



# RBS H1 13 results

## Analyst call

Held at the offices of the Company  
280 Bishopsgate London EC2M 4RB  
on Friday 2<sup>nd</sup> August 2013

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## Presenters

### **Stephen Hester**

*The Royal Bank of Scotland – Group Chief Executive Officer*

### **Bruce Van Saun**

*The Royal Bank of Scotland – Group Finance Director*

# Presentation

## Operator

Good morning ladies and gentlemen, today's conference call will be hosted by Stephen Hester, Group Chief Executive of RBS. Please go ahead, Stephen.

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## **Stephen Hester** – *Group CEO, RBS*

Good morning everyone and thank you for joining us for our half year conference call. Hopefully you've all picked up the different materials on our website; slides, there's a webcast of Philip and Bruce and I, and all the different analytical materials and so on as well. I will make a couple of introductory remarks; Bruce will go over at a very high level the numbers, but you've seen most of them; and then we'll spend most of our time on Q&A. Philip Hampton is here as well for anyone who might have questions for him. Simply, all I would say, I think, is that we, I believe, have two quite cheerful things that we're reporting today. I'm delighted that we're reporting my successor as Chief Executive, Ross McEwan; of course, I'm biased because I hired him a year ago, but he's a terrific person, very accomplished executive, and I wish him well and will work very closely with him over the next two months, for him to take over at the beginning of October, and obviously there'll be plenty of opportunities in the coming months for you all to see and touch and feel him as he steps into his new role. So, I think that is a very good result for RBS, an ending of one kind of uncertainty, and good also that it's an internal appointment, I think for all of our people. The other cheerful point, I believe, is our results. Of course, it's nice at headline level to be in a billion four in profit for the half against a billion seven in loss last year, but I think that throughout the results, all of the things that people have worried about vis a vis us and other banks, we're producing some good answers to, whether that be 50 basis points up in the quarter in fully loaded Basel capital ratios, whether that be a bank leverage ratio of 3.4%, whether that be Non-Core assets upgrading our targets for disposal, Non-Core coming down, the balance sheet is 720 billion below its peak, and by the end of this year we think we'll only have 37 billion left to go. And indeed, Irish and Non-Core losses are 90% below their peak, so hopefully we're getting quite close to delivering a bank which will allow Ross to focus on the future rather than on the past, and to drive the operational improvements that together with an improving economy are the next thing that we need. Our core businesses are resilient, but they're not moving forward. I hope the environment will change to allow that, as well as our efforts, which are building the foundations for that. The Markets restructuring is a particular feature which Bruce has provided more data on in his slides, but all in all, I think we feel that these are a decent set of results; they show where our

problems are ending, and they show the problems we've still got to grapple with on an ongoing basis. With that, let me hand over to Bruce.

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**Bruce Van Saun** – *Group Finance Director, RBS*

Thanks Stephen, and good day everyone. Our first half operating profit of 1.7 billion was up 5% on a year ago. Income declined versus last year, reflecting lower revenues in Markets as we resize and reshape the business. Offsetting this were continued tight management of expenses and an improving impairments picture. At the bottom line we recorded a second consecutive quarter of profit, as Stephen mentioned, over half a billion Pounds so far this year. The fully loaded B3 CT1 ratio has strengthened considerably year to date; it's now up to 8.7% and our TNAV per share is stable year to date. Our core results are broadly stable in Retail and Commercial, while Markets performance reflects the decision to resize and reshape the business. Core ROE for the first half was 7.4%; excluding Ulster this was 9.4%. Ulster Bank losses were lower by over 200 million in the half, as the economic picture stabilises in Ireland and our credit costs decline. Non-Core continued to make good progress this half; third party assets declined to 45 billion, and given the strong first half performance, we've set a lower end target of 36 to 38 billion. Our cost to run the down the portfolio continues to decrease as well, as the bottom line loss declined 42% year on year to 800 million.

Turning to the balance sheet, our balance sheet is strong and our liquidity and funding matrix now compare favourably to our peers. We continue to strengthen our capital base, our half year fully loaded B3 of 8.7% puts us in a good position to hit our year end target of 9% plus, as well as the 2014 target of around 10%. We highlight in our slide pack updates on two key initiatives; first on expenses and second on our Markets reshape and resize which I draw your attention to.

So, to sum up, our core businesses have produced resilient performances and our franchises are maintaining their strong market positions. We've continued to make good progress on our capital plan, the run down of Non-Core, and on the safety and soundness agenda. The balance sheet is strong and we are ready to land. We still have some major milestones ahead, but we continue to make good and steady progress. Back to you, Stephen.

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**Stephen Hester** – *Group CEO, RBS*

Thank you, Bruce. Let's go straight to questions; operator, if you could handle that please?



# Questions and Answers

## **Operator**

Thank you, Stephen. Ladies and gentlemen, if you would like to ask a question please press the star key followed by the digit one on your telephone keypad. We will pause for a moment to give everyone an opportunity to signal for questions. Your first question comes from Rohith Chandra-Rajan from Barclays. Your line is now open.

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## **Rohith Chandra-Rajan – Barclays**

Good morning; a couple of questions on the Markets business, if I could; the first one is on the revenue performance in the quarter, which was down 20 odd percent, which I guess is pretty much in line with what we've seen for FICC across the industry. I'm just wondering about sort of, the interplay; you mentioned in Q1 I think, a weak Q1 performance partly attributed to, I think you called it, a dialling down of risk. Just going forward in terms of the moving parts; risk appetite, restructuring and market moves; how we should think about the interplay of those two things when thinking about forecasting Markets revenues? And I have a follow up as well, please.

