The Royal Bank of Scotland Group

Interim Management Statement Q109

ANALYST AUDIOCALL

Friday 8th May 2009

Presenters

- **Stephen Hester (Group Chief Executive)**
- **Guy Whittaker (Group Finance Director)**

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.

Stephen Hester: Good morning everyone, thank you for joining us. Guy Whittaker is with me as usual, and what we'll do is spend a few minutes reprising what you have received this morning, and then hopefully spend most of our time on Q&A.

The first thing, let me remark on of course, is that you have had a pretty large, detailed and dense document land with you this morning. I make no apology for this.; it was done deliberately, to torture you, which we enjoy doing, but it was also done because I believe very strongly that part of our route back to good grace can be achieved through transparency, and an openness and welcoming to investors. I think that makes us manage better: if people know the truth, we have to address it and can't dodge it, but secondly, it's our job to expand our investor base, to welcome investors back, and to allow the Government to get out, and I think this is one of the ways to do it in communication terms, although of course, in the end, it is substance that will or won't count.

Turning to the results, and I will come back and talk more in a second, once Guy's gone through the numbers, but I think the headline that I really want to leave you with, is that there are two parts to these results. The part that I'm very pleased about, you can see in the revenues, where we've reported our best ever Quarter in history on the revenue line, driven of course by the Investment Bank. There were many people who thought we shouldn't have one, but the revenues tell a different story today. While that may not be sustainable, I think what we can say about the revenues, and importantly about the customer indicated beneath them, which I'll come back to talk about, is that RBS has intact customer franchises around the world that are strong and powerful and will one day be very valuable once again as we administer the work we are administering to them. That gives me confidence that together with the action that we're continuing to take, that we will get there in the end and there will be a good place to be.

The other part of the results is of course though, that despite record revenues, we've made a loss, and that is because we have very large credit exposures in a very difficult world economy, that are causing losses, and that will continue for some time. I am concerned that the outside world is getting too carried away with enthusiasm for green shoots. I have to tell you we do not see those green shoots at this juncture, and I think everyone must be very cognisant that there are headwinds in our industry, both on revenues and on credit losses that will continue for some time, even if we ultimately get to the right place.

I think that those are the things that I want you to take out of these; you may take quite different things of course, but why don't we have Guy just highlight the key numbers, and then I'll come back with a few other remarks on the business.

Guy Whittaker: Thanks very much Stephen, and good morning, and again, the results this morning do reflect both the strength of the business franchises, as well as the weakness of the economic environment in which we're operating. Headline income, £9.7 billion pounds, is up 26% versus the First Quarter of 2008. Costs of just over 4.6 billion left us with pre-impairment profits of £4.1 billion. After taking an impairment charge of just under £2.9 billion, write-downs on credit market exposures of £2.1 billion, of which 1.6 was an additional provision against our exposure to monolines, offset by about £1 billion on the gained fair value of own debt as well as a £240 million gain on the disposal of Bank of China.

After deducting integration charges and restructuring costs, we are left with a loss before tax of £44 million, and then taking off tax and preference shares and minority interests an attributable loss to our shareholders of £857 million. Stephen mentioned income, driven very much by a strong performance in GBM, where income rose 97% over the First Quarter of 2008 to £4.3 billion with a strong performance, really across all of the major product areas, but in particular within rates, currencies, local markets and the commodities business.

In our Retail and Commercial banking businesses around the world, income was more subdued; in part a reduction in fees, both in business activity led, as well as some regulatory pressures and tighter margins on the businesses, principally driven through lower interest rates and deposit floors.

The risk margin for the Group fell from 2.1% in 2008 to 1.73% in the First Quarter, with the larger part of that attributable to significantly higher wholesale funding costs across the business, both short term and long term debt, as well as additional stocks of liquid assets that we are now holding on the balance sheet.

Cost: income ratio came down from 50.3 to 48%, reflecting a tight cost discipline and restructuring initiatives in our main businesses, offset by adverse foreign exchange movements, and the rise in performance-related compensation, in line with the GBM business performance.
Our impairment charge of £2.9 billion was pretty evenly split between GBM and the Retail and Commercial businesses. Charge-off rates were 1.33% of loans and advances, which is a similar charge-off rate to the second half of 2008. Impairments on AFS securities totalled about just under £600 million.

The gross balance sheet fell by 158 billion, largely as a reduction in revaluation gains on outstanding derivative contracts; in nominal funded balance sheet we were down 35 billion, to just under £1.2 trillion pounds, largely a result of a GBM deleveraging, offset by slight balance sheet growth elsewhere. The loan-to-deposit ratio was steady at around 150%. RWAs were down just a couple of billion pounds, at 576 billion from the year end and our core Tier 1, measured on the FSA basis consistent with guidelines that were published on the 1st May, proformaed for the £5 billion preference share conversion to equity that took place in early April, and the £4 billion gain on our recently completed exchange and tender offer, core Tier 1 was 6.7%. That on a like-for-like basis would be down about 80 basis points from the end of 2008; the drives of that principally being the loss of minority interest on the Bank of China state of around 25 basis points. Our attributable loss to shareholders after backing out fair value of own debt gains, also contributed about 25 basis points. The balance, a further 30 basis points of regulatory deductions, largely related to expected loss in excess of provisions and first loss tranche of securitisation, those regulatory deductions now total around 50 basis points on core Tier 1.

There are the financial highlights of income and balance sheet. With that I'll hand back to Stephen.

