2011 Interim Results

ANALYSTS PRESENTATION

Held at the offices of the Company

280 Bishopsgate London EC2

on Friday 5th August 2011

FORWARD-LOOKING STATEMENTS

Presenters

- **Sir Philip Hampton (Group Chairman)**
- **Stephen Hester (Group Chief Executive)**
- **Bruce Van Saun (Group Finance Director)**

Presentation

Sir Philip Hampton – *Chairman*

Welcome to RBS half year results...at the end of another quiet week for bank stocks. Our results once more are quite a mixed bag. We've got continued good progress on the balance sheet. Again, capital funding, the Non-Core rundown all going very well and our businesses are, generally speaking, performing much better – certainly our retail focus businesses doing a lot better. GBM is obviously suffering from the general market weakness in that area, but once again we've got some big charges coming through which are effectively continuing aftershocks of the financial crisis – in our case, Greek sovereign bonds, Ulster Bank and, of course, the PPI charge for redress. I think we're all looking forward, probably on both sides of this divide, to the day when our results can be simply dominated by the operating performance of our businesses, rather than these material items, which seem to be a recurring feature of our results.

We're also looking forward to the publication of the ICB's final report, especially the recommendations on ring-fencing. We at RBS are obviously the biggest casualty of the crisis in banking and, of course, we did make a big, ill-judged acquisition, but our losses recording since the financial crisis got going have been, generally speaking, plain vanilla credit problems rather than losses resulting from trading activities and so, for example, in this half we have £2.5 billion provisions in Ulster Bank – and that's a relatively simple focus to Retail and Commercial Bank along the lines of the ring-fenced activities described in the ICB report. So it will be interesting to see how an efficient, enduring, ring-fenced structure can be identified, the deals with the dynamic changes, customer needs, market conditions that are really a feature of our world.

What we will never get away from is the need for effective, internal risk controls, external supervision and an appropriate management culture and team. We've made great progress, I think, on our internal risk controls, we have plenty, now, of external supervision and I think we've got a fine management team in place at RBS and I'll hand you over to the top two of that team to talk to you more fully about the results. Thank you.

Stephen Hester – *Group Chief Executive*
Thanks, Philip. We'll go through the normal format – introduction from me, Bruce will go through the numbers and then obviously Q&A afterwards and we'll try make it brisk as I know you all want to get back to your screens and be uplifted after what I hope will be a characteristically cautious presentation from us.

So in terms of running through the headlines of the business achievements – and obviously most of you will have seen this in our press release – we feel that RBS has delivered a solid performance in the challenging market conditions. You've seen the operating profit up year on year, whether measured in the first half year or second quarter on second quarter. Clearly the Retail and Commercial businesses are the stronger performers, as you would expect in this kind of market, with UK Retail our strongest contributor, but we are seeing turnarounds in the areas we needed to see them and I'll talk about that more lately. And even in GBM, which is going through the most difficult time, our first half return on equity is 15%... is really not too terrible. We'd like it to be better; it may not be for a while but, you know, I feel that there are many good things in that business line as well.

You've seen some of the key business metrics – our net asset value per share confusingly went up when there was a bottom line loss, which is really to do with the movement on available for sale. Bruce will take you through that. Our Core-Tier 1 I think again is standing in some very good stead and, of course, we still have the remainder of Non-Core to come down and to further support our capital ratios. We've been increasing our position coverage in the quarter, becoming more conservative in that area and, despite that for the half, Core impairments continue to go down and that's the underlying trend. Our business de-risking continues to be on or ahead of schedule, whether that be measured by Non-Core or whether that be measured by the structure of the balance sheet and its liquidity and its loans deposits ratio and so on. Philip referenced it, we still have plenty of issues from the past we're working through – most of those lie in the Non-Core line, some of them lie at the loans and the two big ones... again, Bruce will take you through them – PPI and Greece... Greece, where I think we've taken the most conservative view of any banks so far, but that's another story. And, as it relates to supporting the UK economy, you'll notice that our lending, which we believe we're doing sensibly, nevertheless is something double that of any of our competitors to the UK economy.

And in financial highlights – again this is picking the Q on Q measure, Q2 this year against Q2 last – operating profit up a bit, driven by UK Retail. Return on equity hovering around or above, depending how you calculate it, the cost of equity in our Core businesses. Our net interest margin actually up year on year, stable in Retail and Commercial... Bruce will take you through that in more detail... Cost income ratio not where we need it to be; that will require more work, both on the cost front and on the revenue front. Impairments gently coming down and the business pretty well funded; we have more deposits than we have loans in our Core business and that's, I think, and important place to be, and the Non-Core progress we've talked about.

And simply to remind you and update you on this, not to talk you through it, we think that there are merits to the balance... to our bank that you see across different times and different market positions. You'll see that we continue to be pleased that we are weighted, as to the majority, in Retail and Commercial, but with a strong Western banking presence. The geography, clearly we have UK dominance, which will change quarter on quarter depending on how businesses change, with good presence in the US and less in Europe and Western Asia, and then we set out at the bottom some comparisons of our positioning, if you like, dominance of Home Market versus International, Investment Banking versus Retail and Commercial, against the market, which you might find interesting to reflect on.

