits to our total income over that time - a very stable proportion!

Looking to another aspect of our results, efficiency, again it is pretty important I think. It is one thing to have good income growth but if at the same time you are sucking in costs at an alarming rate then you do destroy most if not all of the benefit. It is a subject, as you know, which is dear to our heart.

There on this slide are the bald facts of the matter, that you will be familiar with, a continuing improvement in the cost:income ratio, 2 whole percentage points off this year. I think the figure excluding acquisitions was something was 1.5/1.6.

I thought we could have another go at the 'Jaws' debate - it has caused much debate since the expression was first coined and first used, but it is interesting in talking with people that there are differing schools of thought whether (a) the 'Jaws' are opening or (b) the 'Jaws' are closing and whether it is good for the 'Jaws' to be opening or good for the 'Jaws' to be closing? Hopefully if we can maybe agree some consistent definitional context here I think it would help the debate as we go forward.

As we view it the ‘Jaws’ are the difference, as you see on the slide there, between our income and our expenses and in our view of the world the ‘Jaws’ are opening. For every pound of income we generate now 58 pence of it is profit, or at least before bad debts and so forth, whereas back in 1999 it was only 42.2 per cent. So the ‘Jaws’ are opening and the outlook for the ‘Jaws’ is that they will continue to open.

Just putting some flesh on that, I referred at the Interim Results and I think also at last year’s Full Year Results I mentioned in passing, that we were moving on to a programme, a specific programme, aimed at picking up some of the best practice from the NatWest integration and rolling it out more widely across the Group. That is indeed the case and that is what we have doing, and Fred touched on some of the consequences of that in his talk.

It is important to recognise it is a specific programme, it is being managed in the same way as we managed the NatWest integration, there are no below-the-line costs for it, all of the costs are taken ‘on the chin’ through the P&L. Fred mentioned some of the features that some of them fall in Manufacturing where the benefits fall elsewhere but they are all above-the-line costs.

It is a three year programme, it began this year and will roll through into 2005. What does that mean? Well, as again Fred said earlier, it is pretty much break-even this year. We spent a chunk of money and we got back benefits that covered that chunk of money and ‘washed our face’, and left things pretty much ‘line ball’.

During 2004 we will be spending more money but the rate of benefit pick-up will be greater, so the programme is profit positive during 2004. During 2005 the project will complete and by the end of 2005 the benefits will be in full flow, but it will be 2006 before we get a full year’s benefit of the full benefits.

The question that is forming in all your minds is, ‘yes, but how much?’ As ever, I am not deliberately going out of my way here to tease you, honestly, but it is difficult to predict. It depends on what the rest of the Group will look like at that time.

Obviously any acquisitions or any disposals would alter it, but as we stand here today if I could wave my magic wand and have the programme implemented now it would not be idle to speculate that the cost:income ratio would not begin with a ‘4’. You can go away and think about that and come back later! (Laughter) But it will move we believe to a number beginning with a ‘3’ - if it could be implemented today which of course it cannot!

Looking forward then, what are the strategic options we have? As again you will know, there is a consistent theme we have had, we try and not have a strategy, we just try and generate lots of options.

One things I thought might be helpful was to try and take the list of things we have bought this year, as shown on this slide, which at first blush or even second blush looks slightly eclectic, and persuade you that it does in fact fit entirely with the strategy which we have been articulating to you now for sometime.

To do this I am going to resort to my beloved ‘tick’ chart. You will be please to hear that I am not going to go through these tick by tick, I will just skip through them and show where the acquisitions fit in. I am also going to go on and give you quite a bit more granularity about what we are up to in each of the Divisions. But just at the outset for those collectors of the ‘tick’ charts these are still a definitive representation of our strategic thinking and the bias in our strategy, so the ticks are still valid albeit I will not be developing them very much today.

UK and Ireland then, Churchill and First Active: I am hedging my bets a bit down at the bottom of the slide. They are not strategic for the Group but they are highly strategic for Ulster Bank and for Direct Line, now RBS Insurance. I think everybody got where they fitted into the picture.

Continental Europe: as shown on this slide, that is what we said we would do and that is what we have done. We have acquired, if you like, sundry businesses, Nordisk Renting, Santander Direkt and Bank von Ernst. All fit into the category of businesses we have acquired to fit into the different Divisions.

In the United States, as shown on this slide, a slight variation of the theme. You would have spotted all of the Citizens' acquisitions fitting into the in-market acquisitions and mopping up of smaller banks. The acquisition of People's Bank (credit cards) was a slight departure from that. It was a desire to get a toe-hold in the United States credit card market, highly competitive we know but, by the way, the European market is pretty competitive too! It is a prime and super prime book we have bought with some quite interesting partnership business in it. I will come back and touch on that a little bit more in a moment.