Stephen Hester: Thank you very much Guy. Just a few other points to make before turning over to Q&A and these are obviously set out in the release. I mentioned, that for me, one of the positive aspects was related to our customer franchises being intact. You'll see within here that by way of example our current accounts and saving accounts in the UK, we've got about 1.6 million more than we had a year ago. We've got another 600,000 insurance policies in Ulster Bank. We're also increasing customer numbers, as we are in the US and within GBM, an example being our foreign exchange rankings, have moved from 5 to 4 in the world in the Quarter.

It's not that these are numbers that we don't believe we can better. We intend to better them, but they do represent a foundation from which to build and, I think in some ways extraordinary that they have not suffered more damage with the disruption and the public criticism and controversy of the last 6 months or so. Building on those foundations, I hope you agree that quite a lot has been accomplished in terms of charting the future course and beginning to execute against it. This will take 3-5 years but the key aspect of starting, which is the plan; the management changes that we've announced; the cost savings that we've kicked off and many, many other things I am pleased with where we are on them.

I'm very conscious that when we give you more information you will develop a thirst for more and it will take us time before we are able to present the Group exactly as we intend to manage it going forward.
That will be a half-year event and the half-year will be when, obviously, we'll give you full details of the Asset Protection Scheme and our KPIs and detailed strategic plans re-confirming our targets and our actions so that you can keep track of whether we do what we'll say we do. I'm afraid I'm going to have to ask for patience in that regard, but hopefully within perspective you can see that we are getting on with the job and giving you more information than you have had before.

The non-core division obviously is a crucial bit to our strategy or, in particular, the wind down of non-core division, not only as a crucial bit of our risk strategy, but importantly of our balance sheet strategy.
We're making progress in that area, but I want to be clear that most of this is going to be slow. Many of the assets are covered by the Asset Protection Scheme. The good news is they're protected; bad news is that sales have to be signed off by the Government and are likely to be relatively slow to make. On the risk standpoint, of course we're stuck with the risk we've got and you're seeing that in the provisions, but I think we're making excellent progress in putting in place the measures and the people that would stop us reloading in the future in those positions.

I mentioned the Asset Protection Scheme; this is still on track.
The headline of figures and terms that we gave you in February are still the ones we are working to and expect to conclude on. It's phenomenally complex as we go through it and so it is taking time, but I don't think you should be alarmed by that time. Obviously I'm sorry that I can't give you more details at this juncture, but there's no point giving you ones until it's all buttoned down. Of course in parallel with that are the UK lending commitments; we are gearing up our lending to try to meet those. As I've noted, we're seeing slowing demand for credit in the UK and that's a good thing because if it doesn't happen the economy won't rebalance. I'm very clear that we're not going to lend irresponsibly or uncommercially, although we will try to meet the commitments and that's what we're doing.

Lots of work going on and lots of headwinds to get over; I think, if anything the headwinds can be thought of in two components. There are cyclical headwinds, both in terms of credit impairments and in terms of margin squeeze on deposits from low interest rates; and then there are headwinds that are harder to judge in terms of how long they will last and how much they will amount to, which largely you can see in funding and liquidity costs. The Regulators are going to insist on, and we should insist on, banks being more conservative. That's another way for saying higher cost through more conservative funding and higher liquidity levels.

We're still, over the next couple of years working through what the end-game will look like. Similarly, obviously banks at the moment are not flavour of the month in funding terms. Funding is high cost and there is obviously limited transparency on how fast the cost of bank term financing comes down. Those are issues that are hard to judge and are probably not entirely cyclical; some of them are secular, but against which we think we can nevertheless make progress on the top line.

With that, as I say, let's move into Q&A and very happy to answer any questions that we can.

Operator: Ladies and gentlemen if you would like to ask a question please press the * key followed by the digit 1 on your telephone keypad. We will pause for a moment to give everyone an opportunity to signal for questions. We will take our first question from Robin Down from HSBC; please go ahead.

Robin Down: I appreciate you don't want to give us more detail on the APS scheme, but I just wonder if I could clarify the comment you make about 75-85% of the impairments and write-downs in the First Quarter would have sat within the APS scheme. If I look at the P&L, you've obviously got a credit impairment charge going through, but you're also on the face of the P&L, reporting a credit market write-down of a short 800 million. That's obviously net of about a billion or so of gain on fair value of own debt. When you're thinking about 75-85% we should be looking at the gross numbers, should we?

Stephen Hester: Gross.

Robin Down: Great, that was it.

Operator: We will take our next question from John Kirk fro Redburn Partners; please go ahead.

John Kirk: Firstly, Stephen, you're pouring a bit of cold water on the slightly more buoyant attitude out there at the moment and I just wanted to explore that…

Stephen Hester: It's had no bloody effect on the share price.

John Kirk: That's the first time I've head a CEO complaining about the share price going up; the indication for me from what you're saying anyway, is in the market, at least, there seems to be a view now that because things are not getting worse as quickly as they were, that that is a good reason for bank share prices to rally. From what you're saying, perhaps, is it a bit too early to draw the conclusion that we're out of the worst of it yet. Is that basically what you're telling us? I think you said the loan impairment charges in the First Quarter are pretty similar to those in the second half of the year. Are you basically telling us that you would expect those loan impairment charges to continue rising quite fast from here?

Stephen Hester: First of all I think it is a deeply hazardous activity for people in my seat to speculate on, or even spend a lot of time worrying about share prices, and I figure that's your job not mine. I suppose one thing that, I think is fair - and in fact as those of you heard me the first time on this call back in October I was in fact speculating on then - is that I do think that there has been a very important transition. That is to say that last year the markets and the economy were dominated by an extraordinary level of uncertainty and fear associated with that uncertainty. That in turn caused almost a cliff-like drop in economies around the world beginning into the Fourth Quarter.

