Final Transcript

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Corporate Participants

Stephen Hester

Group Chief Executive Officer, RBS

Bruce Van Saun

Chief Financial Officer, RBS

Presentation

Operator

Good morning, ladies and gentlemen. Today's conference call will be hosted by Stephen Hester, group chief executive of RBS. Please go ahead, Stephen.

Stephen Hester - *Group Chief Executive Officer, RBS*

Good morning, everyone. Thank you for joining us, and welcome to RBS's first quarter earnings call. Bruce Van Saun is with me as usual, I'll briefly introduce the quarter, then Bruce will take you through the figures. Hopefully most of you have got up on the website to access the slides, as well as the rather longer disclosure in terms of the company announcement; the slides try make things a little simpler for you, although we won't go through the slides specifically one by one.

I would say that we hope we are delivering a quarter with no surprises where we have done exactly what we said we'd do, and where we're showing continuing progress against all the different things that the RBS story is about. We can see that in a few different components; obviously a big bit of what we have had to do in our turnaround is get away from the sins of the

past and we can see that that process is continuing well, we can see from our balance sheet that the capital ratios are strengthening well; we can see that all the other ratios we care about, loan to deposit ratio, funding, leverage, all the things that make up a solid balance sheet are already at our 2013 targets. Along with that we can see that the risk in our non-core division continues to come down nicely both in P&L and in asset terms, and so the sins from the past are receding, but there are still a few of them with us. And there'll be several more quarters obviously in which that receding happens, and yet again these results show a series of below the line items that represent if you like those past charges that are still taking away from the bottom line. What we will of course get to, slowly by surely, is the position where the operating profits we're creating are all available to shareholders. But speaking of those operating profits, we believe that in this quarter we continue to show that the core ongoing businesses of RBS are doing well against their competitors, are recovering from the impacts of the economic recession, and from some of the surgery we're doing to them. We still have a way to go in a number of businesses and therefore with future prospects for growth, but we're already operating I think at a decent and solid level, and one showing some broadening including, for example, the recovery of RBS insurance, which we predicted would happen and has.

So I think generally speaking we're pleased, both with the development and the predictability of that development in Core, and with the continued progress getting the sins of the past behind us. We are of course conscious that this will take time. We're conscious that the growth in the economies we serve, and the growth of our customers, will make growth something we have to fight for, and we're conscious of the regulatory headwinds that can hit in all sorts of different ways. But notwithstanding all of those issues, we believe that RBS is coming together as something that can make progress even in sluggish markets, and that's what we're aiming to do. So with that, happy now to ask Bruce to go through the figures.

Bruce Van Saun – *Chief Financial Officer, RBS*

Thank you, Stephen. I would summarize Q1 as a solid quarter, with good momentum in our UK core franchises, a seasonably strong performance from GBM, and, as expected, Insurance returning to profit. Non-core saw smaller P&L losses, while the run-down of third party assets, or TPAs, continued at a good pace.

The quarter's key financial highlights include group operating profit up £1 billion versus last quarter to £1.1 billion. Core's operating profit improved by more than £400 million to £2.1 billion, driving cores ROE up 300 basis points to 15%, which was led by GBM.

The group's bottom line showed an attributable loss of about £500 million, reflective of APS, fair value on debt, and tax write-offs. All items tied to the past, as Stephen indicated, which are volatile and will be with us a bit longer.

Non-Core's TPAs fell to £118 billion, including our pending signed deals. It's worth nothing that Non-Core TPAs are now down over 50% from the start of the plan. The group's core Tier 1 ratio remains strong, increasing 50 basis points, to 11.2% in the quarter as capital remains steady and RWAs, mainly in Non-Core, decreased by £33 billion.

The Group loan to deposit ratio continues to make progress: it's now at 115%. The Core LDR remains stable at 96%, and our funding liquidity and leverage ratios now compare favourably against our targets, and against our peers.

Looking at the major P&L items, the Group income was up 8% on last quarter; however NII fell 8%, reflecting both fewer days in Q1 and the reduction in Non-Core assets. Groups NIM was up one basis point versus Q4, after adjusting for the fewer days in Q1. This was driven by a six basis point increase in Retail and Commercial, but tempered somewhat by asset margin tightening in the GBM loan portfolio and the impact of asset run-off in non-core.

Our non-interest income improved strongly versus Q4, which was driven by a better trading performance in GBM and lower disposal losses in Non-Core.

On expenses, the Group's strong performance on expenses control continued in Q1 as our cost reduction programme continues to deliver. It's now at a run rate of £2.7 billion per annum.