As I say to try and give you some more flesh, I will put some more flesh on the bones around those and talk. I do not want to lose the geographic focus because I think that is helping people to frame what we doing, so I will retain the geographic focus but I will concentrate business by business what we are up to.

As ever in the interests of self-preservation a 'health warning' to start with. There was a 'health warning' when we first started to use the ticks and cross slides, and I am grateful to you all for observing that 'health warning'. What I am about to tell you, our options have been conditioned by how we see the world today and it is conditioned by opportunity. They may change, as indeed the next point highlights!

The world can change out there so we are not going to flog this to death. If the world changes and some of these things do not work anymore, fine, the beauty of having lots of strategic options is we can move on and develop others. And they are options, they are not promises. The other point I would make is that they are illustrative and by no means a comprehensive list of everything we are up to in each of the businesses.

I am not going to go through all of these in details but basically Corporate Banking and Financial Markets is a huge business, a huge business in the United Kingdom, and a long list of things that we are still able to do. We are outperforming in the mid-market, the mid-corporate and commercials and we see that continuing for sometime. We have made some quite big investments in our model of how we do business, to my mind it has echoes of what we have been doing with branches, and there is a degree of 'back to the future' here.

You will be astonished to learn that the more people we have on the ground speaking to customers the better our customers like us and, curiously, the more business we do and the less time those people have to spend doing administrative things the more time they have got to speak to customers, and the more people we have doing administrative things the better the service we provide to our customers. We are thinking of copywriting this! (Laughter) It is a tried and tested formula and it does seem to be delivering for us and we have made quite a big investment in that in the corporate bank.

Our position: we do have a strong position of large corporates and we are continuing to leverage that. The development of our Capital Markets business is not at all unconnected with the strong traditional banking relationships we have with our customers. As I say, I am not going to go through all of it.

Similarly in Retail Banking I am not going to go through all of it. In many respects it is a continuation of the same them, bancassurance picking up quite strongly now as the market starts to come back. We are stepping up our activity in direct sales. It is an area where traditionally we have not really done very much, our sales have been very heavily branch based. There is a big opportunity for us to do more directly and we are moving into that.

You have heard me before on the subject of bringing telephony back and our commitment to branches and having people in branches to speak to people. However old fashioned that sounds as well it has had a very positive impact on our business.

Retail Direct has had a very strong year and we see that continuing. Tesco Personal Finance continues to go from strength to strength, more and different products coming into that business and we see great opportunities there.

Merchant acquiring: we are a major player in merchant acquiring not just in the UK and we do see opportunities to develop that further.

Wealth Management: a distinctly more cheerful outlook now than there has been for sometime. Again perhaps in a somewhat almost traditional manner opening up Coutts offices in the regions seems to offer more profit opportunity than some of the more extravagant Coutts plans of yesteryear. Building an expatriate franchise - we are ideally placed to do that in offshore banking; indeed, we used to have a wonderful expatriate franchise in NatWest and that has been left to slip a little, and we are coming back into that.

RBS Insurance: dominated to the large degree by the Churchill integration, which I think is exactly as it should be. Just again just to confirm formally to you this morning, that integration is proceeding fully on track and is full delivering the benefits that we anticipate. We have validated all of the benefit we anticipated in the business case. Already popping out of it are a number of opportunities to enhance our business and develop it further.

Ulster Bank: a similar theme to Direct Line - or RBS Insurance I should say! - dominated by the integration of First Active and Ulster Bank. There are already a number of opportunities popping out. It is extremely early days, the acquisition was only completed on 5th January, but we can confirm again that the transaction benefits have all been validated and the transaction is fully on track.

I thought this slide might be helpful, before I go and talk about what we are up to Europe. You would not struggle to pull this together, you would not be able to pull this together because our activities in Europe are scattered through a number of the business Divisions and are not reported separated. But I thought it would give you a scoping shot or help you to scale what I am talking about by seeing what we have been up in Europe over the last few years as measured in terms of income.

You will see quite a marked step up in that income during the course of the year, in many instances achieved without the benefit of acquisitions. The RBS Insurance increase was not attributable to any acquisitions during the course of the year. We have made very strong headway in all of those businesses in Europe.

Against that backdrop, what are we up to? Well, maintaining organic growth at those sorts of rates does not seem like a bad idea and we will be doing that in corporate banking. We entered double our lead relationships. We are not going in to try and compete toe-to-toe in straightforward banking with the existing incumbents. We are looking to growing lending, yes, but also in combination with risk management products and some of our other financial markets products.