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## **Bruce Van Saun – Group Finance Director, RBS**

Yes, sure. I think our second quarter, as you say, was roughly in line, if not slightly better sequentially, but again, that comes off a weaker first quarter. I think in the first quarter the market conditions were somewhat treacherous, and because of some of the personnel departures that we had, we also decided to take down risk. We're still running a pretty controlled risk position through the second quarter, but again, I think the business is stabilising, I think we have a very clear strategy of what we need to focus on; we need to bring the cost base down; you're going to see more of that happening in the second half of the year, and so the kind of model that we lay out in some of these slides of low threes of revenue getting to low twos in expenses, we think we'll be able to deliver that towards the end of 2014. We're bringing the capital out and so you put that mass together and we can get to, I think, a 10% ROE again, with a basically very focused and smaller business. So, I'd say so far in Q3 we're off to a decent start, and I think the outlook for the second half will depend mostly on the market conditions. If we see opportunities to put a little risk back on and take advantage of market moves, we will.

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**Stephen Hester** – *Group CEO, RBS*

And also, buried in the slides on Markets is an implicit upgrade in capital release, because we're saying although 80 billion was the Markets end target, within that are 12 billion or so of what we call passive RWAs, which we will run off and maybe run off within the period, so the end point on markets is more like 65, 68 billion, which is roughly 15% of our RWAs, and so there's a bit more capital release to go there, depending on when we can get that out.

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**Rohith Chandra-Rajan** – *Barclays*

Okay, thank you, which was my second question actually; part of my second question was the pace of the run off of, that legacy asset portion, which you just answered. The other part actually, was just in terms of looking at the Basel III inflation and the mitigation, so 38 billion of inflation, 29 billion of mitigation; I was just wondering if you could outline perhaps what the key parts of that mitigation are, and how confident you are of achieving it, or what needs to happen for it to be achieved?

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**Bruce Van Saun** – *Group Finance Director, RBS*

Yes, sure, I think a good amount of that is just continuing to shrink the balance sheet and run down the positions, so we have that slotted in, business by business, and we'll do it in an efficient way so there's no friction in getting to those levels, and without, we think, ultimately disrupting the strength of our franchise. We also have certain model approvals that we're still waiting for, which I think put us back in line with peers and we think some of those are imminent. We also look to run down some of our securitisation positions which are particularly harder hit under the new Basel III rule, so I would say it's really those three things.

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**Rohith Chandra-Rajan** – *Barclays*

And just on the asset reduction, Bruce, is that part of the FLB III mitigation, or what you call business mitigation?

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**Bruce Van Saun** – *Group Finance Director, RBS*

It's most...it's more business.

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**Rohith Chandra-Rajan** – *Barclays*

It's the business part, so that 29 billion Basel three mitigation is model changes and securitisation?

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**Bruce Van Saun** – *Group Finance Director, RBS*

Yes, principally that.

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**Rohith Chandra-Rajan** – *Barclays*

All right, thank you very much.

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**Operator**

Thank you. Your next question comes from Chintan Joshi from Nomura. Your line is now open.

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**Chintan Joshi** – *Nomura*

Hi, good morning; can I just follow up on that; I missed how long will those 12 billion take to run off; in terms of timeline, what should we be thinking about?

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**Stephen Hester** – *Group CEO, RBS*

I'm afraid we don't know, because our focus has been on isolating them and our biggest efforts have been on getting to the 80 and getting the cost programmes scoped and underway, which is now all done, and so I think in the second half of the year we'll try and come up with a better timetable for that. Personally, I think it'll be mostly out over the next two, two and a half years, but we don't have a plan that says that, so that may be just me giving someone else a headache before I leave; I don't know.

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**Bruce Van Saun** – *Group Finance Director, RBS*

Yes, I think obviously we'd like to run it off, but we have to balance that with the cost to do that, and so that's the tension in that decision and that timeline.

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**Chintan Joshi** – *Nomura*

Okay, and could you give us some colour on what these 12 billion exactly are? I know you said you were trying, you were struggling to isolate ?

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**Stephen Hester** – *Group CEO, RBS*

It's the same as Barclays passive stuff; it's basically long...it's derivatives that, A, suited a more derivative intensive business model from the past, and, B, have become deeply uneconomic with new regulatory standards.

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**Chintan Joshi** – *Nomura*

Understood.

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**Bruce Van Saun** – *Group Finance Director, RBS*

Long dated derivatives.

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**Chintan Joshi** – *Nomura*

Understood. Just again following up on the RWA discussion at the Group level; could you update us in terms of how we should think about your RWA targets going forward; I have a 440 billion number in mind, but there've been a lot of moving parts, so I just wanted to check where your models tell you we should be thinking?

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**Bruce Van Saun** – *Group Finance Director, RBS*

Well, we don't give explicit guidance on that, but we still think we'll be down over the course of the balance of the year, largely due to Non-Core run down, a little bit also from markets. So...

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**Chintan Joshi** – *Nomura*

Sorry, I was thinking more the longer term, like 2014, 2015?

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**Bruce Van Saun** – *Group Finance Director, RBS*

Yes, I think it's kind of flattish; what I would see is continued run down in Non-Core on a more passive basis, creating some capacity that would be filled by loan growth. So we're, I think, looking at 3-4% loan growth through the second half of this year, through 2014, and so that's going to put some RWAs on and will be effectively funding that by continue to run down Non-Core.

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**Chintan Joshi** – *Nomura*

Okay, and finally on costs, you've given us an indication of being below 12 billion by 2015; if I think about RBS cost income ratio 60% on consensus numbers by 2015; we've seen a lot of reshaping of the business recently; could there be more scope on that cost number, because it just feels like 12 billion is already what market is expecting?

**Bruce Van Saun** – *Group Finance Director, RBS*

Yes, look, we keep chipping away at this; we started out with a programme of around 2.5 billion back at the beginning of the recovery plan; we've actually reduced our cost by over 4 billion through the period. We're calling out, if we're at 13 now, another billion to that. I think we can't stop, given the pressure that we have on the top line and the sluggish economies that we service. We need to keep looking for ways to operate smarter, and we need look out and say, what's the future shape and size of the Group, and, what's the kind of infrastructure that we need to support that, and that we're running the Group in the optimal way. So, these things get harder; we picked, I think, all the low lying fruit, the mid tree fruit, and we're reaching up to the high branches, but I do think there is another prize there that we'll keep working at.