We also clearly have, since the beginning of the RBS recovery and turnaround plan, set our stall out, I hope, with great clarity – not just in disclosure and frequency and reporting, but set our stall out in what we're trying to accomplish and what we think we can accomplish and again we report here on this slide where trying to get to, where we've come from and the progress, which you'll see in the majority of measures year on year is going in the right direction and, in some measures, has already arrived where we want to arrive. We have, on this slide, presented unchanged 2013 targets from those that were adopted five years ago... two and a half years ago... before the five year period. Our view is that those targets should be refreshed; we don't see the point in doing it before the regulatory position is clear, so my guess is early next year or something would be the time that we would revisit it by way of a preview. My guess is that all of what I'll call the risk balance sheet structure-type targets we will keep the same. In capital we will make that more conservative – obviously the (unclear) number is 9.5, so greater than 8, and it's covered by that, but clearly we're going to be 9.5+ and how much plus, a little bit, depends on regulation as well. And my view is that the cost income ratio, I think that we are likely to think that 50% is still the broad territory that a bank like us should be aiming for – although whether we get there in exactly the year we wanted to might be impacted by the pace of economic recovery slowing and that leaves, of course, return on equity. I think we believe strongly that we are in business to create a business that returns more than its cost of capital and I think we believe that we need to keep working our businesses until we get to that position. Whether that ends up being precisely 15% or whether that number softens a bit, I do think is open for debate and open to be impacted by wherever regulation comes out.

And so a couple of slides on our business performance during the recent period, starting with our Retail and Commercial businesses and obviously Bruce will go through some of these in more detail, and there are a few key things that we are trying to do. What's not on this slide and underlies everything is to do a great job for our customers and I would say in our Retail and Commercial businesses we are seeing some positive signs in that respect. We are seeing, if you like, brand awareness, customer satisfaction improving, dropping of complaints, some nudging upwards in cross-sale levels – so all the programmes that we've talked about in the deep dives in our businesses, that many of you have seen, at the moment seem to be pointing in the right direction though it's early days for businesses of this kind. And you'll see that in profitability terms it is already the case that the majority of our RNC businesses hurdle higher than the cost of equity. There are a couple that don't at the moment – the US and Ireland – about which I'll talk about more in a second.

It's also true though that those businesses, while being... I think like most of our business, while being in good shape in profitability terms; we have business improvement programmes that have still got more to deliver. The credit outlook on balance, we believe is still improving – there's more to come there – but clearly slow economic growth and low interest rates soften the speed with which income can advance and Bruce will also talk about that more. Despite that soft picture in terms of being able to get money out of the door in a profitable way, there are a couple of bright spots. In the UK mortgage market we are still one of the few players because we've got more deposits overall than we have loans, that can fund itself and compete and gain share, and in the US which... hopefully the lead for the UK... we've begun to see the ability to grow our commercial loan balances, which is an encouraging early sign which I hope continues. You'll see the slope of impairments up here, which is another key aspect of what we're doing in Core in terms of risk, and balance sheet structure remains an enduring focus for us and you'll see again this quarter against a period a year ago, that the funding surplus from our Retail and Commercial businesses continues to improve. Again a very important thing, given wholesale market turmoil, but we also make the point, which is important to understand, that a chunk of our Retail and Commercial deposits the... about half of the deposits... a bit more that are in our GTS division actually relate to GBM clients and so in a sense the Retail Bank is not funding the Investment Bank, but the clients of the Investment Bank are funding the Investment Bank through deposits, as well as our normal wholesale operations.

We have obviously been focused, in addition to strengthening all of our businesses, and specifically on some turnaround situations in Retail and Commercial, the two underperformers relative to cost of capital have been the US and Ireland, and you'll see that at the moment, despite a slow, tough US economy and despite significant regulatory headwinds on fee-lines, in particular in the US, we believe that we are making progress in the US, which gives us encouragement that we can get that business back to the point where it is pulling its weight within our overall portfolio. We've stripped out, just to be clear... there was a one-time pension gain in the second quarter of last year... for the ease of comparisons... we stripped them out and you can see, I think, a reasonably consistent upward trajectory in profitability which is driven mainly by continuing increase of net income margin, including the last quarter in the US business and, as I say, now just beginning to be some expansion of the asset line as well. And, along with that, you'll see... which you'll see on the right... impairments have been coming down.

On Ulster Bank... and, again, Bruce will go through that in rather more detail as he relates the impairment line, which is clearly the main story still in Ireland... we are hopeful that the corner has turned at the moment and, there are the first signs in economic statistic terms of that, our provisioning has got down for the first quarter. Of course we hope that what's going on in markets around us doesn't set that back, so we're not doing any victory marches at this juncture, but anyway there are some hopeful signs there and, given the turmoil in Ireland over the last year, I think it is to the credit of our business that we actually have been able to improve slightly the funding profile of the Irish business by holding our loans steady and slightly increasing deposits. We obviously need to keep going with that.

The Investment Bank clearly, particularly all banks that have Investment Banks are particularly in the spotlight, given that that's where the market turmoil is hitting the most, and clearly we have subdued revenues as you would expect in this market... set of market conditions... and our revenue performance and therefore our profit performance also reflects a relative weighting towards Europe in our business and a relative weighting towards fixed income in our business. These things will come and go according to market patterns over quarters, but that's where we are.

Clearly we are working very hard to keep the return on equity (RoE) as high as we can, to keep the cost income ratio in a position where not too much of it is given away... of the revenues is given away... and priority number one in our business is just actually not to make any stupid mistakes. You'll notice our VAR came down something like 44% Q on Q. That's a bit of an exaggeration as to how much risk came down because there's some time series [VOL] that came out of it, but nevertheless it's showing you that we are picking safety over high octane revenue that's in this business. I think that will mean that we'll run on low revenues for a while, but I think that's the only responsible thing to do in these kinds of market positions and obviously, whilst we do that, we've got a huge amount of change inside the business in any event, which is expensive, but I think retooling us for the future and we need to keep looking at cost and we will.

And then the final one of the ongoing businesses Insurance, clearly the turnaround in Insurance is important in any event and particularly important given the EU requirement to sell this business. We believe that we are on course for a sale process in the second half of next year and we continue to think that an IPO is the most likely method and we believe that this business will stand up well to scrutiny and when we get there, in fact, we plan an investor teaching on the business and a teaching for you later in the Autumn, but in the meantime clearly, as you know, the makeup of the business is number one. Motor Insure in the UK – number one, Home Insure in the UK... the problem is there's a number of other personal lines. We've held those market positions, we've done major surgery to the risk profile of the motor book as well as to the competencies that will govern it in the future and that's showing through nicely in profit recovery and recovery of the key operating risk lines.