This year, I believe that those levels of uncertainty and fear are receding and being replaced by the certainty of a deep and ugly recession which is going on around us. That of itself, I think is inevitably positive, both for markets and for people's spirits because it's always better to deal with something you know than something you're just worried about, even if the thing you know is not a positive thing. In that sense I'm completely accepting, if you like, of a more positive mood both of markets and among ourselves and, as I said even within our results. I take a great positive from the endurance of the RBS franchises and our customers and our people in working through the First Quarter. That, if you like, gives us a known from which to build, but that said the known is that credit losses will continue to be high. The unknown is still how high and for how long. The known is that margin squeezes remain ahead of us; the unknown is how much and for how long.

Then finally, in the case of RBS – well in the case of everyone – there remains a big unknown on regulatory action, albeit that will be a slow burn over a number of years in terms of the economics of our industry. That regulatory action obviously relates to capital balance sheets and liquidity, but also relates, in particular in retail banking, to various regulatory actions around the world on items of revenue.

Then, of course, in our case there's the unknown of how effectively we execute our own restructuring. I'm simply wanting people to be very clear that there remain a series of, still hard to bracket headwinds; some are cyclical, some are less cyclical into which we're all facing.

John Kirk: You've partially answered my next question already which is on the cost of liquidity, or improving the liquidity position which you've very helpfully broken out. I guess the two big items in your margin erosion are that and also just the impact on spreads within the Retail and Commercial businesses. Are you able to say with any certainty at all where we might be in respect of those two trends i.e. have we now got the worst in, in terms of where Retail and Commercial banking margins are going to go, or is it still…?

Stephen Hester: We've given an outlook for the year. Let me just try and break it down. I think that the squeeze on saving's margins shouldn't get worse from the Second Quarter onwards. In other words, in most countries the interest rate declines are now basically behind us. Obviously we had the ECB yesterday and therefore you'll see the full squeeze on savings margins in the Second Quarter for most people and then that should be a constant. That should gradually be outweighed by the working through of higher asset prices on back books.

In that sense, I think that that pace of squeeze has got another quarter to go and then where it goes thereafter, it should be more benign. Albeit, I think, that we're facing a world with permanently higher competition for deposits and even when interest rates go back up, I do not believe that savings margins will go back up to where they once were, but of course that's speculation.

Then, as you say, on the component of wholesale funding costs, the variables on that are what happens to bank spreads, which we can all have a view on and presumably will come down at some point, although I doubt down to where they once were. Secondly, the quantum of wholesale funding that has to be done; obviously if a balance sheet shrinks there's less of it, but I think the term structure will get longer. Banks will have to have a longer term structure than they had in the past, which will be more costly. Then finally, probably the most costly of all of these things are the liquidity proposals and although they are going to come in over many years and are still very indistinct, I think they can cost a lot of money.

John Kirk: Just to summarise, I think what you've just said, to make sure I'm not misreading what you're saying; the Retail and Commercial banking margins have troughed, or at least stop falling in the Second Quarter, but the increased costs of a stronger liquidity position could run through the P&L for a number of years to come, basically.

Stephen Hester: That's sort of what I think, yes.

Operator: We'll take our next question from Jonathan Pierce from Credit Suisse; please go ahead.

Jonathan Pierce: Just got a couple of questions; can I just follow on from that last one regarding Retail and Commercial bank margin? Are you including the winding off of the structural hedge within your Q2 stabilisation guidance?

Guy Whittaker: I think yes is the short answer; the hedges typically on the non-interest balances are between 3 and 5 years or hedging of 36 to 60 of each month rolling that out. If there is a long and sustained period of low long-term rates then you'll see some pressures there, but, as Stephen said, you'd expect to have the time to recover those margin losses on re-pricing on the asset side.

Jonathan Pierce: Just come onto commercial property book the stock of provisions I think in place at the end of last year was pretty low, about 1% or so going to the UK book and it doesn't look like you've taken much more in Q1; we can see the GBM number. Maybe you can give us a bit of an update on what you're thinking there, particular in light of the pretty big impairment numbers we saw from Lloyds yesterday on that portfolio.

Stephen Hester: Obviously I can't answer for what other people are doing, but what we're trying to do is play a very straight bat on provisions. The instructions to the people in the field are to provide in exactly the way they have been doing in the past; not to try and front run on provisions, but nor to try to minimise and so it's coming out how it's coming out. As I have said in the past, while we do have too much commercial real estate – and it will be a source of significant losses to us I believe – the important mitigants are interest rates. The overwhelming majority of our book was investment property backed and low interest rates mean that it is much easier to service most of that debt, so that the issue for the commercial property book is mostly busting covenants and inability to refinance, unless we extend financing, rather than inability to service debt in the meantime.

That means, I think, that the losses a) are slower to come through and b) that the way we and other banks behave will have an impact on what the ultimate losses are. As I say, this is not an area where we think we will escape or where we're happy with the exposures we have, but I think it just simply is one where actual losses are slower to come through.

Jonathan Pierce: It sounds like a slightly more positive story than perhaps the caution you were talking in the tail end of last year on.

Stephen Hester: I'm really trying not to be more positive, but whatever.

Jonathan Pierce: A final question, this may well be a no comment, but clearly with the share price now very close to the Government's average in price, can you give us any insight at all on what UKFI's intentions may be longer term?

Stephen Hester: I think the insight is they want to get out and we want them to get out, but my guess is that they would regard it as important for there to be enough passage of time, not only for the share price to be solidly founded at attractive levels, but for there to be significantly volume demand for shares behind that. It seems to me that the process of our rehabilitating ourselves in size with investors is not going to be accomplished in one or even two or even three or four Quarters. I still regard this as a multi-year timetable, but I have no specific insight from UKFI whatsoever.