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**Stephen Hester** – *Group CEO, RBS*

But all of that said, we've also turned on interest margins, so we've reported higher interest margins. We think that we can get a bit more progress on interest margins, and then frankly, the real thing is if our customers have begun to grow, and it looks like they have just begun to, then we need to capture the opportunity to grow with them. So, I think doing more with our customers is absolutely the essential battle for the next few years.

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**Chintan Joshi** – *Nomura*

Thank you.

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**Operator**

Thank you. Your next question comes from Chirantan Barua from Bernstein. Your line is now open.

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**Chirantan Barua** – *Bernstein*

Thank you. I've got two questions; one, a fluffy one, Stephen, for you; if you could just help us understand why did you recruit Ross and go all across the world to get him to do UK Retail? And the second one is for Bruce on the PFE line; we're scared after the Barclays situation on the PFE line and derivatives book; if you just give us some idea on how comfortable are you with the PFE line and how should we think about sensitivities on the derivatives book, and how will the derivatives book shape up in the next two years? Thank you.

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**Stephen Hester** – *Group CEO, RBS*

Well, I've always found New Zealand Sauvignon Blanc as being fresh and spicy and leaving a good aftertaste, and I thought that was a good start for Ross. But no, obviously the two things that I've always looked for in stocking or restocking the executive committee at RBS are people who can do the job that we're recruiting for well, on a world class basis, and also it was my duty to try to produce some people who had the ability to succeed me, such that the board had a selection of those available when that time came. And so I was thinking about both of those two things when we looked to replace Brian Hartzler, who Ross replaced. The particular things, I think, that came through to me with Ross; in business track record, obviously the Australian market has some parallel to the UK, I think it is a market you can switch between sure-footedly. And what Ross had done is he'd taken one of the major banks in Australia and really moved it very clearly forward in customer service and therefore in all the customer rankings, whilst at the same time making good profits out of doing it. And these things are not easy to do. It's much easier to stay in the pack than to move within the pack in a consolidated market like the UK or Australia, so I was impressed with his detailed operational skills and customer focus skills. And then frankly, as you will come to know, he's got, I think, a really good personality, he gets on well with people, sensitive leadership but not domination, and one that I think will do the human things of leadership that are needed to be done well, and so those were the things that stuck out in my mind. I promised him an adventure; he was a little unsure about the adventure, and he'll now get a bigger adventure than he bargained on, but I think it'll be good.

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**Bruce Van Saun** – *Group Finance Director, RBS*

Okay, I'll answer the second question then. On the derivatives, I don't think we had anticipated any surprises; it's fairly straight forward for us, so the PFE issue, we see the amount is up a little bit, we're going to go to central clearing, so that'll have an impact, but there's no surprises in this number, it's a pretty straight forward calculation. I think as it relates to all of the CRD4 text

changes, we were quite conservative and prudent in the assumptions we had made in any guidance that we had given previously or any numbers we had put out there. So when the actual text changes came through, we had a little bit of up-tick actually, to the overall numbers; we benefited by about 20 basis points in the fully loaded B3 Set 1 calculation. So, anyway, I think we're in good shape and relative to others, so I don't see any issues here.

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**Chirantan Barua** – *Bernstein*

And Bruce, how much of the PFE line do you think will be taken out through CCPs?

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**Bruce Van Saun** – *Group Finance Director, RBS*

It's hard to say; I think we'll just have to see how it develops; I don't really have a hard estimate on that at this point.

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**Chirantan Barua** – *Bernstein*

Thank you.

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**Operator**

Thank you. Your next question comes from Joseph Dickerson from Jefferies. Your line is now open.

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**Joseph Dickerson** – *Jefferies*

Hi, thank you gentlemen, for taking my call. I have two quick questions, the first being on your liquidity portfolio. On your own medium term target definitions you've got about 103 billion of excess liquidity. Is it really the demand side of the equation that's preventing you from redeploying that into lending and other activities; and I was just wondering if you can comment on

the size of that portfolio? And then secondly, and I don't...perhaps I'm just being thick; I just wanted to know, the ROE target of 14 plus percent that you have for the Markets business in the slide pack, is that pre tax or post tax? Thank you very much.

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**Bruce Van Saun** – *Group Finance Director, RBS*

First on the liquidity portfolio; we have a liquidity buffer of 158 billion currently. We manage that, it's kind of a linear programme involving a bunch of metrics that we look at, different stress outflow tests, different FSA metrics, and different internal metrics. I would say that we probably have room in that liquidity buffer to take it down 20 to 25 billion with time, and so that's probably the amount that is sitting there in cash ready to fund increased loan demand as that materialises and picks up. And certainly that will offer a nice boost to net interest income as that happens, because we're making very little on those assets as they sit in the liq buffer, and putting them into funded loans will pick up the spread.

On the second question in terms of that, Markets at 14%, so the target is 10% just on a pure Markets look, and then with the connected revenues that we book in some of the other divisions where they have the customers, and so Markets takes half the revenue and the customer facing group takes the other half. If we attribute that revenue back into Markets, that's where you get the 14%, that 4% uplift from 10, and all those numbers are on an after tax basis.

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**Joseph Dickerson** – *Jefferies*

Thanks.

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**Operator**

Thank you. Your next question comes from Alastair Ryan from Bank of America; your line is now open.

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**Alastair Ryan** – *Bank of America*

Good morning, thank you; two questions if I may. First, the Q2 shows a lot of improvement in the balance sheet, but a relatively difficult income picture. Is there a... smile is the wrong word, but do the assets go before the cost benefits of the programmes you've announced or detailed further come through? I.e., is there a difficult period in profitability too?

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**Stephen Hester** – *Group CEO, RBS*

The answer to that, a simple answer, is yes. You can't take people and infrastructure out until the things that they're doing, they don't need to do anymore, and that's obviously most visible in Markets where revenues go first and costs and capital take two years, but it's also true in Non-Core. Once we go passive with the remaining Non-Core portfolio at the end of the year, there'll be some very strenuous activities to make faster dents in the Non-Core cost base as well.