That said, it is interesting to see a number of the players, particularly in Germany now, really knuckling down to driving margin up. One of the issues that the business faces, particularly in Germany, is not lack of business or lack of people willing to do business but it is lack of margin that it would make it worth doing the business. Realities continue to encroach on the German banks and the margin environment is improving quite markedly in Germany now.

We continuing the rapid organic growth of our debt capital markets and Financial Institution coverage again, that is entrain, and, forgive the pun, what is also entrain is the further development of the Angel Trains business in Europe where we have already started to lease quite a bit of rolling stock.

On the acquisitions front, there may be some specialists businesses around the piece to pick up. I would not see any of them being large but there are some opportunities out there.

Retail Direct, represented principally by Comfort and Santander Direkt. It is quite a big business now, a lot of it concentrated in Germany. We are looking to develop further retail partnerships and, again, I am highly confident of our ability to do that. Tesco are in Hungary, you will know. We are launching a PFT offering through their business in the course of year. There are some businesses to pick up around Europe, again not very huge in the consumer finance and the cards area. And in merchant acquiring we have ambitions to develop that business further in Europe.

Wealth Management: picking up on the Bank von Ernst acquisition, it takes us into a number of new cities. There is a strong German connection in Bank von Ernst, as the name would suggest, which is how Montevideo makes it on to the screen; it wasn't one of those natural choices otherwise! And still some consolidation opportunities in Wealth Management although there are a lot of lame ducks out there, so it is not a huge range of opportunity.

RBS Insurance: it is worth reminding ourselves that RBS Insurance is the leading direct motor insurer in Spain and Italy already, albeit particularly in the case of Italy the market is quite small, but it reminds yourself of the rate that we growing that business organically. There may be some acquisition opportunities as well, but we will see!

Turning to the United States, again before diving in to talk about the United States it is probably worth just a ranging shot or a scoping or scaling shot here. That, as shown on this slide, is the business in terms of income which we generate in the United States, split between Citizens, Corporate Banking and Financial Markets.

As ever, to give you a sense of what is actually happening in the ground against the backdrop of the dollar depreciation this slide might be more helpful. Again you see that business growing quite dramatically. Fred has already covered off what is happening within Citizens but within Johnny's business a lot has been happening in the United States.

A lot of it, the vast majority of it in fact, is domiciled in RBS Greenwich Capital and I thought now might be a moment to give you a bit more insight into our RBS Greenwich Capital because it is something that is buried in the bowls of CBFM and it seems to be quite content to be there, to be honest! (Laughter) It is coming out of the undergrowth quite markedly.

It has a position of market leadership in the distribution of US fixed income securities, particularly US Treasuries but also asset-backed securities more generally. It is driven principally for institutional investors - we do not sell to the general public - and it is very much a business geared to the professional market. It has about 680 employees.

To give you a sense of its income and its performance, there are the figures in pounds on this slide. I guess this kind of explains why we do not talk very much about it. Although I guess, what's that, it must be about half of BarCaps profits of itself, it is less than 10 per cent of CBFM's profits. So that is why it does not really get much of an airing, it does not feature very largely in our minds.

It has good income growth, even in pounds. At the provisioning line it is not a mistake or it is not an accident. Greenwich Capital does run credit risk but it is perhaps of a more technical nature than actual, the credit quality is extremely good and we are not generally in the business of taking credit losses in Greenwich Capital. It is managed very conservatively in that sense.

Where does it sit? There is some other granularity around. Well it is, and I would say this, but it is getting towards pre-eminence in its own particular field. In the *Institutional Investors* magazine, as shown here on this slide, those were the rankings of its sales team last year - we came out number one against some quite stiff opposition.

The Orion Consultants' rankings are considered to be definitive in this area also. You can see our rankings on this slide - I don't think you need to read all of it as the print might be a bit small - but you will see our rankings not just in 2003 but also in 2002. Greenwich Capital is right up there as a major player in this particular, I hesitate to say niche market, but it is a very particular market.

Against that backdrop then, what are the prospects for CBFM in America? Well, we do aim to build on the successes we already have. We are growing our Acquisition Finance, our Asset Finance and Project Finance businesses in the United States. Greenwich Capital will continue on its organic path and we will be doing more in the debt capital markets in the US in due course, but leveraging that Greenwich infrastructure.

Citizens: more of the same, I guess! Continuing the very strong organic growth we have seen both in New England and Mid-Atlantic. In the short to medium term we see the acquisition of Fleet by the Bank of America as being an opportunity.