Turning to Non-Core, I mentioned in my introduction things going according to plan, so another £12 billion off the asset total in the last quarter, heading for under £100 billion this year. The P&L – Bruce will explain a bit more – but there were some loan write-offs that appear in income, which otherwise should never cross the impairments. But the P&L behaving itself relative to our expectations and managing to get down risk across the portfolio. We've always been clear that the Real Estate bit would be stickier than some others, so that the percent of Real Estate is increasing, but nevertheless we have reduced our Real Estate exposures by 41% in the last two and a half years, and so I think that should give encouragement that this division as a whole is on track – not immune from what's going on in the outside markets, but on track to do the things we need it to do.

So my final slide, just in terms of outlook. Clearly no one needs telling that there are external uncertainties. Whether that relates to the economic and interest rate outlook, sovereign debt issues, the path of the Irish economy, which at the moment tentatively is in the positive, Basel III which is becoming clearer in the way we expected and support, and the ICB which we have talked about. And in terms of the outside world which we can't effect, the contrast with the inside world which we can effect, we do see the ability to continue to progress in Retail and Commercial, we do see the ability to continue the performance improvements in the turnaround that we had on our docket.

We are cautious about the outlook for GBM in the next quarter or two – as I think anyone would responsibly be – and Non-Core tentatively we think is on track. We would expect impairments to fall, but a fair chunk of the, if you like, the [broom] made by that to use... that we would use in disposal losses to make sure that some of the stickier assets get gone as well. So with that introduction in terms of what's going on in the businesses I'd ask Bruce to take you through the figures. Thank you.

Bruce Van Saun – *Finance Director*

Thank you, Stephen, and good morning everyone. Let me start off with a brief review of the second quarter financial performance, looking at the Consolidated Group financial highlights for the quarter, Group Income was slightly down versus the prior quarter, as GBM income declined in a tough income environment after a seasonally strong first quarter. On the other hand, the Retail and Commercial business retained its strong performance, with underlying income up 2%. Expenses were down versus Q1 and versus a year ago, reflecting both a lower GBM income and strong cost discipline. Our Claims cost continued their improvement, both on a prior quarter and year-on-year basis, as the Insurance division's de-risking strategy is paying off.   The profit before impairment losses, or PBIL, was up about £100 million versus the first quarter and £350 million versus the year ago quarter. Impairments ticked up in the quarter in Non-Core, which reflected a targeted position to Irish land values and a few single name corporate impairments. The so-called below the line, quote unquote, items increased in the quarter to £1.5 billion. That included a PPI provision of £850 million and a £733 million provision against our Greek sovereign exposure, which resulted in a bottom line loss of £897 million in the quarter. Nonetheless, the Core Tier 1 ratio held steady at 11.1% and our T NAV strengthened to 50.3 pence.

Looking at the detail of our P&L categories, the net interest income was down 2% versus the prior quarter, with Retail and Commercial flat. Note that 87% of our net interest income comes from Retail and Commercial. The Group average interest earning assets were up by about £3 billion. That was driven by GTS in Retail and Commercial as well as Group Treasuries expansion of the liquidity portfolio. On the right side of the slide, Group NIM was off by 6 basis points on a headline basis, but its 3 basis points if you adjust for the UK Corporate one-timer in the first quarter.

Now, in R&C, the underlying NIM expanded slightly versus Q1, up a bip, and its 11 basis points higher than a year ago quarter. We've now moderated our expansion assumptions at this point, given the persistence of low rate and the flattening yield curve, but we clearly expect R&Cs NIM to remain stable. GBMs NIM decline largely reflects Q2s subdued Money Market income and GBM in Non-Core also bear the brunt of the costs of strengthening our liquidity and funding profile, given their funding gaps and that hurt the Group NIM by about two basis points in the quarter.

Our operating expenses fell 6% relative to the prior quarters, net's down 5% versus a year ago – a good performance in light of increased investment spending in the quarter. Against the prior quarter, second quarter staff costs were down 10%, driven by lower incentive accruals in GBM and the cost reduction programme that we've undertaken delivered a further £100 million of savings in the quarter. The programme continues to deliver against its target and we're actively working on further initiatives. We anticipate £3.3 billion rate of annualised savings by 2013. The Group cost to income ratio improved by 200 basis points in the quarter to 56%. At the headline level, Q2 Group impairments rose over £300 million versus the last quarter, as Core impairments declined modestly and Non-Core impairments increased by about £350 million.

The Non-Core increase reflects the provision against land values in the Irish portfolio, as well as some large individual corporate cases. Note that the recoveries on equity positions from workouts that we recorded in Non-Core largely offset this increase in Non-Core, so there's a little bit of income statement geography going on here. Those gains for equity positions are recorded in other income, which is why you saw income pop in Non-Core, so we managed to a total budgeted loss in Non-Core that reduced £200 million relative to the first quarter. Turning to Provisions, the loan impairment provision increased further by £1.5 billion, so the balance sheet sits at £21 billion at the end of the quarter. This gives us REIL coverage of 49%. We continue to see a gently positive trend for impairments and we expect Irish impairments to decline in the second half.