Q1 costs were broadly in line with prior quarter despite incentive accruals tied to GBM's stronger performance. Costs were down 7% versus the first quarter of 2010.

Impairments are down 9% versus the prior quarter; Core's down 6%; Non-Core's down 11%; and compared with a year ago, impairments are down 27%. Provision coverage remains stable at 47%.

REILs increased by £2.4 billion versus the fourth quarter. Note that £2.2 billion, or 92% of that, was due to Ulster.

Taking a closer look at Irish property, Q1 saw Ulster Core and Non-Core impairment levels increase by 12% to £1.3 billion, driven by CRE and mortgages. Ireland continues to be the exception to the otherwise positive impairment trend. We still expect Irish impairment will remain elevated in the first half before starting to decline over the second half. The so-called 'below the operating line items' in Q1 saw a sharp negative swing versus the prior quarter. Q1 had negative charges for both APS and fair value upon debt (FVOD), with the FVOD swinging £1.1 billion negative versus Q4. In addition, Q4 had reflected a significant gain on disposal related TOGMS.

While the large swings in these items distort the underlying picture, there's also a positive side. This quarter's FVOD charge means our spreads are coming in, and the bank is becoming safer. This benefit will feed through to future income from lower funding costs. The rapid expensing of the APS fee also indicates the bank is less likely to claim on the arrangement. Again a sign we are safer and credit costs are declining.

The Q1 tax rate remains elevated and was impacted by the ongoing unsheltered tax losses in Ireland, which cost us about £245 million, as well as other one-off items such as the £90 million write-off of deferred tax assets resulting from the reduction in the UK corporate tax rate. We expect the Group's tax rate will remain elevated for the remainder of 2011, before beginning to normalize of 2012.

So let's turn our focus to the Core division and its performance versus the prior quarter. Overall Core operating profit was £2.1 billion, as GBM had a nice seasonal balance, and R&C's (Retail and Commercial) results were stable.

Taking each business in turn, first, UK Retail saw another strong quarter with further improvement in ROE to 26%. Income was up 10% relative to a year ago as the NIM increased by 33 basis points. Relative to Q4, asset margins were down slightly due to mix effects as mortgage originations continue as a healthy pace. Excluding one-off items in Q4, underlying profit increased by 11% in the quarter.

A UK Corporate continued its improving performance with a Q1 ROE of 16%, adjusted for a £50 million one-off item. After a tick-up in impairments in the fourth quarter, Q1 saw an improving trend in loan book quality and credit metrics.

Loan demand remains stagnant, but we are hopeful there'll be a modest improvement in the second half.

Wealth's new management team has begun to sharpen the focus of the business; the new strategy is underpinned by a new IT platform to be rolled out across the business during this year. Key highlights from the quarter include a 4% rise in revenues, and a solid increase in loans, deposits and AUM.

GTS is also under new leadership and continues to focus on improving cross-sell, and cost-effectively delivering value-add technology to our clients. The Q1 results were negatively impacted by the sale of the GMS business and a one-off impairment. However, we're optimistic for stronger results as the year progresses.

The Ulster business remains challenged. While the economic environment is showing early signs of stabilizing, conditions remain rather difficult.

Asset values continue to fall and unemployment has increased, stressing the residential book. That said, we believe we may be at the high-water mark for impairments, and we still expect a gentle fall in the second half.

Citizens continues to deliver improving performance: their operating profit was up 26% versus the prior quarter. Management continues to actively manage the balance sheet through the low rate environment, to manage expenses tightly, and our commercial lending initiatives are gaining traction with good growth in loans and a strong pipeline.

As expected, our Insurance business returned to a bottom line profit in Q1, as claims were down 13% on the prior quarter. We expect the level of profitability to increase in the coming quarters as the management team continues to execute effectively against its turnaround plan.

GBM saw a robust quarter as it benefitted from a rebound in investor activity. Our rates, currency, and mortgage businesses performed well, helping the business deliver revenues of £2.4 billion for the first quarter, and a cost to income ratio of 55%. Each of our key GBM business lines continues to maintain its market position.

Turning to Non-Core, Q1 was another good quarter: operating losses again, down 33%, on a year ago. TPAs were lower by £13 billion, £5 billion of that was disposals, and about £7 billion run-offs, while the risk-weighted assets fell £25 billion as assets and risk were reduced. We now have a £7 billion disposal backlog for deals that are signed, but have yet to close. Non-Core impairments were down 37% versus a year ago, and 11% versus Q4. Favourable trends across most of the book continued in Q1, with the exception of commercial real estate, in particular Ireland. Ireland

accounted for 78% of Q1's impairments of £1.1 billion. Provision coverage levels in Non-Core improved on the quarter, up 100 basis points to 45%.