Beyond that, I think it would probably be fair to say that Bank of America would be a better or a more challenging competitor than Fleet has been over the years, at least we would expect Bank of America not to trip over its shoelaces as often as Fleet did, so things will toughen up in due course. But in the short to medium term we see quite a significant opportunity to pick up and capitalise on being the New England bank which Fleet no longer are.

We do aim to expand in New England, particularly through the supermarket banking franchise. The Stop-in-Shop has proved to be an extremely valuable partnership for us and there are opportunities to develop that in ways not unadjacent to Tesco Personal Finance.

Citizens has also had a growing business selling more sophisticated products to its customers underwritten and manufactured, to use that expression, on the Royal Bank platform. We do not want Citizens to get any fancy product capability or any sophisticated risk management - we have got that and it is on the Royal Bank balance sheet - but it has proved very successful Citizens selling those products.

The acquisition strategy is unchanged. There is no change to our acquisition outlook or appetites in relation to Citizens.

In Retail Direct and the People's (credit card) business I mentioned earlier, as well as servicing People's own customer base, which we will continue to do, we will put the Citizens customer base on to it. About 90 per cent of its customers are non-People's customers there. It is already a distributed national business and we would be highly confident of our ability to sign up further retailers to that operation.

Rest of the World: the Rest of the World does not usually feature but I think it rates a mention at the moment. We are seeing in Asia distinct opportunities at the moment. The Financial Markets business that we have is growing well in Hong Kong, Singapore and Tokyo, and we are growing well in Australia in particular niche activities.

We will see what is going on, I do not think we will be rushing headlong into China, although as it happens I am going to China next week to open our branch in Shanghai. In Wealth Management we are seeing some quite dramatic growth in Wealth Management in Asia and we are riding that particular 'tiger' as it goes forward.

The suspense is killing you, I know! (Laughter) Acquisitions and capital.

Acquisitions: what can I say to you about acquisitions that has not been said before? Well, I apologise in advance, this is going to be a statement of the blindingly obvious. We can now fund smaller acquisitions from own resources. We funded somewhere in the order of £2.7 billion worth in the course of the last year from our own resources and the prospects of being able to do that going forward continue.

It seems to me that the way we go about acquisitions must be completely divorced from how they are being funded. Where the money comes from should not influenced the discipline around acquisitions and that is the case, that is the frame of mind with which we approach this. A 12 per cent post-tax return is required.

We do monitor centrally the delivery of all of the businesses we buy, we do not just buy it and let the business themselves get on and run it. They are monitored in a high disciplined way, in exactly the same way as we did for the NatWest integration.

And we are completely committed to transparency of material synergies, in other words, where we make a big acquisition or where there is a larger acquisition that hinges heavily on transaction benefits we will tell you what they are and we will report against them.

We actually benefited greatly by doing that during the NatWest transaction. Had we not published the benefits and had we not held ourselves up to be accountable against them I do not think we would have made that acquisition happen as well or the integration happen as well as it did. So we are completely committed to transparency around the synergies, in the event that there were any material synergies around.

Again the blindingly obvious, we are not just going to go out and make acquisitions to provide sport and entertainment for commentators - although it would appear that not making them causes as much sport and entertainment and making them! (Laughter) - but we do not do acquisitions for fund. I made the comment in connection with First Active, we do not buy businesses just fun; they like puppies, we do not buy them just for Christmas! We do not do acquisitions for fun. If there are no acquisitions that make sense we are not going to do any.

Capital: I have a nice graph coming up after this one, and let's see if it hits the spot! A conditioning shot, capital ratios as published, 7.4 per cent at December. If we take out, of you like, the existing commitments to pay for First Active - which in fact has already been paid for - and assuming People's Bank (credit cards) gets regulatory approval, would take the ratio down to 7.1 per cent before this year's profits and capital generation come in.

Again to give you a sense, it costs £300 million in capital to move our Tier 1 ratio by 0.1 per cent.

Here is the chart, and let's see if this helps you do your own ready reckoner for capital. I think I said before, but again just in case people did not hear it or you became confused, I would feel slightly embarrassed if the world that we live in today - if the things changed dramatically and the risk outlook and then maybe 8 per cent Tier 1 is a good number! - but in the world we live in today I think there would be quite a lot of pressure to repay capital if we got beyond 8 per cent. I would say we would probably buy-back if we got into that territory. I am really committing myself here!