Now turning to the, so-called, below the line items, Q2 saw a total charge of £1.5 billion, which is up about £300 million on the previous quarter. Q2s items include the previously announced £850 million PPI charge, as well as £733 impairment charge against the Greek AFS bond portfolio. So you're aware of the £850 million PPI charge – it's worth commenting probably a little more on the Greek impairment. We've written our entire position to market values after deeming it impaired. If the current planned restructuring of the pre-2020 maturing Greek debt is approved in the second half, we would stand to recover about £275 million of that charge in the second half. Fair value of our debt swung positive in the quarter. That remains volatile, given significant moves in our credit spreads. And the APS charge declined versus Q1 to £168 million. Now, to date, we've recognised £2.2 million... billion cumulatively versus the minimum fee of £2.5 billion. The quarterly tax charge also continues to be a drag. It's driven by the ongoing Irish losses and in this quarter also by the lack of tax relief on the Greek impairment, which is housed in NV, our Dutch entity. We continue to look forward to seeing these drags from the, so-called, sins of the past, diminish with time.

Focusing on our Core performance, the operating profit declined versus prior quarter, given the falling GBM revenues, which reflected a more difficult environment and a decision to dial back on risk. Our average trading VAR in GBM was down 44%, relative to the first quarter. As Stephen indicated, some of that is a statistical anomaly from time series data, but also indicates directionally that GBM was really crunching back on risk. R&C, so underlying income and NIM rise and impairments fall, which led to a 13% sequential improvement in underlying operating profit. ROE improved to 12% in the quarter, in spite of the drag from the Irish loss. Compared with prior quarter, Core delivered a 6% increase in operating profit, as declining claims and impairments boosted the bottom line. Within Retail and Commercial that interest income was up 3% with declining costs and impairments driving an underlying 24% bottom line growth.

Walking through each of the divisions with a few comments, UK Retail continued its strong performance. Income was up 3% on the first quarter. It's driven by good fee growth related to transactional and investment sales income. Good cost discipline continues, driving down direct costs and that boosted the bottom line by 3% relative to Q1. UK Corporate's underlying income was broadly flat on the prior quarter. Costs were down 5% versus Q1. Impairments – headline impairments were up Q1 due to a handful of single name impairments and lower releases. I think there's some lumpiness there between the releases and the timing of taking impairments – nothing that we're concerned about. You have to look at this on a half year on half year basis – the impairments were down by 16%.

Wealth moved forward with the execution of its strategy in the second quarter, adjusting its footprint, refining products to better meet client needs and rolling out its technology programme. The quarter's highlights include strong income growth, which was up 6% versus Q1, not as boosted by improving asset margins and good growth in lending volumes. GTS continued to gather momentum. Its PBIL was up 5% versus the first quarter. Again that was driven by strong net interest income performance. Loans and Advances were up 12% on the prior quarter, reflecting good levels of activity in trade lending in Asia. Impairments though were impacted by a large single-name charge in the quarter, which is really highly unusual for that division and one that we would have hoped to avoid, but anyway we're working through it.

Continuing on Ulster Bank, we're pleased to see better performance in the Core Ulster Bank, although there's clearly still a long way to go. The Profit before Impairment losses is steady in the quarter. Impairments fell by 42%, mainly in residential mortgages. Again there's a bit of timing in that, but we think we're at a better run-rate now. Customer deposits were up slightly by about £0.5 billion during the quarter, which is a strong performance relative to our peers. The US R&C business had a strong quarter, as the franchise continues to improve. Our income was up strongly in the quarter due to lower funding costs and recovering fee performance. Lower impairments further boosted our operating profit for the quarter and our ROE improved to 7%. So we're confident that we think at least that level of ROE is sustainable and we're looking forward to getting back to double digits.

GBM performance was in line with peers. Adjusting for the business mix, GBM saw a subdued income performance in rates. That reflects receding expectations for rate rises in the UK and in the US, as well as a reduction in our clients' risk appetite, but the bottom line here though is that GBMs first half performance of £3.9 billion of revenues and of 15% ROE is quite respectable, all things considered. Management tightly managed our risk and the balance sheet position that we will continue to maintain, as Stephen said, until the markets settle down. Insurance saw the second straight quarter of improving profit as the turnaround plan continues to deliver results. Expenses were down 7%, due to our reengineering programme and our underwriting and profits improvements resulted in a 10% fall in claims. Q2s ROE was 15%. The first half ROE was at 11% and we continue to work towards an IPO in the second half of 2012.

Turning our attention to Non-Core, the bottom loss declined further this quarter, down by nearly £200 million. The strong income performance in the quarter reflects sizeable securities gains from our recovering workout portfolio, including the IPO of Samsonite. Impairment losses were higher in the quarter, as I previously mentioned. It's probably worth pointing out our coverage ratio of REILs in Non-Core improved further to 48%. Non-Core's rundown continues to make excellent progress. You can see the glide path here during the quarter of the £12 billion reduction to £113 billion. £7 billion of that was disposals and £4 billion was runoff. At the end of the second quarter we had pending transaction backlog of £2.5 billion and we have a fairly strong pipeline considering the environment and we're hopeful that it hangs in there reasonably well. We believe we're on track to meet the £96 billion yearend target at this point.

So let's turn to the last section. I'll give you an update on the excellent progress that we've been making on risk reduction, as well as on our funding and liquidity position. Improving our risk profile remains a key underpinning to achievement of the Group turnaround. Good progress has been continuing in the first half and some of the highlights we note here on the slide. First off, very topical, is the peripheral European sovereign exposure in the banking book. We've listed here the countries of greatest interest and you'll see that our exposure is quite modest, very limited in the case of Ireland, Spain and Portugal and then the bigger one is Italy, but again that is quite modest relative to our capital on our balance sheet position. We have very fulsome disclosures of all of our other exposures in these countries. I think again though, if you look at what happened in Greece with respect to banking book sovereign exposure, it's an outsize position and it was a legacy of ABN Amro being a Eurozone bank and investing in those types of sovereign bonds in their liquidity portfolio.