Operator: We will take our next question from Michael Helsby from Morgan Stanley; please go ahead.

Michael Helsby: I've got just a couple of questions; firstly on GBM and there are a couple of parts to this. I was wondering if you could give us an idea of the phasing of the revenues throughout the Quarter. The reason for the asking is that I think Credit Suisse, when they announced their results, said that there was quite a substantial element of the credit revenues due to a bounce back on inventory gains because of tightening spreads. I was wondering if you could give us a bit of flavour of that.

Stephen Hester: It was certainly true that January was by far the best month and the run rate dropped in February and March, albeit it was still a very attractive run rate and indeed has continued in April at the February/March levels, not at the January level. We estimate that inventory gains were probably about 300 million or so of revenues in the Quarter; not significant which is pleasing of course, because that means that the results are higher quality, but I don't want anyone to believe that that's a sustainable level. I don't think it is, but what I think is good is that we had every possible excuse to underperform others and we didn't. I think that's a great credit to our people as well as the flow elements of the franchise on which we are now majoring.

Michael Helsby: On the rates business, that is eye-popping in terms of how that performed and clearly there was an immense amount of volatility, but now with quarter end rates are settled at the shorter end of the curve. I was just wondering if you could give us a flavour of what the business leaders within the rates business are telling you in terms of the outlook for the year.

Stephen Hester: They're telling me not to multiply by 4, but I'm old enough and wise enough to know that anyway.

Michael Helsby: Exactly; no more colour.

Stephen Hester: It's fruitless; I think what you can see is that we performed, at worst, in line with other investment banks in this area and actually more charitably probably better than many and I'm very pleased by that. If you can tell me what other people are forecasting, I imagine it will be quite similar, but I remain cautious on this level.

Michael Helsby: I was surprised to see on GBM the asset and portfolio management revenues up, despite the disposals that you made last year. What's going on there?

Stephen Hester: The portfolio management is our loans and we didn't really dispose of loans last year. The balance sheet that came down last year was very much securities inventories and repo. The loan book - in fact the whole issue of the non-core division in APS is the loan book is very slow to shift and, of course loans are, to some extent, re-pricing so you get a little bit out of that; then more important than that, a currency effect because the increase is actually a decrease in constant currency terms, so I don't think there's anything peculiar going on there.

Michael Helsby: I thought Angel Trains and there were a few other big things were in that line.

Stephen Hester: Angel Trains was largely in operating depreciation lines; that doesn't come in now.

Michael Helsby: On the monoline write-downs that you've taken, I appreciate that you use CDS unlike other banks that use credit ratings, but the downgrade of some quite big monolines in April, whether that would effect the CVA.

Stephen Hester: I don't think we have material additional April charges on monolines. I'm just looking at my colleague…

Guy Whittaker: The CDS spreads; I think Michael, the ratings, if you like, is catching up with where the market's already been. I am conscious that the spreads and also implied recovery rates fell in the First Quarter and we take that into consideration as well.

Stephen Hester: You're right to point out that we do have a conservative methodology on monolines, which a) I think will stand us in good stead, but b) means that I don't think you should be multiplying the credit market write-downs by 4 of that ingredient of our results, even if you do multiply the normal impairment by 4, as it were.

Guy Whittaker: We've got about 8.2 billion of CVA now against the net 12.1 exposure.

Michael Helsby: That's helpful and if I may follow up on the margin questions that everyone's been asking. I'm surprised at your saying about the Q2 margin pressure from liability is bottoming out. I think Barclays yesterday quite helpfully actually told us what the hedge gain they'd book in the year of about 2 billion. Have you got a similar number that you've got to hand?

Guy Whittaker: No, that's not a familiar number to me, Michael, in terms of a hedge gain on that. The purpose of a hedge is not to actually take the gains; it is to protect an income stream and a margin…

Michael Helsby: If you didn't have the hedge … that Barclay's are saying it will lose 2 billion off the revenue this year, so the equivalent number of that for you. It feels like structurally you're not as well hedged given the comments that you're making about the liability pressure easing from the Second Quarter.

Stephen Hester: I'm afraid we don't have that number at our fingertips and I don't think … it is clear that the hedge running off will produce a continuing savings squeeze or the liability squeeze. I think, as Guy said, however that hedge is a medium-term hedge so that comes through into the P&L over a 3-5 year period steadily. I think what we were hoping, was that the re-pricing of the asset book would be an offset to that, but would not be an offset to the higher wholesale funding and the liquidity costs.

Again, I just want to caution everyone; we are not yet at the phase of our journey where you should take as gospel these sorts of predictions. We have uncertainties in the outside world and we have uncertainties in our financial structure which we're trying to get on top of. I hope each Quarter we pronounce, both of those uncertainties will get better, but please don't take these as absolute gospel yet.

Michael Helsby: Finally and thanks very much for the airtime but just as a point of detail, the restructuring costs, given everything that you said at the full-year look quite low in the Quarter, so I was wondering if that's more of back half loaded…

Stephen Hester: It's timing; I would not in anyway reduce the guidance we gave over a number of years about restructuring costs, but as an example, we announced 9,000 redundancies the other day, but those redundancies will actually happen over a two-year period. We're not trying to front run on restructuring charges; we know that our P&L will be very bitty for several years and so there's no great merit in front running.

Michael Helsby: The B share coupon and the fee amortisation, is that going to be a backdated event at the start of the year and that's not in this year, or is it going to be a part-year event?