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**Bruce Van Saun** – *Group Finance Director, RBS*

Yes, the revenue picture in Retail and Commercial is fairly stable. I think we have... there are signs of life, and there's a reason for optimism. I think our customers are starting to be more confident, which should lead to increased loan demand. We do have the NIM tracking in the right direction, so on the R&C side I think the outlook is starting to brighten. Clearly, on markets we've just got to get the business to the other side of the river and get it stabilised, and so we're going to have some tough comparisons as that's happening, but once we get it to the new shape and size, I think we can hold revenues there and eventually start to rebuild a bit.

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**Alastair Ryan** – *Bank of America*

Thank you. And the second thing on Citizens; clearly not much going on in the... well, not much going on in the outside of the quarter; is there anything not immediately visible that would suggest to you that income momentum picked up?

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**Stephen Hester** – *Group CEO, RBS*

They're waiting for Bruce; they're saving the best stuff for Bruce.

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**Alastair Ryan** – *Bank of America*

Very gladly; everyone's taken a long holiday till Bruce gets there.

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**Stephen Hester** – *Group CEO, RBS*

No, but actually, not to rain on anyone's parade, but one of the things we have to watch out for is if you look at all of the US banks that have reported their first half, although the US banks are awash with cash and capital, that means that what loan growth is available in the US is being a bit offset by some margin squeezes as banks compete for that loan growth. And so the one thing you have to be careful when you're projecting the UK, is certainly, I believe, that there will be some better asset growth in the UK in the coming periods, but I don't think you can guarantee all of that comes to the bottom line, as most of the UK banks are now pretty well financed, and even people like Lloyds and Santander are coming to the end of running down their mortgage books, and so you have to build into your model some thought that there may be some margin squeeze offsetting at least some of the asset growth. And that's certainly what's happening in the US, so it's hard in the US as well.

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**Bruce Van Saun** – *Group Finance Director, RBS*

Yes, I would just add to that. We clearly have set out a timeline under which we want to take citizens public, and one of the keys to that is to improve performance from where it is today. We've adopted the same approach that we took with Direct Line Group in terms of taking some of our smart people here from our strategy team and working with the company, and really looking hard at where the opportunities might lie. And we've built up a fairly comprehensive programme that we're in the process of implementing, which I think will bear fruit, so I'm looking forward to getting over there to do that. As Stephen said, some of the economic backdrop is still challenged on a competitive front, but I think underlying there's also some signs of life in terms of growth in the economy. I think you're going to get to a point where interest rates flex and the short end of the curve starts to move up, hopefully in the next couple of years; given citizen's asset sensitivity, that'll also be positive to revenues. And so anyway, we have a plan, we know the timeline, we have a sense of urgency, and we're going to work hard at it.

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**Alastair Ryan** – *Bank of America*

Thanks very much; thank you.

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**Operator**

Thank you. Your next question comes from James Alexander from M&G; your line is now open.

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**James Alexander** – *M&G*

Hi there, just two things; one, is I just wanted to say thanks to Stephen for doing a pretty good job in the extremely difficult circumstances, so sorry to see you go, but thanks for the job you've done there.

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**Stephen Hester** – *Group CEO Royal Bank of Scotland*

James, thank you very much; maybe it'll allow you to start going long the stock instead of short, now that I'm gone, but no, thank you, I appreciate it.

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**James Alexander** – *M&G*

I've never been short, just have no money, but things might have changed. On the Markets business, I just wonder whether you're being a touch unfair on the Markets business, because you only really do FICC these days, and the revenues are down 20% quarter on quarter, which looks like it's in line with peers, really. I know £93 million doesn't seem like a lot of profit in the quarter, but it's partly just that's the only business you're in, isn't it, I think, really, and so the revenues don't actually look so disappointing, because it's just the cost thing that's really the problem with FICC at the moment.

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**Stephen Hester** – *Group CEO, RBS*

All right, James, what's true is that the half year revenues are within 50 million of our budget, so it's very close to where our budget was. We always knew that adopting this next round of shrinkage would mean revenues will come out faster than costs and capital. All of that, and when you look at the journey that our Markets business has been on, I think they have done a remarkable job. Five years ago there were 900 billion of assets here; it's now 250. There were 23,000 people, it's now 10,000. There was 6 billion of costs; it's moving to 2 billion. There was 10 billion revenues, moving to three; and all of this done profitably throughout the period, and so I think they've absorbed a massive amount of change. The shrinkage has been done without accident; we're no longer 60% investment banking, we're less than 20% investment banking at RBS, with 80% R&C. And I agree, I think that that is a good thing, is a good strategic reshaping, but a good performance. Inevitably though, you get to the point where there's a lot going on, there's morale difficulties, and a sense of fatigue, which we have to overcome. And so I think that we need to worry about this business and give it all the assistance we can to execute this latest strategic restructuring, and the next few quarters will probably still be uncomfortable until the costs and the capital have made the adjustment and until we can demonstrate we can stabilise the people situation.

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**James Alexander** – *M&G*

Yes, I think that's probably fair enough, but it's done a pretty good job, I agree.

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**Operator**

Thank you. Your next question comes from Tom Rayner from Exane BNP Paribas; your line is now open.

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**Tom Rayner** – *Exane BNP Paribas*

Good morning chaps. Don't really want to disagree with James, seeing that he's such an important client, but I was going to ask about the Markets business as well, actually. It looks in the second quarter, you held the compensation ratio flat, so clearly you did, I guess, bring down the accrual in line with the weak revenue, but still the cost income ratio let...which looks like

there's a bit of a fixed cost problem in the business. Is that; would you agree with that, and is that something which your plans over the next year or two is really focused on, because you just didn't seem to have quite the same cost flexibility in what was a difficult quarter for everybody in terms of revenue, but you've been hit harder because of that sort of, fixed cost issue? And I have a second question, please.