In the overall sectors we continue to work on taking down concentrations. Property is a big one that we've been focused on. That's reduced 7% over the past 12 months and it reduced by 3% in the first half. We're also very focused, on the right there, in continuing to make headway with our single name concentrations, or [tall trees]. That's down 33% versus a year ago. So clearly there's more work to do here at the halfway stage of the five year plan, but we can certainly see signs of tangible progress. Digging in a little bit further in Ireland, we continue to provide quite fulsome disclosure here as well. In the Non-Core portfolio, the REILs continue to rise. The CRE development book has now got 87% of its loan book in non-performing, so it's quite impaired and we've improved the coverage ratio at this point to 56% versus 46% in the first quarter. So we feel good about that level of provisioning. On the rest of the Non-Core provisioning, it's also up quite a bit. It's 53% as at the end of the half, which is up from 47% at the end of the first quarter. Provisioning levels in Ulster Bank Core book have also continued to strengthen. We're actively managing these impaired assets, but of course Ireland will continue to be a long term workout and it's heavily dependent on the path of the economy from here. The Q2 Irish impairments across Core and Non-Core were down 4% relative to the first quarter. Our view at this point, again, is that the second half impairments will fall particularly in Non-Core.

We continue to make good progress with our funding in liquidity position. The Group loan to deposit ratio has improved further to 114%, while the Core loan to deposit ratio remains at 96% which is below our 2013 target. We remain focused on bringing down the level of wholesale funding, to actively term it out and to continue with our deposit growth initiatives. A standout in the first half was the GTS business where deposits increased by 6% to £73 billion. At 30 June the wholesale funding grade with one year was stable at 56% and deposits represented 58% of our funding structure – a number that compares favourably with our European and our UK peers. The improvement of our funding position continues to be driven by the rundown of Non-Core and our ability to issue term debt across the spectrum of markets, currencies and term structures. We targeted £23 billion of issuance in 2011 and we've made good progress. In the first half we issued £18 billion, £8 billion of private, £5 billion of secured and £5 billion of unsecured. Now, looking forward into the second half, we have a relatively limited term funding requirement of £5 billion remaining.

Our gross RWAs were down by £9 billion due to a reduction in GBM market risk, as well as the net impact of Non-Core de-risking. Our Core Tier 1 ratio remains strong at 11.1%, despite the £1.6 billion of one-offs that we took during the quarter. Looking forward, our guidance on Basel III remains unchanged; however we'll continue to work to mitigate the CRD impacts on our capital base. So to sum up, our Core franchises have shown resilience in a challenging environment as well as the benefit of having a diversified business mix. The Non-Core rundown, the overall de-risking and balance sheet strengthening continued to progress and are either on or ahead of target and our capital base remains robust. Thanks and let me turn it back to Phillip to lead to Q&A.

Sir Philip Hampton – *Chairman*
Thank you. Usual basis, which is put your hand up, we'll identify targets and, if you can announce name, rank and [CL] number that will help everybody.

Questions and Answers

Tom Rayner – *Exane BNP Paribas*

Hi, it's Tom Rainer at [ex] BNP Paribas. I wonder if it's possible to get slide four up because it's quite difficult to read in the pack here, but my question was just going to be, looking at your liquidity portfolio versus your short term wholesale funding and if the market is worrying about the possibility of another short term funding squeeze in the market... I'm just wondering, how significant is that, the fact that your liquidity portfolio is now actually greater than your total short term wholesale funding. Can you run that portfolio down materially if you needed to?

Stephen Hester – *Chief Executive Officer*

Yes, the answer to that is yes. Obviously we hope not to, but you know we built it up for a reason. For the same reason we did more term funding than the pro-rata amount earlier in the year and that's standing us in good stead at the moment. Clearly these are difficult markets, but for the moment so far, so good.

Bruce Van Saun – *Finance Director*

Actually, Tom, the number that's just slightly incorrect, the short term wholesale funding excluding derivatives collateral is £148 million. The liquidity portfolio is £155 billion. Those derivative positions are netting – they're shown broad – so we've excluded that in the calculations that we do have more liquidity than we do short term wholesale funding.

Tom Rayner – *Exane BNP Paribas*

That's what I thought the slide showed actually. Okay, just one other question, the £7 billion of disposals in Non-Core... what were the losses, if any, associated with that disposal?

Bruce Van Saun – *Finance Director*

They were quite modest because we've taken... and remember, in the fourth quarter we had a very big pipeline and we've been pulling through that pipeline, so a bunch of that disposal loss was already incurred previously and recognised in prior periods.

Tom Rayner – *Exane BNP Paribas*
Okay, thank you.

Michael Helsby – *Bank of America Merrill Lynch*
I've just got a question on the stress test actually. You guys came out relatively quite bad, so I just invite you to comment on that and also, just hypothetically... clearly everyone's extremely worried at the moment... if that scenario came to pass, as a Group would you be... I wouldn't use the word happy... but would you comfortable to see your Core Tier 1 rundown to that level, or is that a level which would require additional capital? Thank you.

Bruce Van Saun – *Finance Director*
Well, the first part of that, I think it's been well chronicled that there is a real straightjacket that the EBA applied in terms of the rules around that stress test, which one of the... one set was particularly inappropriate for a bank like ourselves... the limitation of trading income to the average of the past five years, given the sizeable loss that we took earlier in the crisis and then putting a stress loss on top of that, which basically moved us to a negative income position in trading. So that alone was worth 80 basis points. Adjusting for that would put us much more back in the pack.

And there were quite a few other things which have also been well-chronicled, which I think... the way insurance was treated, for example, the way some of the Non-Core rundown was not permitted even though we have a pipeline, that it wasn't a mandate like with the EU... so there's some other adjustments that we would make, which would say I think our performance was somewhat misleading in terms of the bottom line. Having said that, we do still have a big balance sheet and we do have exposures and so we're very mindful and careful of how we're managing the risk and we're trying to obviously de-risk and deleverage as quickly as we can. Stephen, do you want to take the broader one?