If we were in what has historically been our target zone of 6.5 per cent to 7 per cent I think it is not impossible to do buy-backs but it is less likely, which leaves the 'Maybe' range. For those of you who carry around some notion of what our surplus capital might be during the course of this year, let me just put it to you that we will be in the 'Maybe' zone for all of 2004.

We would have to make over £3 billion surplus capital during the year to get us out of the 'Maybe' zone. I do not think I am giving away any big secrets here to say it is unlikely, as things currently stand, that we would generate more than £3 billion of surplus capital during the year. So, we are in the 'Maybe' box. I hope this is helpful! (Laughter)

Here we are, we are at the end.

Summary: we have got good income momentum and so much in the business, in any business, hangs from your income momentum. If you have not got income momentum you kind of got a problem, it is just a question of when it is going to catch up with you.

Our efficiency is improving and it is going to improve further.

We are generating a lot of capital. We do have strong capital generation, which feels like a good place to be notwithstanding that it causes of a lot of *Angst* out there, people have uncertainty about what we are going to do with it. It feels a lot better than not having strong capital generation. Those seem to be the two available choices. I think on balance I prefer to be a strong generator of capital.

We have got a lot of strategic options. The fact of the matter is none of us know what is going to happen, how the world is going to turn out. The certainty of the matter is that some of the things we are planning and doing just now will not seem like such great ideas as we get nearer to doing them, which is why I think our approach of having lots of options gives us real flexibility and helps us to maintain that income growth going forward.

I do believe we are well positioned for the future and we will be very happy to try and answer any questions you have got around that. Thank you very much.

THE CHAIRMAN: Thank you, Fred. Now we come to question time. There will be someone with a microphone, and if you could identify yourselves when you ask the question that would be helpful. Thank you.

Over there at the back!

MR. JAMES EDEN (Commerzbank): Good morning. I have got two questions please and the first is on capital. Now I accept that your recent acquisitions have represented very sensible use of surplus capital but my feeling is that your job is not just to make sensible use of surplus capital, it is to put it to the best possible use.

Now if you think your shares are as cheap as I think they are then share buy-backs will be not just earnings accretive but also value creative and may have represented the best possible use of that capital. When you consider acquisitions do you compare them with the alternative of just buying your own shares back?

MR. GOODWIN: Yes, is the short answer, James. But, I think we have got to recognise that this is a long term game. Our share price goes up and down every five minutes and that is up to you guys, that is the market. Every rumour that comes along makes our share price go up and down, so I find it quite hard to make very scientific comparisons with the share price on a particular day: should we buy First Active? Should we not? Someone comes out with a stupid story that we are buying something or not buying something the share price goes ‘Clunk’ and you go, ‘well, we better do buy-backs today. First Active is not a good idea’. Anyway, I just pick First Active as it is the most recent substantial one.

It seems to me that we are here to deliver long term sustainable value for our Shareholders and if we are not meant to be doing that someone should tell me. In that context it is important that we keep that income momentum going forward and that we maintain our ability to generate income going forward and we increase our ability to generate strategic options going forward.

The last organisation I can see that got itself so hung up on returns and relative returns was Lloyds, and Lloyds have now got themselves in a place I think they are going to find very difficult to get out of because they did not expand their business, they did not develop strategic options.

As it is, there is no question in my mind whatsoever that the capital we have deployed on, say, First Active, just as a case in point, was extremely well deployed. Even if you value the future business growth at nothing and even if you do not value any of the strategic options which that gives us at anything, the simple synergies that come out of bringing that business together, together with our funding cost, make it a very attractive transaction.

To the generality, yes, we should think about share buy-backs but the vagaries of the day-to-day share price and the need to generate long term value for Shareholders I think take us into a place that is maybe more measured than the one you suggest.

MR. EDEN: Okay. Thank you. My second question please is on interest rates. I think you would encourage us to believe that rising interest rates are good news for Shareholders because of the impact on margins. I wondered at what level of interest rates you thought rising interest rates would be bad news because the financial nemesis would outweigh the positive impact on margins?

MR. GOODWIN: I am not a big one for financial nemesis, as I think I am on record as having said before. The simplest way to answer it is that I do not see interest rates getting anywhere close to those that would cause there to be a marked step up in bad debts, certainly not in our book.

It is interesting, a lot of the credit that was put on the books was put on at interest rates that were higher than they are today so, in fact, the customers have, if you like, enjoyed a benefit of lower interest rates but the credit was affordable at a higher rate. I do not see it going back to any of those rates. Fred mentioned earlier maybe one, maybe two 25 basis point rises for the rest of this year, that is the kind of territory we are in. Beyond that, again not a sense that interest rates are going to ramp up, so I do not see them getting to a level that would cause particular bad debt stress to us.