Stephen Hester: It's not in yet because we don't have a contracted APA.

Michael Helsby: No, exactly yes, but will it be backdated to the start of the year or is a part-year event when it's signed?

Stephen Hester: I haven't the first idea, to tell you the truth.

Guy Whittaker: Honestly, I don't know, but it's a good question.

Michael Helsby: Can you maybe ask them next time you see them. I'm only kidding obviously.

Operator: We will take our next question from Mike Trippitt from Oriel Securities; please go ahead.

Mike Trippitt: Just two questions; one a follow up on liquidity; you've talked about a 17% growth in interest earning assets driven largely by holdings of liquid assets. I just wondered in your margin…

Stephen Hester: No, it's driven largely by foreign exchange Michael.

Mike Trippitt: I just wondered, if you could in your 15 basis points guidance going forward just give a rough idea of what the liquid assets to total assets component, how that's going to change from say '08 to '09; what your working assumption is for that margin guidance?

Guy Whittaker: The working assumption that underpinned the margin guidance is an incremental charge of 300 or so million Pounds in the Quarter related to both the combination of term-funding and the negative carry-on additional liquid assets and we're flagging it. We think that will move up in the quarterly run-rate that's heading towards something in the order of a billion, billion 5 a year.

Mike Trippitt: The second question is, I just wondered – I'm sure we can work this out eventually - but what the impact of pro-cyclicality and currency was on the risk asset base.

Stephen Hester: Well there was effectively no currency movement on the Quarter - very, very little - and the pro-cyclicality is around plus 20 billion on the Quarter. Be careful because pro-cyclicality will show up in two places, not just in risk weighted assets but it shows up also as a deduction from capital because once loans have defaulted they have a different treatment. You'll see on our capital ratios that that deduction increased and part of that in a sense is a form of pro-cyclicality.

Mike Trippitt: Why are you saying currency doesn't impact the risk assets? You've had quite a big move on the spot rate year-on-year.

Guy Whittaker: Over the Quarter, we're talking about 2 or 3 billion Pounds on a base of just under 600.

Stephen Hester: Year-on-year there's obviously a big change but quarter-on-quarter there isn't.

Mike Trippitt: Yes, fair enough.

Guy Whittaker: Over the Quarter aren't vastly different in either Sterling or Euro terms.

Mike Trippitt: Thanks very much.

Operator: We will take our next question from Peter Toeman from HSBC; please go ahead.

Peter Toeman: Two questions; one is the full-year, you were talking about 150 billion reduction in risk weighted assets and I wondered if you actually…

Stephen Hester: Sorry, where did you get that from?

Peter Toeman: From the presentation on … full-year presentation global markets, 150 billion of the RWA reduction.

Stephen Hester: 150 billion over 5 years.

Peter Toeman: I just wondered, is that including or in addition to the APS scheme or…?

Stephen Hester: That was ignoring APS; what we're saying is that the restructuring of GBM over 5 years should take, out order of magnitude that amount of risk weighted assets and you will see that reported from the half-year in the non-core division. So, in a sense we will show it optically almost immediately, but of course it won't actually happen until the non-core division runs off which, as I say, is a 5-year job.

Peter Toeman: The other question is on the Asset Protection Scheme you talk about 75-85% of impairments relating to assets in the scheme. Do you think that's atypical and an unusual figure, or is that what you might expect going forward?

Stephen Hester: This is unpredictable because obviously we don't quite know where losses are going to arise and what amount in the future. Most of our personal lines are not covered and Citizens is not covered. The primary sources of – by personal lines I mean credit cards and unsecured loans, which obviously some of the worst of the mortgages are, but that's not a big problem with us unlike some others – the principal leakage lies in those areas. It will also be the case that there will be assets that go bad that we weren't expecting to go bad and we didn't put in APS; and of course what we don't know is how good predictors we are and time will tell.

Operator: We will take our next question from Tom Rayner from Citigroup; please go ahead.

Tom Rayner: Could I just ask you a question on your strategic plan; I'm particularly interested in what the balance funding and liquidity profile consistent with an ROE of at least 15 is likely to look like. The things I'm interested in is the liquidity, the liquid assets to total assets, and what the Group LDR might look like I saw it as unchanged, I think, at 150 in Q1 and duration of wholesale funding. Could you give us a bit of a feel, I know it might be too early for you to give details on your 3-5 year plan but…

Stephen Hester: Unfortunately a number of those things are out of our control. Loans to deposit, our Holy Grail is 1:1; whether we actually get to 1:1 over the 5-year period, I think, will be more dependent on whether the US and UK economies rebalance properly or not, because it's impacted by the savings gap since in the end banks are a mirror of the economies they serve.

Tom Rayner: Can I just ask you Stephen, why that's the Holy Grail? Do you think that is optimum? It would seem to me that to have no wholesale funding is unnecessarily hair-shirted maybe?

Stephen Hester: Just bear in mind that we will have substantial wholesale funding to support our non-loan assets, since we have a large and successful Investment Bank as well as, obviously, some non-loan assets in other parts of the Group. I'm not saying that we have to get to 1:1, but I want to get to get as close to 1:1 as the economies let us. I believe that that is right given the amount of other wholesale funding we'll be doing in respect of the other items on our balance sheet.

If you crudely do the numbers, as we presented in February, the run-off of the non-core division gets you a lot of the way there. Of course we also expect to increase our savings balances, albeit the whole world is competing for those and so it remains to be seen how successful that will be. But it also is true that 5 years is an awful long time to predict the extent to which wholesale markets will come back, be willing to fund banks both in volume and cost. Similarly I think we have a great deal of water flow under the bridge with the Regulators on term funding structures and liquidity, which is why I can't give you detail now - partly we don't have it, partly the Regulators haven't imposed it on us - and why, when we set out the half-year more granular targets, they will be aspirational as opposed to certain, given those variables.