Stephen Hester – *Chief Executive Officer*
I think, on the broader one, obviously it's hard to second-guess circumstances. We are certainly working towards a point that when we're done – and we're not done now – we would want to be able to keep our Core Tier 1 over 7% in the future, even in extreme stress, but we're not at that point yet and that would be under Basel III. But I think, as Bruce has indicated, our Core Tier 1 is higher today than it was in December for the European stress test. The European stress tests

were very idiosyncratic and hit us in a disproportionate way, in a way that we don't think would happen in real life, so at the moment we're feeling fine on this front.

Rohith Chandra-Rajan – *Barclays Capital*

A couple of questions on GBM, if I could – firstly just on cost flexibility. Given your outlook for an understandably tough revenue environment, comp ratio picked up to 39% in the quarter, despite some reduction in those costs. I just wondered how we should think about that going forward? And, secondly, on GBM £7.5 billion RWA reduction in the quarter, to what degree is that a one-off or part of an ongoing programme?

Bruce Van Saun – *Finance Director*
Sure, on the comp, there is a fixed element to the comp pool, so there are clearly salaries and there's deferred compensation for prior periods. So just mathematically as revenues go down, you're going to see a picking up of the comp ratio, but we certainly did lower our current projections for the annual award to GBM in line with the lower revenues. So I think that what you have to look at from here obviously is that you're in a protracted period where you think revenues are going to be lighter. You probably have more capacity in the plant than you need and so you'd have to look hard at your headcount and see if there are opportunities to reduce heads. So that would be the first one. The second one on the VAR decrease, we did get the benefit, as Stephen indicated. Some of this is related to time-series data, so when markets were highly volatile, you go back in historical reference point and you pick that up, that's been rolling off. We might be replacing it in the current environment with new volatile data points and so that might net out, but at this point a portion of that reduction looks like it will just flow through, provided the markets stay reasonable here and then the other part, it was discretionary in the part of GBM to take down a risk and then, assuming the markets got firmer, we would dial up the risk a little bit and capture the revenues that we'd see in terms of increased flows in the business. I can't give you the exact split, John... if it's 50/50 or what the split is... but clearly some of that is the time series data and some of that is the risk dial-down.

Rohith Chandra-Rajan – *Barclays Capital*
Thanks. Can I just ask briefly on Non-Core? Are you slightly paring back your asset disposal aspirations for the year? You previously guided 96 that are now a little bit softer. It's less than £100 billion.

Bruce Van Saun – *Finance Director*

We're still targeting 96.

Rohith Chandra-Rajan – *Barclays Capital*

Okay, thank you.

Robert Law – *Nomura*

Could I explore a couple of areas please? Firstly, on the Capital side, I know you're looking at the risk-weighted assets, gross of the APS and that, could I ask you to comment on the capital on a stressed position, assuming you were to exit the APS... and I know the FSA is obviously looking at capital in a stressed position rather than a regulatory side... and assuming you exit the APS, can you advise us on your thoughts on where you progress on capital distribution, at a later point obviously, given the way the stock price is now in relation to the conversion of the B shares? That's the first area.

Bruce Van Saun – *Finance Director*

So effectively we will be working with the FSA through the stress test process at the later part of this year. They run two scenarios a year and they'll have a fourth scenario that we need to run probably off of the third quarter data and then we'll have to roll that forward to the yearend data, so I would anticipate that no decision by the FSA will be made on the exit until we get through that process, which given the amount of crunching that takes place round those numbers, you're probably looking at some time in the first quarter. I don't know if they'll be by results; I'd like it to be by results, but it's hard to say if it will be at that point. And so clearly one of the views is, you know, the stress scenario that they develop, based on how the word looks then and then where our capital position is, which we've been trying to maintain at a very robust position clearly, given the current situation.

So we're still stating that it's our public desire to exit APS in October of 2012, we don't want to put any new money up beyond the £2.5 billion minimum and we're working very hard to accomplish that. Clearly beyond that, how much additional capital would we have to turn on the coupons and then ultimately do something on the [DAS] and ultimately put the dividend back in place, will depend on how we do financially. We believe we'll have the capacity to do that in a reasonable timeframe, though that could elongate and that will impact the timing of the privatisation.

Robert Law – *Nomura*

Thank you. The second area was on Non-Core. Could I ask you to comment on the trends in the margin in Non-Core, given what's happening in funding markets at the moment, and overall given the RWA's... I think you still have there as £125 billion... the shrinkage in the quarter losses were bigger than the capital release... could you comment on whether you think Non-Core rundown will be capital accretive over the period? Thank you.

Bruce Van Saun – *Finance Director*

So, in the margin... with respect to the margin... we are seeing a bit of an eroding margin. I think it went from 90 basis points to 87 basis points in the quarter. We're, A, selling off loans that have high yield in some instances and, B, as we improve the term structure at a wholesale funding. They have a big funding gap, but largely a wholesale funding, so that gets passed through to them. So we could continue to see erosion in that net interest income. I wouldn't worry about that so much, frankly, because we run Non-Core overall on a budget and so that also expands or contracts based on (unclear), and so if we have a little bit left on net interest income, we try and make it up elsewhere as we go down through the P&L. So what I'm trying to get people to focus on here now is the Retail and Commercial NIM ultimately, the NIM that's associate with Non-Core goes away and essentially disappears and the key number to stay focused on is Retail NII which at this point seems rock solid... was 322 versus 321 in the first quarter.