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**Bruce Van Saun** – *Group Finance Director, RBS*

Yes, well I think, look, we're kind of in the high twos in expenses and we need to bring that down to the low twos to make the maths work and to make the new financial framework deliver the returns that we want. The way we need to attack that is to make some hard decisions around specific product areas, so one is the structured retail product and equity derivative area, which has quite a high fixed expense base and it's very thick kind of, front to middle to back, and so we're going to exit that business over time, and that will remove a bunch of costs. We have a fairly wide footprint, and we have pretty reasonable staff levels in different countries in different markets, and we're going to move that back to more of a hubbed approach, and we're going to thin out some of the peripheral markets, and so again, that'll take out some of the fixed cost base. And then in addition, we just are going to try to simplify processes and streamline front to back work. All of that takes some time, and we really just got agreement on the strategy and all the details identified in a May, June timeline, and so we really haven't had a chance to start to work on that. We have the plans, we've gone through consultation on some folks, and that will now play out in the second half of the year; you'll start to see that expense base come down. Having said that, I think where we are this year on our ROEs, in a mid single digit territory, is something that we had anticipated as we go through this change. I think next year that gets up into high single digits and then we're calling out by 15 we can have that back to 10% plus.

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**Tom Rayner** – *Exane BNP Paribas*

Yes, thanks for that, and that's exactly the second question; that 10 to 12% 2015 target; I mean, that looks to be based on a sort of, 80 billion of RWAs that you're going to move to more like 68 billion when you've exited the residual areas.

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**Bruce Van Saun** – *Group Finance Director, RBS*

And that's the extra 2%, Tom, if you get the RWAs down to 68.

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**Stephen Hester** – *Group CEO, RBS*

Tom, slides 17 and 18 of Bruce' pack that are on the website detail this for you, give all these numbers.

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**Tom Rayner** – *Exane BNP Paribas*

Okay, because I was just concerned that the real issue here was that you're getting to a sort of level, you know, there were scale dis-economies, and it looks like you're now shrinking to an even smaller regulatory balance sheet, and I'm just wondering, isn't it going to be even harder to make this 10% ROE with 68 than it is with 80, 85?

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**Bruce Van Saun** – *Group Finance Director, RBS*

Tom, the 80 going to 68, I mean, that's just dead wood, that's removal of dead wood. So, we shaped the business to get to the notional 80, and then underneath that there's some dead wood that we don't think we can get out, notwithstanding Stephen raising the bar on his successor. I think it's quite a challenge to get that full 12 billion out over the time line. We will work at it, we'll see if we can do that, but we're not really making much return at all, and it doesn't impact our market position in rates at all, really, if we had those 12 billion or if we didn't have the 12 billion.

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**Tom Rayner** – *Exane BNP Paribas*

Sure

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**Stephen Hester** – *Group CEO, RBS*

12 doesn't; but look, Tom, you're right; we have decided that it was in the best interests of the overall company to take some risks with the scale of the Markets business as a way of producing capital, so that we didn't need to do a rights issue. And the way we get up to the FPC and FLB capital ratios is a mixture of Non-Core run down, markets, and then if needed as a fall back, you citizen's partial IPO. So, that was the route we took; we're conscious that it puts quite a strain on markets to adjust to this new equilibrium, but when you look at the P ratio of those banks that have got 50 and 60% of their business in markets, you can see why we thought that that was an acceptable business risk. But we're very conscious that the markets business needs close attention, good support from us, and hopefully some consistency around the execution.

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**Tom Rayner** – *Exane BNP Paribas*

Sure, and just finally, it's not on that slide, it might be in your big release, but the capital allocations, the tax rates, the pref, all the things you're assuming to get you from your...to get you to that 10, 12%, can we have the numbers so we can back test them?

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**Bruce Van Saun** – *Group Finance Director, RBS*

Yes, you could pick that up with Richard, sure.

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**Tom Rayner** – *Exane BNP Paribas*

Yes, perfect, thanks a lot.

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**Operator**

Thank you. Your next question comes from Mike Trippitt from Numis. Your line is now open.

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**Mike Trippitt** – *Numis*

Good morning; two quick questions; I don't know if I'm reading too much into the signalling, but certainly on the fully loaded BIII ratio, you've gone from around nine to now firmly over nine. I just wonder if you could just talk a little bit around any sort of, sensitivities or risks around that, and should we conclude that perhaps you would have, if you ran the PRA test now, would there have been a better result than you had a month or so ago? The second thing was just on margins; you're signalling, I think, a slight improvement on margins in Retail and Commercial; is there any particular factors you'd want to highlight, or is it just...I'm just thinking particularly as we've probably had the benefit now of low deposit pricing; I'm just wondering how you see the moving parts within Retail and Commercial margins in the second half? Thank you.

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**Bruce Van Saun** – *Group Finance Director, RBS*

Sure; on the first question on the 9%, I think given some of the uncertainties around the CRD4 legislation, to be, to have a little weasel word in there and say, around 9%, was probably appropriate. Now that we've seen the text clarified and we're halfway through the year, I think we have a clearer view that at 87 it's...we're pretty confident that will be at 9% plus. The things that obviously are variables through the rest of the year would be our level of profit, would be one thing; making sure that we get the RWA reduction that we need, and then whether there's any conduct costs could also be another factor. But again, I think those things, we have pretty good sight on all those things, and so we can put the 9% plus out with some confidence. On the second thing, on R&C margins, again, over time, we have a five year tractor on our hedge, and that, you know, we're burning off kind of, higher rate periods and now it's becoming less of a drag with time. We would expect that to continue. We, I think, have a pretty good environment around the asset margins, and there's still some room to go on deposits. You can see with the amount of liquidity buffer that we have, and the LDRs where they are, we can, I think, be aggressive on reducing some areas selectively in deposit pricing, and if those deposits run off it doesn't really hurt us, and if they stick we continue to benefit in terms of that spread. So, I think it's a combination of those things that give us, again, some confidence that that number will continue to trend up.

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**Mike Trippitt** – *Numis*

Thanks Bruce.

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**Operator**

Thank you. Your next question comes from Manus Costello from Autonomous. Your line is now open.