We'll try and give you more at the half-year, but even then I think you will be not as satisfied as you'd like to be.

Tom Rayner: So fully deposit funded loan books is the goal and probably an absolute trinket in the wholesale funding of the rest of the book.

Stephen Hester: Although I am cautious as to whether we will achieve that goal because I think that the rebalancing required of the UK and US economies to make that goal feasible, is a big ask. That's a direction as opposed to where we'll definitely get.

Tom Rayner: I don't suppose you'd be willing to give a margin figure consistent with your ROE objectives, or was that again a lot of moving numbers.

Stephen Hester: As I said before, I regard this in a sense as an outcome. Our industry cannot exist if it doesn't cover its cost-of-capital in the long run and 15% I take for now is covering a cost-of-capital. Therefore we will have to adjust asset pricing more and more and more until such time as we get there. Asset pricing and costs of course.

Operator: We will take our next question from Leigh Goodwin from Fox-Pitt Kelton; please go ahead.

Leigh Goodwin: Hello, good morning gentlemen; two or three things it should be quite quick. On the APS, you've answered a couple of questions on this already, but just 75-80% of the 4.9 billion is being covered; monoline, CVAs a cost of 1.6 billion. Can we infer that you are intending to have your monoline exposures included within the APS scheme?

Stephen Hester: We said that at the time, so yes you can infer that.

Leigh Goodwin: Is that one of the areas that causing one of the most debate perhaps?

Stephen Hester: No, it is not.

Leigh Goodwin: On the UK Retail and Commercial, there was a drop in the non-interest income and you've told us broadly what those things were attributable to, but I wondered, with regard to PPI is that just a timing issue, or is that something where you think there's been a permanent step down in PPI income?

Stephen Hester: There is a permanent step down, it affects some others more than us, but the amount that we used to sell and the way we used to sell it is permanently gone. Of course out there and not yet addressed, both in the UK and the US, are current account charges which both in the UK and US there's regulatory pressure on. I think there are other headwinds on retail bank revenues in both sides of the Atlantic in the next year or so.

Leigh Goodwin: Taking these things on their own, leaving aside Tesco things, there is a permanent element to this stepdown; it's not just a cyclical issue to do with levels of activity?

Stephen Hester: That's absolutely right and I said that back in February as you'll recall at the results presentation, retail banks need to restructure and reinvent themselves because there are some big headwinds in some elements of the revenue. We are going to do a massive amount of work to our retail banks in the next five years, particularly on the costs side, but also on the revenue side in order to combat those headwinds. I think we will combat them, but it's going to be hard work.

Leigh Goodwin: On Global Transaction Services, this has been a very successful business for you and one of the good plus points from last year. It seems to have had a fairly weak First Quarter and I wonder if you could just talk us through why that is the case and what we might expect from that business.

Stephen Hester: I think it's the same issue that a large bit of the earnings of that division are from the deposits it produces and obviously that's getting squeezed in margin terms. Then secondarily, there are some aspects of slowing business volumes, for example trade finance has got slowing business volumes; some of the transaction fees have been slowing. There's no great drama, but the principal issue, I would say, is narrowing deposit margin.

Leigh Goodwin: There's no change in terms of things like market share would you say?

Stephen Hester: No. There will be some impacts; some elements of this division will be hurt by our pullback from some of the more exotic geographies because obviously some of the global money transmission and clearing activity relies on elements of that network which we're dismantling. I don't think it will be a drama, but there'll be some headwinds there as well.

Leigh Goodwin: Coming back to the strength of the FIC incomes within Global Banking Markets, would you say that … clearly one should extrapolate, as you say, 4 times the performance in rates and so on, but if and when that performance starts to abate because maybe volatility changes or the interest yield curve changes, should we be considering that there would be offsets in other parts of the business? In other words that even if that particular element of your performance isn't sustainable at the levels we've seen, that we should be thinking, though, there may be other parts would be, in those circumstances, actually performing better.

Stephen Hester: Not in the short-term; I think in the balance of this year the revenue run rate will be lower in GBM and will not be higher in the rest of the Group. Over the 3-5 year period, of course we do expect to make our targets without the benefit of unusual quarters, but the balance of this year, most definitively not.

Operator: We will take our next question from Sandy Chen of Panmure Gordon; please go ahead.

Sandy Chen: Firstly, congratulations on being the CEO that says, "You should borrow less and save more", and that you don't see green shoots; it's very courageous. The questions I have are mainly around impairment.

Stephen Hester: By the way, I haven't heard from the Government yet; I'm going to see them this afternoon.

Sandy Chen: Good luck. The question on impairments, not to be boring but focusing on the monolines, and again well done on taking it looks like about 66% CVA on your CLO exposure within the monolines.
My question is, given still the 27 billion and notional exposures in monolines, £12 billion of notional on CLOs, what are your expectations over the course of this year et cetera if corporate default rates, in particular, rise and what your CVA estimates are?

Stephen Hester: This is a hard one; there are two aspects, I think, to your question. The first is what will happen to the value of the assets that are wrapped? Our risk people think that the vast majority of those are, whatever happens to their mark-to-market which will obviously move around, will in the end return an amount similar to where we've got it now booked in cash flow terms, whatever the internal volatility; but of course it may well be that corporate loss rates rise to a level where that's not true. There's still a degree of unpredictability and, as you know, corporate default rates are still rising.