Capital accretion, we are doing this to very much focus on getting a bang for our buck in terms of delivering capital and having the losses. We look at the size and shape of the losses going forward relative to the capital that's generated and it most definitely will be capital accretive. One of the reasons for the little blip in the second quarter is we are also doing some de-risking in our market risk positions, which doesn't haven't a TPA impact. It will have an RWA impact as we work through the trades to do that, which are somewhat complex. We can see a counter RWA move for a period of time before all of those trades novate off, which is what you saw in the second quarter.

Leigh Goodwin – *Citigroup*

Two questions please, one on which is a good performer in the quarter. The combined ratio is now below 100%, I wonder if you can give us an idea whether you can see continued improvement in that, notwithstanding volatile weather related-type of issues. And my second question is just about whether you can give us a comment please on (unclear), which is in relation to GBM and also on the sovereign exposures?

Paul Geddes – *Chief Executive, RBS Insurance*

Yes, the second quarter is always a good quarter for insurers. Homes tend not to get flooded by snow and the drivers aren't yet on the roads, so it was a great quarter and it was a particularly good quarter for us, so whilst our longer term ambitions are to have a double-digit rather than treble-digit core, you know, 99 is a good performance and we wouldn't expect that to necessarily be attained through this year, but it's more in line with our longer term expectation.

Stephen Hester – *Chief Executive Officer*

On GBM trading and sovereign exposures, as you can see our sovereign exposures in the chart that Bruce put up are not material, so they're not the ones that a particularly worrying us. July trading was poor in GBM... not big losses, but just the revenue rate was poor...; I suspect it would have been everywhere else.

Peter Toeman – *HSBC*

Your 15% ROE target that you've had for the last two and a half years is now under threat from regulatory intervention. Obviously there's a minimum sort of ROE below which you can't fall and hope to pay a sort of realistic dividend to shareholders and organically finance balance sheet growth. So I was wondering if you might be able to steer us towards what you feel the minimum ROE might be.

Stephen Hester – *Chief Executive Officer*

I'll simply repeat what I said earlier on that I think any business needs to exceed its cost of capital and if it comes it needs to keep restructuring and keep changing things until it does. So that will be what we do.

Chris Manners – *Morgan Stanley*

I just had a couple of questions on the Retail and Commercial division. Firstly just on the net interest margin, obviously you managed to increase by one basis point in the quarter. Given what we've seen in the wholesale markets and presumably deposit competition is likely to hot up, should we be expecting a flat progression or do you think it should actually just nibble down a little bit as we go through the rest of the year? And secondly, just on Core loan growth in the Retail and Commercial division – it seems to be growing 1% on a year-on-year basis, UK Corporate loans fell in the quarter, that's below normal GDP – is there potential that we could actually see some meaningful growth in this division? Thanks.

Bruce Van Saun – *Finance Director*
As I said, I think the Retail and Commercial NIM, we would expect that to be stable, so what are the kind of cross currents? We still have a modest amount of asset re-pricing, although we're largely through that. That's somewhat offset by a business mix tightening, if you will. So, for example, in Retail we're doing more mortgage origination and less personal loan secured origination, so that tends to work against the margin and negate that asset and a re-pricing benefit. And then on the liability side we've been, I think, reasonably stable. We are not out competing aggressively for deposits, but we are seeing some growth in pockets like GTS and wealth in terms of deposits. So I think we'll continue to see stability there in the second half.

The variance is really a hard call, particularly if the economy is on the cusp of a double-dip or a recessionary environment. The hard part has been demand, to stimulate demand. We're certainly open and hoping to lend and I think we're now aggressively trying to hit our lending targets. In the US we're actually seeing a pickup, as we indicated in the prepared remarks in the US, on the commercial C&I side of the business and that's been helpful. So the pipeline has been pretty strong there, but I think it's going to be spotty and it's going to be challenged to see any kind of long volume growth until the economy gets stronger.

Manus Costello – *Autonomous Research*
I noticed that you've had to delay the closing of the Santander transaction to the end of 2012. Should we assume that you just keep the profits for those second half of 2012 or will there be a change in the terms of that transaction and is there any risk if conditions deteriorate in the market further that that transaction doesn't happen at all?

Bruce Van Saun – *Finance Director*

No, I think the likelihood is this transaction gets down probably closer to sometime in Q4 at this point, so we retain the incidence of ownership up until that point, so we own the RWAs and we get the profit in the business until it closes. Clearly there will be some to-ing and fro-ing contractually. I think there's going to be a bigger separation effort and transition effort over to Santander and how those costs are absorbed, are things that we're working through. I think we're in a pretty good space with them in terms of having that sorted out at this point.

Michael Helsby – *Bank of America Merill Lynch*

Just a couple of follow-on questions... Firstly, in GBM, I guess there's been a couple of banks now that have said they're going to scale back on risk and not necessarily focus on driving top line revenue in that business. If I think back three years ago, what categorised that period was you saw quite a big expansion in margins as banks looked to widen a bit of a spread. The question is do you think that can happen again? At what point do you start putting your prices up to your customers to try and capture the more volatile environment.

The second question, looking for a bit of perspective from you guys, clearly your share price is as low now today as it was since the depths of the crisis. Could you maybe just wrap up by giving us a perspective of how you see things at the moment? You just said we're on the cusp of a recession potentially. When I look at your numbers like you've seen at the moment, clearly everyone's worried about the future. Can you give us a bit of perspective today versus where we were maybe in 2008 and maybe just reiterate where you are today versus where the bank was in 2008. Thank you.

Stephen Hester – *Chief Executive Officer*

My own view is that it is always important and valuable to be calm when people around you aren't being calm and normally that's the right thing to do and I think that the transmission mechanisms between market upset and real economies are normally less strong than markets fear. And so my own view is that the greater probability is that economies do continue, on balance, to recover, but we always thought and planned... and that's one of the reasons I've always struck a cautious note... we've always expected the process of the world working through its imbalances to be a slow and difficult one, even if it's one with generally an uphill slope to it. That's still my view and I think it's becoming more apparent.