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**Manus Costello** – *Autonomous*

Morning everyone, I have a couple of questions please. Firstly, on UK commercial real estate, Lloyds yesterday told us they thought that it was getting a bit better, but if I look at your Q2 numbers versus Q1, it looks like NPLs in the UK property sector ticked up, and your LTV disclosures make it look like the LTV has gone up in your non-Irish book as well. So, I wondered if you could let us know what happened during the quarter and how you see the outlook for UK CRE?

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**Stephen Hester** – *Group CEO, RBS*

I think it's just noise in the quarter this; I would say it's flat in the quarter in taking a rounder view of conditions; in any one quarter you have any of the things that pop up and pop down, but there's no notice of...there's certainly no deteriorating trend, and nor would I say...now would I call a particularly better trend in the last quarter.

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**Manus Costello** – *Autonomous*

Okay, so you wouldn't want to encourage us to get more bullish on the outlook for that over the next 12 months?

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**Stephen Hester** – *Group CEO, RBS*

We are not worried about commercial property; we think that commercial property will be a slow burn as that acid bubble works through, but we think it's unlikely to get worse, and will get better but will get better slowly. And so when you look at the pie charts that are in the appendices to our

slides, of the extent to which we've shrunken CRE exposure and Non-Core, you know, it shows that despite a market that's hard work, we've dramatically shrunk the CRE exposure successfully, and I expect us to continue to shrink it, but it will be slow; it will be the slowest thing to shrink, but I think it is a headache that's receding rather than one that's getting worse.

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**Manus Costello** – *Autonomous*

Okay, thanks, and my second question was just more strategically, within the Markets detail which you've put out here, is the US asset backed business something which is going to shrink or do you think the US asset backed, given the returns it makes, stays the same kind of size and it's other areas would shrink?

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**Stephen Hester** – *Group CEO, RBS*

Everything will shrink in capital terms, and I think this in that the US asset backed market has had an unusually high period of profitability the last few years, as the chaos of the mortgage conditions change and as interest rates came down, and spreads came down, and so part of the rationale for that to be part of our shrinkage is that we think the ROEs in that business will still be attractive but will be not quite as attractive as they were in the last three years. So, I think we feel that we have sensibly captured the profit, the really super-profit when it was there to capture, and we will have a bit of a smaller business, but one which we think will still be profitable going forward. So, it will participate in the overall probably broadly pro-rata in the overall capital shrinkage of the division.

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**Manus Costello** – *Autonomous*

Okay, that's clear, thank you.

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**Operator**

Thank you. Your next question comes from Michael Helsby from Merrill Lynch. Your line is now open.

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**Michael Helsby** – *Merrill Lynch*

Thank you, morning Stephen, morning Bruce. Stephen, I've always seen you as a champion of the minority shareholders interests, and certainly when I think about the Royal Bank shares at the moment, one of my biggest worries actually surrounds this government plan to look at a good bank, bad bank split, so I was wondering if you would offer your opinion on that, ahead of any report that's going to be published in September, so you could give us some views? Thank you.

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**Stephen Hester** – *Group CEO, RBS*

Well, I guess you can safely assume that as between the two groups of shareholders, it was clear which one was happier with me, but look, I don't want to court particularly controversy; I think that there are enough people from the Tyrie Commission and so on that were asking for this study of the bad bank to be done more than on the back of an envelope. We clearly have done it ourselves every single year for five years on the back of an envelope, but it can now be done more efficiently by the government, to discover whether there is a case for the government taking assets off our hands at a price that minority shareholders consider advantageous. I've always thought that that's a hard circle to square, as it were, because if you're a minority shareholder you don't want us to sell assets other than at a higher price than you value them at, and it's not obvious why the taxpayer wants to pay such a price, but this is what will be discovered. And I think it is highly likely that if a proposal was put it would have to be approved by minority shareholders, with the government recusing itself, and so there obviously is that opportunity should the proposal even get to that stage. But at the moment it's just information exchange going on. Our job, I think, was to deliver a bank that didn't need it, such that it was an option rather than a necessity, and I think the numbers today very clearly demonstrate that it's an option and not a necessity.

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**Michael Helsby** – *Merrill Lynch*

Yes, I'd agree. Thank you.



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**Operator**

Thank you, and our next question comes from Christopher Wheeler from Mediobanca; your line is now open.

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**Christopher Wheeler – *Mediobanca***

Yes, good morning gentlemen; a couple of questions please. The first one is on Williams & Glyn's, and I just want to get a bit of a feel for where you are on that, and perhaps linked to that really, just talk about the fact that we seem to have a lot of bank paper possibly coming to the market next year, with obviously possibly Lloyds, TSB, talking of Santander UK, Virgin Money. Does that cause you in any way to seek a bit of a longer delay on that to make sure you can get perfect execution on that transaction; that's the first question. And the second one, and I hate to give more work for Ross when he's only, well, he's not even been in the job yet, but obviously next September we have the vote on Scottish Independence, and I think most of the people on this call have been talked to by civil servants about the impact of this on Scottish banking, given the fact that clearly 1254% of GDP is not going to work for Scottish...if Scotland goes independent. Have you done any work at all on what the cost might be if you have to re-domicile part of the business, and what the other impact might be on the business in terms of suddenly having to move it to south of the border? Thank you.

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**Bruce Van Saun – *Group Finance Director, RBS***

Okay, I'll take the first one and Stephen will take the second one; on the Williams & Glyn, I think the main thing that we've been doing since Santander pulled out is to develop a plan to set up a stand alone bank, and that's quite complicated, so again, this is a carve out from some of the business relationships and customers that we have in both NatWest and RBS. We've segregated the data, we now have to set up a legal entity, get a banking licence for that entity, and staff it appropriately, get our models approved, have an operating systems infrastructure that can support that business, so we're cloning our big RBS system to drop in, kind of in a re-tooled fashion to support Rainbow's needs. And all of that takes time, so we're on a timeline where that's going to run into probably early 15 before we've got a bank stood up that has its licenses and has all its PRA and FCA approvals and is ready to go to the market. So, in terms of the

question as to whether all this bank paper flooding the market in 14, at this point we won't be in that traffic. I think one of the reasons for optimism here is that when you look at the business itself, it has some very attractive characteristics, so it is self-funded, it's been delivering consistently a mid-teens ROE, it has a nice 5% SME market share which positions it as an interesting challenger bank. And so we have had interest from investors in potentially joining with us in this journey and coming on as a partner, either as a pre-IPO investor or potentially in terms of a forward sale. So, we've been running a process; we are getting to a stage in the process where we're going to see some indications of interest in the next couple of weeks, and we'll have a better sense where we are from there. Stephen, second.