The second issue clearly is are the monolines, on the extent to which we rely on them, going to default to the tune of 66% where we've got them covered or more or less? You've got a pretty big bid offer spread in the UK banks and you pay your money and it takes your choice.

Sandy Chen: Understood; can that read across into the CDPC exposures as well being made, because it looks like your CVA there is about 34%. Are you effectively assuming better credit risk in the CDPC sector?

Stephen Hester: Yes, in short, but it's also the case that our CDPCs are one of the things we submitted for the APS.

Sandy Chen: Understood; the next question is more just a general one on customer loan book, both in the UK and in US, Retail and Commercial. It looks like NPLs are up roughly 37-40% with quarter-on-quarter; could we use that as a guide in terms of expecting what the increase in impairment charge might be quarter-to-quarter next quarter?

Stephen Hester: No, we don't know; but I don't think we're seeking to move consensus on bad debt up from where it currently it is, particularly, because I think the consensus was already quite bearish, but obviously there's a range of possible outcomes still.

Operator: We will take our next question from Robert Law from Nomura; please go ahead.

Robert Law: Good morning, I have two questions; firstly on the margin - thanks for the guidance and information you've given there - there is a thought in some quarters that margins in the UK are ultimately going to expand; obviously it doesn't look like you share that. Could you give us some view as to what you think the benefit of asset spread widening is currently likely to be on your margins?

Stephen Hester: Robert, I do think margins will expand; I just think it will take 3-5 years for that to happen. They have to expand because if you have a less leveraged balance sheet and you need to cover your cost of capital that's the way you have to do it, plus costs, but I think it will be a slow business. On the asset side, one of the things that frankly we make harder for everyone as well is that we tend to move around the basis of where we cut asset versus liability spreads. As wholesale funding costs move up, we move that basis up so you can get apples and oranges. It's clear, as you know, that in the UK mortgage books have re-priced considerably. Corporate loan books are re-pricing albeit that that takes more time and, as we've indicated today, we think that that will start making up for what's lost on savings albeit not necessarily in the near-term for what's lost on the funding liquidity side.

Robert Law: I was just after some kind of indication as to what you think that's going to be, whatever it is - basis points per Quarter or whatever.

Stephen Hester: I don't feel well enough prepared to not risk misleading you.

Robert Law: Secondly, on the asset protection scheme are the assets that are going to be put into that scheme now permanently fixed and you're just talking about documentation or whatever. Or do you still have some availability to change the mix of assets that you're putting that scheme?

Stephen Hester: We did make some shifts in the assets about a month ago. We have not shifted any of the assets since then and so at the moment we're working on the principle of a static pool. If there were particular reasons to shift them, we leave open the possibility, just as the Government leaves open the possibility of rejecting it, but at the moment there isn't a whole lot of movement. Where we are is not radically different from what we indicated in February, at least in quantum now. The risk weighted assets will bounce around because, obviously, that changes with that migration, but the quantum of assets and where they're coming from, we'll have some changes but not radical ones.

Operator: We will take our next question from Simon Samuels from Citigroup; please go ahead.

Simon Samuels: Just a question on the US business so I see it's loss – I'm on page 27 – obviously it's in Dollar terms loss making and pretty much all the lines revenues down, costs up, obviously bad debts up a lot. A couple of questions; one is, are the trends you're seeing in the US – the Citizens franchise – are they essentially likely to continue. Is this business in your assessment going to be loss making for an extended period of time? I guess linked to that is, whether that's in anyway going to challenge your presumption of keeping it within the Group. The second question in the same area is, obviously I know you were exempt from doing a US stress test even though by balance sheet size, obviously Citizens would have qualified. I'm just curious to know whether you have done your own internal replication of what the Fed's done externally and whether you can comment on how you see the Citizens franchise versus its post-stress tested peers.

Stephen Hester: I think the first thing I should say in fairness to Citizens is we disadvantage it in the way we present it because we put a bunch of Citizens' profits into the GTS division, which on another presentation are in the Citizens' legal entity. Citizens is actually profitable as a legal entity and frankly as a bank and that's just the way that we handle GTS.

Secondly, I'd say to you that although there is deterioration, as far as we can see Citizens is behaving rather similarly to comparable banks. When we look at our impairments, our impairments are actually, as a percent of book, still significantly less than comparable banks and our provision coverage is significantly higher than comparable banks. We remain on the positive asset quality and conservative provision path. However, it is also the case that Citizens' income margins are not as wide as some comparable banks and that's one of the things that we have to fix.

Citizens also by - as part of our plan as you know - retreating to its core footprint will be running off certain books which will impact the income line before it impacts the bottom line because of the provisions of the risk in those books. I would say to you that, so far it appears to us that Citizens overall is going to behave broadly similarly to comparable regional banks in the US. As such, I believe that regional banks like this in the long run are attractive valuable things to have and in the short run are caught in the headlights of what's going on in the US economy. It doesn't in any way change my perspective on Citizens.

The stress test; we have not conducted a specific stress test on Citizens, but obviously in a sense there has been a stress test conducted by the UK Government or the FSA on RBS as a whole, including Citizens, in reading the Asset Protection Scheme conclusions. Within Citizens itself we remain strongly capitalised, although I think there is every possibility that we would add to that capital over the next year and half; in part in response to what the US banks are doing and clearly that's one of the ways, as we re-capitalise ourselves at the centre, various subsidiaries benefit from that as well.

Operator: We will take our next question from Kushal Kumar from Numen Capital; please go ahead.