MR. EDEN: Thank you very much indeed.

THE CHAIRMAN: Simon!

MR. SIMON SAMUELS (Citigroup Smith Barney): Thank you very much. I have two questions actually. One is on the sort of aspirational cost:income starting with a ‘3’ instead of a ‘4’ by kind of 2006, can you just give us a sense of what kind of revenue expectations you factored in, in getting to that number? I assume you are not going to tell us your revenue forecast! (Laughter)

MR. GOODWIN: I was just about too. You have stopped me now! (Laughter)

MR. SAMUELS: Maybe alternative flying! (Laughter) I suppose in terms of acceleration/deceleration, maintenance of pace, of revenue growth versus, say, the preceding three or four years?

And there is a second unrelated question as well.

MR. GOODWIN: If you remember that line, Simon, of our income growth rebased back to 1999, I would not be encouraging anyone to think of revenue growth slowing down. There is a revenue element in the Group Value Programme, as it is called internally, but to my mind it is skewed, there is a big cost component in it.

Where the trade-off comes it is in, if you like, costs avoided. It gives us capability such that going forward we do not have to put cost on at the same rate as we do into the face of the income growth we have got. But it is probably two-thirds cost oriented, one-third revenue oriented, albeit it will come through in cost avoidance rather than cost reduction.

MR. SAMUELS: Thank you. The unrelated question, I am just trying to get a sense of some volume growth trends between the first and second half of the year. In Retail Banking it looks like there has been a significant acceleration in mortgage market share in the second half of the year, you seem to have put on about a net £3 billion of sterling of mortgage balances from June to December. One is, can somebody just talk around what the trends are there and what your aspirations are for market share in that market?

Then secondly, and I guessing it might be an exchange rate.....

THE CHAIRMAN: Can we take one at a time, Simon?

MR. SAMUEL: Yes, okay. Fine!

THE CHAIRMAN: Benny!

MR. BENNY HIGGINS: We have had a good second half on mortgages, we have actually also increased our margin over the course of the year, so we have not been chasing it through price. We do not have market share aspirations in any of the parts of the market, we have aspirations to meet our customers' needs but also to grow our income.

I think it is interesting that if you look over the last four years in Retail we have grown our income by 7 per cent, 10 per cent, 8 per cent and then the underlying this year, as both Freds have alluded to, has been 8 per cent. It has been a good second half but it has been around meeting customers' needs and good sales process.

MR. SAMUELS: The last question I guess is for Johnny on the CBFM business. The total assets are down sharply from the June position, that is excluding reverse repros, and I think more interestingly loans and advances to customers are basically flat against the June position having grown nicely in the first half. I do not know how much that is currency, but I was wondering again if you could talk around the issues there?

MR. JOHNNY CAMERON: The big point is the one that Fred Watt referred to, which is that the mid-market business has held up well and has just continued its growth pattern in terms of loans and advances to customers. In the large corporate market while commitments and therefore risk rated assets are in a perfectly satisfactory place, drawings - actual loan assets on the book - in the large corporate market are down, as you rightly point out.

I think that reflects two things, one is that large companies have repaired their balance sheets to a large degree over the last year or so and, secondly, a continuing trend towards capital markets. The good news there is we have sort of ridden that 'tiger' very successfully which is why we got more than our fair share of that refinancing and fees that are associated with it.

THE CHAIRMAN: Robert!

MR. ROBERT LAW (Lehman Brothers): Could I continue the trend with two questions please? Firstly on this cost target, can I just confirm that without this planned programme you would be expecting the Group organically to continue to generate efficiency gains, so you are inviting us to factor in I suppose something like £400 million of profit benefit from this programme? Is that correct? That is what I am asking.

MR. GOODWIN: I never presumed to invite you to do anything, Robert, but you guys will do what do you! We have highlighted this as a separate item over and above the trend, if you like, and I have said beginning with a '3'. I did not say what the second digit was. But this does not reflect a slowing down in the efficiency improvement that we have been achieving, it reflects a specific activity which we think is bringing over and above that benefit. I am not trying to use 'smoking mirrors' here to dress something up as a special programme that is happening anyway, this is over and above what was happening.

MR. LAW: Sure! What I am just trying to clarify is the answer to a previous question and talking about cost avoidance was one of the issues. I am saying without this does your 'Jaws', if you like, start to narrow?

MR. GOODWIN: No, the 'Jaws' would stay where they are or continue to improve, but at the rate at which we put on extra cost as the income grows will decline as a result of the GVP, the Group Value Programme exercise.