Within that our expectation is that the de-risking and balance sheet recovery that we have already accomplished will stand us in very good stead and that most of our businesses can create solid returns, even if they're not the returns that they would ultimately like, we can do a solid job in this kind of environment. I think the main stream for me as it relates to RBS is that the RBS story goes forward a bit slower than we wanted with a flatter trajectory than we wanted, but nonetheless goes forward. Now, we're not blind and stupid, and of course there are scenarios where some of those bets would be off the table; I think they're low probability scenarios, but they require a lot of concentration and one of the things that we're seeing now is that instead of people talking about a banking crisis, we're now realising that actually from the very beginning what we've had was, yes, a banking crisis, but that was sub-component of a bigger set of world issues in terms of macroeconomic management and that's coming back in view and both the macroeconomic management of individual countries, in the instances where it's weak, and now it's under huge pressure to improve, whether in the US or some countries in the Eurozone and similarly the mechanisms between Eurozone for dealing with liquidity for countries rather than for banks and the framework... we're going to be in the hands of the democratic process to try and come up with some good response. Hopefully they will, but it won't be a perfect process.

It would be stupid not to be cautious and be alert to the significant risks out there that can turn bad, but I think the probabilities are that the world doesn't turn overnight from a place that's slowly recovering to a place that's a disaster area. That's my view.

Bruce Van Saun – *Finance Director*
The markets are indicating we could be on the cusp of recovery, our view is that we'll find a way to muddle through, we'll stay in growth and then it will just be an elongated timeframe before we get back to stronger growth than originally envisioned. If you look at the company two and a half years into the plan versus where it was, there has been a huge amount of progress and we have very good people on the board and the management leading the company. We have a very strong vision of where we need to get to and we're making progress in all dimensions in terms of investing in the Core franchises, making the businesses more efficient, more customer-friendly for risk awareness in terms of the decisions we make and how we run the business.

It's really night and day from where it was two and a half years ago, so a lot of progress in the Core. The Non-Core is less than half the size of when it started and we've done it in a way that's been friendly to preserving shareholder funds. I feel quite good that the stock market's going to move around based on fear and there's not a lot we can do about that. We need to stay focused on executing the plan and doing the best we can. Ultimately that will be manifested in the stock price once people have some conviction that some of these macroeconomic difficulties have been sorted.

Stephen Hester – *Chief Executive Officer*

GBM margins, this is a really hard on because clearly to some extent what you were able to have in 2008 was interest rate falls, which helped and spread compressions and so on and so forth. You're not in that position now, so I think we would err on the side of cautiousness. You're likely to have single digit ROEs for a while in investment banking as you work through these conditions, but there's no point torturing yourself on quarter by quarter predictions for these business lines.

Leigh Goodwin – *Citigroup*

In the context of the current crisis, I wondered if you wanted to comment on the ICB process and the headlines we saw this morning suggesting a rather tough ring-fence might be imposed. It feels like the ICB are making up proposals and recommendations in a different world to the rest of us, but I wonder if the extent to which the potential risks of a suboptimal policy outcome from this have increased as a result of what's going on in the world and whether that's a fact that will be taken into consideration by those who finally make a decision?

Stephen Hester – *Chief Executive Officer*

I couldn't possibly comment on your views of the world the ICB live in, but I do think we and many others have been in engaging intensively with the ICB and regulators for the government and I do believe people are genuinely trying to be thoughtful, they're genuinely listening, and they're genuinely trying to consider the different issues. They're caught in a tough political spot in terms of coalition politics and so unfortunately there must be a possibility of an outcome that is the wrong reform at the wrong time, but it want of thought and obviously however it comes out, we'll deal with it. The market is right to apply some discount factor to bank prospects in the UK until that becomes clear.

Leigh Goodwin – *Citigroup*

Would you be able to quantify that in terms of your ROE target?

Stephen Hester – *Chief Executive Officer*

It's such a difficult thing because there are so many flavours of ring-fencing and the devil does lie in the detail and secondarily if you knew the flavour, you'd then need to understand what the flavour would be in the eyes of your creditors and rating agencies and then what response you'd need to take to that and then the long term impact in the eyes of your customers, and so this could be something that plays out quite a few years before you really know it ended up being a negative, but one that you can deal with. It's really a tough thing. It's the second and third order effects that concern us as they will be a bit unclear for a while.

Sir Phillip Hampton – *Chairman*

There are some forms of ring-fencing which are completely uncontroversial, financially and from every other point of view, and we have spent the last year in intensive dialogue with US regulators about the structure of RBS Americas, which is both retail, wholesale and investment banking operations. The American regulators just want to know what our ring-fenced activates in America are, so they can control it, understand the risk and government processes and so on. That is completely uncontroversial to us. Ring-fencing by activities creates a whole host of extra challenges, costs and problems.

Ed Firth – *Macquarie*

In Ulster Bank you mentioned that one of your reasons for improving was recalibration of the mortgages. Is that a one-off or a new lower base that we should see going forward?

Bruce Van Saun – *Finance Director*

The one-off was really referring to the first quarter where we did the recalibration and so the second quarter was a truer number than the first quarter. In Non-Core in the quarter we looked very hard at the land values we were carrying in the development book and so we did a very detailed analysis, region by region, and trying to estimate what that land was really worth. You had a bit of a one-time nature to the entry in the second quarter there in Non-Core. Given the significance of the non-performing loans in Ireland we will on a regular basis be reviewing this with intensity. I think we're pretty much on the front foot on the residential side and on the development book side at this point.

Sir Philip Hampton – *Chairman*

Thank you very much and I hope the end of August is better than the start.

Operator

Ladies and gentlemen, that does conclude today's presentation. You may all now disconnect.

- End -