Kushal Kumar: A question from the fixed income perspective, if you will call it; you obviously had a pretty successful tender exchange for your debt and a debt-for-debt and debt-for-cash exchange. It strikes me is that the size of it was almost equal to your market cap at the time when you announced it. Given that there are some regulatory changes coming in, clearly the Regulators are looking at different types of capital to be introduced into the future business model. Is it likely that you're examining the debt side of your balance sheet to create capital a little more actively as this process unwinds? That's one specific question; there's a second follow on; we note that you did not include bonds which were callable during the course of this year in that tender. Was there a rationale for that and do you have any specific intention towards the bonds which are callable during this year?

Guy Whittaker: In answer to the first question, I think our interests in the exchange in tender was to a large part stimulated by investor enquiries looking for liquidity in pricing in volume for those securities; it suited both investor purposes and our purposes. What we did at the time was a pretty comprehensive sweep of the liability side of the balance sheet and took into account everything that was there and doable. As you rightly point there are additional securities on the balance sheet for which a similar programme could be undertaken, albeit there are complexities associated with all of that, but it's something we remain alert to and certainly would consider.

I think in the ’09 point of view we were just averting making any oblique signalling on our intentions around calling or otherwise or tendering a decision to make at the time so it excluded as a matter of principal anything that had a maturity this year. We would make an assessment as to whether to call or not to in the light of both failing market conditions and importantly, I think, market practice amongst others who have callable instruments would take a view on each security as it matured. We didn’t want to make any advanced signalling of that so we did it and we excluded them all.

Operator: We have a follow up question from Michael Helsby from Morgan Stanley; please go ahead.

Michael Helsby: You very kindly went through all the headwinds and the uncertainties that the industry is facing over the next few years. One that, I think, you’ve missed out or not missed out, but not really commented on is capital. I was wondering, given you made comments about how you think Royal Bank might look in the new world given the regulatory announcements and the Turner review, if you could update whether your view on core capital ratios in the next few years, whether that’s changed or not or whether it’s still round about the 7% mark.

Stephen Hester: For now I would say around about the 7% mark at the endgame, but obliviously there’ll be lots of other changes in terms of the amount of liquidity in the term structure of the balance sheet and so on above that, that are economically important, even if they don’t impact capital. However, the caveat within that is clearly, particularly on the investment banking side, I would expect the calculation of risk weighted assets to change – as it has been signalled – and become stiffer. Relative to today’s calculation we’re assessing a significantly higher level, more like 10% of risk weighted assets against the Investment Bank.

What I expect to happen is that the calculation basis will change and will bring the 10% down, but in our plans we’re trying to take a sighting shot of what might happen in capital weighting for trading books, even though, of course, they completely obscure what is going to happen, just simply the direction is a negative one.

Operator: Once again, if you would like to ask a question please press the * key followed by the digit 1 on your telephone keypad. We will take our next question from Bruno Paulson from Bernstein; please go ahead.

Bruno Paulson: One element of the APS scheme, a controversial element, was the UK tax losses and you forfeited the 2008 and previous tax losses. Should we assume that this continues with any losses going forward during the rest of the down cycle?

Stephen Hester: Yes; only UK ones.

Operator: You have a follow up question from Mike Trippett from Oriel Securities; please go ahead.

Mike Trippett: On the US SBO book, it looks like the First Quarter charge was probably about the same as the second half last year. Could you update on the size of that book now and where you think - obviously it's still looking like its getting worse before it better - where you think we are in that impairment cycle.

Guy Whittaker: Book size, Mike, it is around $7 billion remaining. They're still trending down slowly; it peaked I think if you recall around 9. And as you rightly pointed out, I think the delinquency rates were accelerated in Q1 and so both charge off and provisions associated with that increased in line with US practice in the First Quarter.

Stephen Hester: It is a perfect lesson in avoiding broker originated loans and out of footprint loans.

Mike Trippitt: What's your gut feel going for? Are we still more of the same to come?

Stephen Hester: In a sense it took another leg down, as you pointed out in provisioning. There were in the Fourth Quarter some hopes that the pace of decline … that the US housing market was nearing its bottom and I think those hopes are being postponed. I think that that will obviously be quite closely related to what happens in Case-Shiller and those other similar indices.

Operator: We will take our next question from Nicole Jackman from Wellington Management; please go ahead.

Nicole Jackman: I just wanted to know, has a capital injection by the Government been vetted with the EU Commission? Has the EU Commission signed off on whether or not this is a valid form of State aid and is there any danger that the EU could come in and intervene further down the line on whether or not you'll be able to pay coupons or call on any of your capital securities?

Stephen Hester It is going through the State aid process as we speak and hopefully that will be concluded within the same timetable as the rest of APS. Is there a danger? Yes. At the moment is that assessed as a major danger? No.

I don't want, by that remark, to in anyway take for granted the process, because obviously we and the Government have to demonstrate the case; but I think, as you know, the restructuring plans that RBS has put forward are amongst the most severe and far reaching of any bank I know of in terms of the 250 billion of asset reduction, the people reduction, the country pullbacks. It's really those of kind measures that the EU wants to see as compensatory measures to the State aid. So, we believe that the case is a good one, but we have to get it through.

I think we better be closing quite soon, so maybe just one more question.

Operator: There are no further questions at this time.

Stephen Hester: Thank you very much listening. Obviously our Investor Relations team, particularly Richard O'Connor, is available at any time to answer follow-ups that you have. I hope you found this an uplifting experience, as have we, in talking to you and look forward to next time. Thank you very much, bye-bye.

Operator: Ladies and gentlemen that will conclude today's presentation. Thank you for participating you may now disconnect.