MR. LAW: Thank you. Secondly and unrelated, at the risk of another graph, I think earlier you have commented about the level of ordinary equity, or equity Tier 1, that you think is appropriate and there was some mention of strengthening that. Can you update us on your thoughts on that now?

MR. GOODWIN: I don't know that I did, Robert. I don't distinguish. The Tier 1 is Tier 1! The ordinary equity component of it, and clearly there is an element of it, there is ordinary equity and a element of it is prefs. We focus around Tier 1 because it is a technical measure for a specific purpose and a specific situation and for that specific purpose and in that specific situation prefs. count the same as equity, so ordinary equity content is not one that we monitor. It is not one we work to. We do believe that leveraging that with prefs. is in our Shareholders' interests up to a point.

I think one of the opportunities going forward might be to retire some of the prefs. which we have which is quite expensive. We have done a chunk of that during the course of this year, there is maybe some more we will do, and maybe in the course of getting up to, if we were heading up towards the 8 per cent figure, for instance, we may take the prefs. content a bit, so I guess it is another one of the variables.

THE CHAIRMAN: Peter!

MR. PETER TOEMAN (Morgan Stanley): Going back to Simon's point, I am looking at the average balance sheet for UK lending, that was up about 9 per cent year on year but it was up by 11 per cent in the first half, so it seems that underlying sterling lending growth is about 7 per cent in H2. I wondered what lies behind that and what the outlook is for 2004?

MR. GOODWIN: Maybe Johnny again!

MR. WATT: There is a technical response, and maybe Johnny will pick up the rest! Technically on the establishment of some of the branches overseas we did in the second half move some of the lending to overseas, so you probably see the counterpoint, being overseas lending going up on that basis quite strongly in the second half. It is not by much but it does distort the figure slightly.

MR. CAMERON: Just expanding slightly on my previous answer, if you look at the mid-market it is very much a game of two halves. The mid-market business is absolutely rock steady and indeed if you look at our share, which we can, of NBBG lending statistics to P&FCs we have grown market share both in the first half and the second half, so we are very comfortable with our relative position in our mid-market.

I have not got much to add to the large companies, only to say as a sort of minor point of detail, we happen to have two or even three fairly significant underwritings on our books in June and do not have particularly significant underwritings on our books in December, which is a technical point but has a slightly distorted half on half comparison.

THE CHAIRMAN: We do not see that as a fall in our market share with the large companies?

MR. CAMERON: Absolutely not! As I say, for commitments to the large companies the trends are fine but drawings in large companies are down.

THE CHAIRMAN: Mark!

MR. MARK THOMAS (Fox Pitt Kelton): Three very quick questions, if I may. The provisioning trend in Retail is obviously rising faster than loans. I was wondering when we can expect that trend to reverse?

Secondly, could you just give us a quick update on what you expect from the pension fund review which is obviously coming up in the first half?

And thirdly, have there been any changes in terms of fraud costs which would distort any of the ratios?

THE CHAIRMAN: Benny!

MR. HIGGINS: The position on provisions in Retail is quite straightforward. If we go back to 2000 and NatWest, the legacy position was that as a result of prudent - excessively prudent! - provisioning and therefore the concomitant releases of provisions allied with lacklustre lending, the provisions within NatWest Retail were incredibly low, in fact, they were kind of getting towards zero! Therefore, the year on year increases have to be put in that context.

If we look at the new provisions this year and were to compare them as a percentage of our non-mortgage lending versus other Retail Banks we will see that, in fact, it is still slightly below though much closer to the competition than it was before. There is still a bit of catching up to do there and, indeed, last year we also as a result of very good performance in terms of bad debts on mortgages were able to release some provisions.

This year we will see in the increase in provisions ahead of lending, but by the end of this year we will be pretty much at the end of that and we will be expecting provisions to grow much more in line with the lending book.

THE CHAIRMAN: Fred, do you want to comment?

MR. WATT: On the second point, the pensions review, I assume you are talking about the actuarial review of our main pension schemes. I do not know where that will end up but all I can tell you, maybe to be helpful, is on the FRS 17 position it is virtually unchanged year on year. The FRS 17 deficit is almost identical to the previous year's position, a combination of equity markets moving in our favour but clearly bond rates and inflation moving against our previous assumptions, so flat year on year.

THE CHAIRMAN: And the last question was on fraud!

MR. HIGGINS: It is certainly an industry trend, fraud costs; it is not so much increasing it is where they land. Credit card fraud costs have been on a declining trend and that has moved fraud costs to other lines and as a result debit card fraud and cheque fraud has actually increased. I guess the future will be 'more of the same'. As we get on top of it as an industry fraud moves to areas where it has hitherto not been.