Turning to the balance sheet, we've built on the excellent progress we made in 2010. In Q1 we saw further progress in the funding mix towards more stable long-term sources. Customer deposits now form 58% of total funding, versus 53% a year ago. Our term funding target for 2011 is £20 billion. We've made a strong start in Q1, there was £10 billion of issuance, 58% of that was through public markets, including £2.7 billion of asset-backed issuance.

Our wholesale funding greater than one year decreased to 56% of total in the quarter, as £16 billion of the Government's CGS funding programme dropped into the under one-year bucket. This process will work itself through in 2011 and 2012, as the £40 billion of CGS funding is replaced by long-term market funding. We remain confident of achieving our 2013 short-term wholesale funding target of less than £150 billion in line with liquidity reserves.

The Group's capital position as mentioned continued to strengthen, Core Tier 1 ratio now at 11.2%. The key driver behind that was a £33 billion fall in RWAs, driven by risk-reduction and Non-Core run-off. In Q1 the APS scheme provided about 1.3% benefit to the Core Tier 1 ratio.

As we look out across 2011, we expect positive trends in our Retail and Commercial businesses to continue as the economy strengthens and results from our investment programme start to deliver benefits. As mentioned, the one exception is Ulster, where we remain cautious. GBM is off to a good start and remains on track for the full year, although markets remain unpredictable.

Our Non-Core business continues to perform in line with expectations, and the disposal pipeline remains active. Below the line items will continue to create some "noise" around the headline numbers, but those should abate over time.

So to conclude, Q1 has been a good start to the third year of our five-year plan. We are making consistent progress, and we remain very focussed on achievement of our 2013 targets. With that, I'll turn it back to Stephen.

Stephen Hester – *Group Chief Executive Officer, RBS*

Thank you very much, Bruce, and let's open up to Q&A, please.

Questions and Answers

Operator

Thank you, Stephen. Ladies and gentlemen, if you would like to ask a question, please press the star key followed by the digit one on your telephone keypad. We will pause for a moment to give everyone an opportunity to signal for questions.

Your first question comes from Steven Hayne, from Morgan Stanley. Please go ahead.

Stephen Hayne - *Morgan Stanley*

Good morning; thank you. I just wanted to ask more about the margin. In particular it looks like the Retail and Corporate is going all right, and particularly on the Corporate side, but you mentioned something about a one-off element to that. I was wondering if you could provide a bit more outlook on both the Retail and the Corporate margin, please.

Bruce Van Saun – *Chief Financial Officer, RBS*

Yes, sure. It's true in that UK corporate in the quarter there was a one-off item which benefitted their margin, and so sort of a little bit of flattery to the number in Q1. Having said that, I believe UK Corporate still has some running room on the asset side to continue to do some re-pricing: their book is a little longer in duration standpoint than the Retail book, so most of the Retail re-pricing is complete. In fact, we could see a very slight diminution on the asset margin as we shift our mix more towards mortgages and away from personal unsecured loans, but I still think it's going to hold in at a pretty healthy level. The real kick, as we've indicated, comes from the rising rate scenario. We don't expect a huge amount of that, maybe one or two 25 basis point increases in the second half of the year here in the UK and none in the US at this point. So again, we expect slight improvement overall across Retail and Commercial, but the real march up continues once we start to see rates go higher.

Steven Hayne – *Morgan Stanley*

Thank you. Could I have one very quick follow-up, which is in relation to PPI. I noticed one of your competitors took a charge; another one did not earlier. When you think about that, is it something that you would consider doing perhaps in a later quarter, or for the time being until there's a ruling you won't take a charge, or how do you think that through?

Stephen Hester – *Group Chief Executive Officer, RBS*

My guess is that with Lloyds having now taken a charge, that irrespective of how the court process goes forward, that everyone else will come under some pressure to make some sort of provision in the coming quarter, so we'll be looking at that hard in the next quarter. But simply for the purpose of this quarter, the range is too wide of possible interpretation and we haven't had the detailed engagement with the FSA - they obviously started with Lloyds, being by far the biggest to come up with a credible number – so we don't know what the credible number is, but whether it's right or not is another issue altogether, but we think that our market position in the relevant products is the order of a third of Lloyds's. Whether that is any guidance to the ultimate provision is at the moment something that we can't determine.

The other aspect of that is whether the industry through the BBA appeals the judgment. That decision has to be made early next week, and in terms of our position on that, we don't think it's fair to front-run the BBA, so we'll wait for the BBA's decision and indicate obviously whether we're part of that or not in the coming days.