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**Stephen Hester** – *Group CEO, RBS*

On Scottish independence; obviously we do do a chunk of work on it, but I would say that until there is much greater clarity on exactly what independence might mean, it's very hard to reach any conclusions, and during the course, between now and Christmas, my understanding is that the Scottish government is planning on publishing a series of, I don't know whether they're white papers or green papers, anyway, some kind of papers, that spell out in some more detail how they would envisage it if it was voted for. And so until that's clear it's hard for us to know what I'll call detailed observations. At first blush, we don't think that there are major detailed implications for RBS in the proposition, but whether there are or not, we truly can't say. At a big picture level I would say the only big picture issue that is significant in our minds for RBS is around credit ratings and whether they are impacted one way or another. We have to be cautious in that, because clearly the whole direction of bank reform, which we endorse, bail-ins and the direction of ring-fencing and so on, is to break the link between sovereign credit ratings and bank credit ratings, so I think that the issue of that link is due to become less important, but I think that that's the major macro issue in our mind as it works through. And again, I think it's premature to really know whether that's an issue or not.

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**Christopher Wheeler** – *Mediobanca*

Thanks a lot, gentlemen, that's very helpful; thank you.

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**Operator**

Thank you. Your next question comes from Raul Sinha from JP Morgan. Your line is now open.

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**Raul Sinha** – *JP Morgan*

Hi and good morning gents; can I just have a couple of detailed questions at the end on litigation. Firstly, in Q1 you disclosed that you had received advance notice from the SEC, where it had recommended that it would initiate civil administrative action against RBS Securities. You have repeated that in Q2 in your disclosure on page 124; I was wondering if you can talk to us about what implications of that might be, or just give us some colour if possible? And then the second one is on FHFA; in your annual report you disclose that you'd underwritten about US \$32 billion of mortgage backed securities. One of your competitors does quantify what's the maximum loss and I was wondering if you could do that for us, or alternatively, give us how much the PRA has assumed, for litigation costs within your capital adjustment? Thanks.

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**Stephen Hester** – *Group CEO, RBS*

I think the 'Wells' thing...there's nothing more I can say than what we've disclosed, but we don't see it as leading to large provisions. On the Fannie and Freddie, every bank is in a FHFA, is in a unique set of positions, and they're vary very considerably. An example is, we're in the Connecticut courts, whereas, for example, UBS is in the New York courts. Our court date we think is probably two years behind UBS, 2015 or so, and we obviously have very different fact patterns which haven't even been fully developed because the process of discovery in our particular law suit, because it's running two years later, is still ongoing. And so all those mean that we are nowhere close to the point where we can put a bracket of risk around it, although certainly to date we have been expecting substantially lower percentages than those of the most recent UBS settlement and in line with other smaller settlements; but the truth is it's way too early for us to have a good view on it.

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**Bruce Van Saun** – *Group Finance Director, RBS*

Yes, I guess I would just caution you all from doing read-acrosses here, because everybody's facts and circumstances are different in many ways, and so we've tried to decipher from people who have gone before us, how does our hand look, and again, it's pretty hard; it's not a very transparent process.

**Stephen Hester** – *Group CEO, RBS*

And we had a small RMBS litigation this week we won the court case on completely, and didn't settle for a dime; it just was dropped, so I'm afraid this is just a swing item out there, which in our case is probably a couple of years away.

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**Raul Sinha** – *JP Morgan*

Could you give us any indication of the PRA adjustments on your capital for litigation then?

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**Stephen Hester** – *Group CEO, RBS*

The PRA headwind adjustments weren't specific as to individual conduct risk; they just generally had amounts of money against conduct risks that were in our headwinds, which are, I think, broadly capital from what we published.

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**Raul Sinha** – *JP Morgan*

Yes, I thought it was put out there; I think it was...

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**Stephen Hester** – *Group CEO, RBS*

But they didn't say it would be X for this issue and Y for the other issue, and Z for the other issue.

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**Raul Sinha** – *JP Morgan*

Yes, thanks.

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**Operator**

Thank you. Your next question comes from Nick Linnan from Qube Capital. Your line is now open.

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**Nick Linnan** – *Qube Capital*

Yes, just thanks for taking my question; just one more on the good bank bad bank split; do you have any comments on how it would be possible for the government to buy assets off you whilst remaining confident that that wouldn't qualify as state aid and result in another couple of years of dividend and hybrid coupon bands?

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**Stephen Hester** – *Group CEO, RBS*

Well, I think it's too early to answer that; you're absolutely right that if a proposal is in the end put forward, it will be a proposal not only have to stand, if you like, on its own two feet, but any knock-on consequences, were they from the EU or otherwise, will need to be part of the evaluation. And you're right, these are hurdles that make it challenging, but as far as I am aware, we're not at the stage of being able to assess any such consequences.

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**Nick Linnan** – *Qube Capital*

Okay, thanks.

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**Operator**

Thank you. Your next question comes from Sandy Chen from Cenkos. Your line is now open.

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**Sandy Chen** – *Cenkos*

Yes, morning gentlemen; just a couple of questions, and sorry to get back onto the Markets side, but thinking about it from an asset perspective, you've got, I guess, 99 billion of reverse repos, 85

billion of securities; is the profitability and the disposal pattern different between those two buckets in the downsizing in Markets?

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**Stephen Hester** – *Group CEO, RBS*

I think the things that cost money is actually getting out of the derivative positions; repos don't cost you anything to get out of, and most of the securities positions don't because they're marked to market with reserves, and we're a reasonably conservative reserver. So, it tends to be that if you have less assets, it's not that it costs you money to get out of the assets, it's just that you have less of a profit engine from those inventories and their turn and the business that you do with them. And secondly, unwinding the derivatives positions normally does cost you some money, and is a bit slower.