MR. THOMAS RAYNER (Citigroup Smith Barney): Can I just ask you on your provision charge as a percentage of loans, which has been very stable in the full year at 57 basis point, but if you look at the half on half split there seems to be quite big swings between the domestic charge first half/second half and the foreign charge first half/second half. Are there some ‘funny’ effects there? What is the actually trend in both the domestic and foreign?

THE CHAIRMAN: Fred!

MR. WATT: I believe it consistent, Tom. It could well be affected by the same point I was saying in terms of the question about the European branches where we have moved loans to branch domicile, if you like, now that we have established branches in Europe. We are not seeing any trend over the whole piece that you should be concerned about.

MR. RAYNER: So the second half Group charge is probably a better thing to look at?

MR. WATT: Yes, I would say so.

MR. RAYNER: Okay. Thank you.

THE CHAIRMAN: Any other questions? Yes - and then you are next in line!

MR. JOSEPH ROWAN (Insight) Just a question for Annette on the Insurance Division. If you could just comment on the rating environment for the General Insurance business and just an outlook for the premium environment going forward please?

THE CHAIRMAN: Annette!

MS. ANNETTE COURT: Sure! Over the last year we have seen Motor rate increases in the market place of around the 1-2 per cent order alongside claims inflation of around 6 per cent, so you question how sustainable that is going forward? But those are the kind of rate increases that we are seeing coming through. We have essentially put our rates up slightly higher than that in line with what we are seeing coming through with regard to claims inflation.

On Homes, a slightly different position with regard to rate inflation, with slightly higher increases coming through and more in line with what we are seeing with regard Home claims inflation.

THE CHAIRMAN: Martin! There is a microphone coming.

MR. MARTIN CROSS (Teather & Greenwood): Assuming the Tier 1 ratio remains in the 'Maybe' range of 7-8 per cent, could I ask you to rearticulate your policy on ordinary dividends? They went up faster than underlying earnings in 2003. Can we expect that trend to continue?

MR. GOODWIN: I guess dividend policy is one that usually gets made up at the time, Martin. I think as far as track records are concerned, you will see a track record there that we would be loathed to break - we are growing at 15 per cent a year I think for the 11th year in succession - but, as you know, we would only make that decision at the time.

I think it is important to try and be helpful in setting dividend policy, to try and set a dividend policy that is sustainable I think. Dividends that go up and down and up and down have not historically found favour with investors, so when looking to dividend policy we are looking for consistency over the longer term. I do not think - it is clear the Board will make their mind up on it - but in setting a dividend policy I do not think I would be greatly influenced by what the Tier 1 is at that particular moment, it would be more to looking forward.

MR. JAMES CHAPPELL (Goldman Sachs): Fred, I wonder if you could clarify? You used the comment earlier, you said where money comes from should not influence acquisitions and you said you historically targeted a Tier 1 of between 6½ and 7 per cent. I am sort of intrigued that the top end of your range you have used for your Tier 1 is actually 8 per cent and that it seems to imply - you have used the comment 'war chest' before in the first half - the £3 billion seems like quite a large 'war chest' to be sitting with!

MR. GOODWIN: Let me just put that one to bed straightaway! Having gone out of my way to express our views on ‘war chests’ I want to be completely clear about that, I highlighted 8 per cent as to where the boundary between ‘Maybe’ and ‘Probably’ exists. I did not say it was a level to which we would go before we would do any buy-backs, I was just giving you a gradation of our sentiment around buy-backs and that is all it was intended to be. My previous comments about ‘war chests’ stand, ‘war chests’ are not a good thing to have. (A pause)

THE CHAIRMAN: Is that it? Over there!

MR. DANIEL DAVIES (ABN Amro): Just one little thing. In the Other Income, Other category, there is quite a big swing of £220 million in 2003 on 2002. That seems to be about half in CBFM and half in Insurance. Could you give us any more colour on what sort of things that Other Income refers to?

MR. WATT: Absolutely! In CBFM I mentioned that Dixon Motors was acquired and that is where that income sit, it is not a banking product, it is an Other Income product. The other one you have correctly spotted is in Insurance. The acquisition of Churchill, for example, investment income on the book goes into Other Income and not anywhere else. So you are absolutely right, that is where it is and that what explains the movement.

THE CHAIRMAN: Thank you, Fred. (A pause) Well, thank you all very much, ladies and gentlemen.

(The proceedings then terminated).