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**Sandy Chen** – *Cenkos*

Right, so is that a way of saying that the RWA uplift would be...benefit could substantially potentially outweigh the negative impact on income?

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**Stephen Hester** – *Group CEO Royal Bank of Scotland*

I think if you do the numbers, it suggests that the exercise of shrinkage, if we hit the targets that Bruce puts out in his slides, is capital accretive, but only something like 30 cents in the Dollar, or whatever; by the time you've got the lost profits and the restructuring costs, something over half of the capital release is used up, but there is the net capital accretion.

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**Sandy Chen** – *Cenkos*

Okay, and regarding Citizens, and this is not trying to usher Bruce into his next career, but could there be a scenario where the IPO disposal is accelerated, because there would obviously be capital benefits for the Group?

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**Stephen Hester** – *Group CEO, RBS*

Well, I think that obviously as a physical matter you could; I think that there would be some significant technical issues vis a vis the US regulators; we've still got a cease and desist order which ideally would be lifted; we've still got a very inefficient capital structure which is only over time going to be allowed to be fixed through dividends and so on. And then the issue after those technical issues is really about value. And so far, we've felt that there would be substantial write offs to RBS of the prices of earlier disposal, and as we improve the results along with the market improving, we think that the shareholder value of what we want to do improves and in the end it's clear we don't need the capital. Our capital path is set to meet the PRA designated requirements, and so we have to be driven by shareholder value.

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**Sandy Chen** – *Cenkos*

Yes, okay, and one last question, and this is really just nicking Manus's question from yesterday regarding tier two debt. With a pretty good path for capital strength, does that give you capacity to pay down more of that tier two and help the NIM moving forward?

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**Bruce Van Saun** – *Group Finance Director, RBS*

Well, again, we're managing the stock of tier two debt to meet the overall PLAC and other PRA capital requirements. We've tried to target a 5% stock on top of our core tier one numbers, and so I think again at this point, as some of that debt either matures or amortises down from a regulatory benefit standpoint, we're likely simply to just reissue because our stock today is roughly around 5%.

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**Sandy Chen** – *Cenkos*

Right, okay; thanks very much.

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**Operator**

Thank you. Your final question today comes from Arturo De Frias from Santander. Your line is now open.

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**Arturo De Frias** – *Santander*

Hi, good morning; I was looking at the trends in your two main UK businesses, it's now UK Retail, UK Corporate; and whilst the trends in UK Retail look really good, with, well, stable operating profit, falling impairments and a nice improvement in returns, which were already higher and are getting higher at 26% return on equity; UK Corporate is following different trends, particularly weaker revenues and slightly rising provisions. So, and as a result, the return on equity on the corporate is coming down quite substantially, from 16 to 11; so, which is...the gap in term of returns between two businesses is starting to look a bit difficult to understand for me. UK Retail is more than...

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**Stephen Hester** – *Group CEO, RBS*

Just having a crack at that; I think there a few different moving parts; it is the case that UK Retail today is one of the more profitable banking markets you can be in; it's obviously being helped by the fact that unemployment didn't rise to the extent it did in other countries, and we didn't have significant house price falls, and so that helped the impairment line, and then the deliberate loss of market share of banks like Lloyds and Santander and Northern Rock also allowed people like us to grow assets and margins to stay attractive, especially in mortgages. So, for all those reasons the retail, the people who are big in retail banking have a good ROE here, as they do by the way, in markets like Australia and Canada and so on. Corporate banking, I think everywhere, has a lower ROE than retail, apart from in the US where they're a bit similar, and that's maybe a function of corporates being tougher buyers of services, given their size and scale. But also the FSA has been much, much more aggressive in tightening capital standards in corporates, real estate slotting being one of the examples, and so ROE is substantially reduced by the like for like increase in capital calculations. And then on the revenue growth side, as we obviously had a tail of commercial real estate which has cost provisions; aside from commercial real estate, actually, the provisioning levels aren't particularly high relative to history; and companies in the UK have been de-leveraging, which has meant we haven't had an asset growth. So, all of those things, in the particular quarters in comparison here, there were various one-off items coming in and out,



which I think exaggerate UKC going down, but I would say UKC has been flattish in business volumes, has had some margin squeeze from low interest rates, and has had an inflation of RWAs from regulatory change. All of that said, we believe that the long term ROE of that business is somewhere between cost of capital and 15%, depending on the year and the moment, so I think we're pretty comfortable it's an attractive business to have, but clearly it doesn't have the ROEs of the pure retail bank, at least if you calculate those ex PPI.

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**Arturo De Frias** – *Santander*

Sure, no, I fully understand that, and thanks for the explanation, I fully will expect retail to have, I don't know, at least seven to ten points of ROE gap versus corporate, but what was puzzling me a bit was the trend; the ROE in corporate is substantially weaker year on year; it's five points lower...

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**Stephen Hester** – *Group CEO, RBS*

I think the RWA change is finished next year, so by...as we go through next year, all of the RWA inflation is in the book, and I think that the margin squeezes from income and so on are also in the book, and so my expectation is that the direction is flat or up, depending on moment and timing, as we look forward in this business, but those have been the headwinds.

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**Bruce Van Saun** – *Group Finance Director, RBS*

Yes, and just another sub title in that is we've been running down the exposure in commercial real estate within UK Corporate, which once we're hopefully tailing, getting to the tail end of that process, and as the UK economy picks up, we'd expect to get some loan growth; that can really move the ROEs in the business back towards that 15% number when that happens.

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**Arturo De Frias** – *Santander*

Okay, thank you very much.

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**Operator**

Thank you. Stephen, I'll now hand the call back to you for closing comments.

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**Stephen Hester** – *Group CEO, RBS*

Well, thank you very much for your questions. You know where to find Richard should you have any supplementaries, and thank you very much for listening to us. Good morning.

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**Operator**

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