Steven Hayne – *Morgan Stanley*

Fair enough. Thank you.

Operator

Your next question comes from Manus Costello, from Autonomous. Please go ahead.

Manus Costello – *Autonomous*

Morning; thank you. I have a couple of questions on the APS actually, please. Firstly on the accounting for the APS, as economic conditions improve and you're accruing the fee, will you technically be able to accrue next year's fee this year? So I think it'd be £2.1 billion will be total for this year, with the potential for another £400 million next year. Would you be able to drag that forward into his year, or would you be prevented from doing that?

And second more strategically on the APS, ex APS your Core Tier 1 ratio is probably going to be over 10% in the second half of this year. If that's the case, and if you have accrued the whole of the APS £2.5 billion by later on this year, would you consider exiting early?

Bruce Van Saun – *Chief Financial Officer, RBS*

Well, the answer to your first question is we can expense the full amount that's the minimum, because it is ultimately a liability for us. So the fact that we won't pay the final cash of £400 million until some time through 2012, doesn't affect the accounting. So it's possible, we've now expensed slightly over £2 billion that that number can continue to increase in coming quarters, but it would be capped out at the £2.5 billion.

In terms of whether we exit early, I do think there are still various considerations to consider. It does provide us some benefits in terms of the notional Core Tier 1, there are a bunch of stress tests that are run and still has some benefit for staying in. So I think at this point we've been fairly consistent that we will likely look to stay in, but the second that it costs us 1p of additional cost, we would seek to exit.

Manus Costello – *Autonomous*

Thank you.

Operator

Your next question comes from Jonathan Pearce, from Credit Suisse. Please go ahead.

Jonathan Pearce – *Credit Suisse*

Morning. I've got three actually. The first is on the gains on securities, which I think were about £200 million maybe, just a little over £200 million in the first quarter. Were those in Core, and, if so, whereabouts were they in Core?

Bruce Van Saun – *Chief Financial Officer, RBS*

Well, there were two elements. One was taken in Group Treasury, and it largely offsets some negative treasury volatile items, like IFRS volatility. The other one was in Citizens, where Citizens had some OTTI impairments on assets, and that was reflected in the impairments line. So there's no kind of unusual or one-time benefits from those 200, but they really offset other things that were expense items in Core.

Jonathan Pearce – *Credit Suisse*

Okay. Thanks a lot. Secondly, the disposal losees, can you give us some guidance on where you might be as the year progresses? Those were quite low in the first quarter. They were about £50 million I think.

Bruce Van Saun – *Chief Financial Officer, RBS*

Yes, I think we've been reasonably comfortable that that number could be anywhere from 500 to a billion, and it really just depends on, you know, opportunistically where we find ourselves in terms of discussions and opportunities to accelerate the risk reduction. We would call out more specific guidance as the year goes on, but you know at this point some of that potentially is above the line in the results, and then any whole business ones would end up being below the line.

Jonathan Pearce- *Credit Suisse*

Okay. Thanks. The third question is a more general one on how you're thinking about the dividend access share held by Government. I mean clearly coupons on that won't restart until next year at the earliest, but with it potentially now a 12-month issue how are you thinking about the dividend access share? Is it something that you would consider buying out from Government in the next year?

Stephen Hester – *Group Chief Executive Officer, RBS*

Well, I guess far and away our preferred outcome is that you folks all recognise the astounding good value in RBS shares, and that as we move through this year and next year, that our share price moves to the point where it disappears of its own right, and so I think that's the best outcome. Obviously we recognize that its existence may be an obstacle to the Government selling its shares, and so it may well be as the Government comes to focus on that, that if the DAS (dividend access share) hasn't fallen away, that they need to talk to us about it, but we haven't had any such discussions yet.

Jonathan Pearce – *Credit Suisse*

Okay. Will UKFI give as an update on their view of the valuation of that in the coming months?

Stephen Hester – *Group Chief Executive Office, RBS*

I don't know.

Bruce Van Saun – *Chief Financial Officer, RBS*

I would expect so. I think when they publish their report they would probably put something in on it.

Jonathan Pearce – *Credit Suisse*

Okay. Thanks a lot.

Operator

Your next question comes from Leigh Goodwin, from Citi. Please go ahead.

Leigh Goodwin – *Citi*

Morning, guys. A couple of questions; just back to the operating performance. Firstly on GBM, I think it looks like a reasonably solid quarter; a good performance in credit and my first question was is that the US mortgage book doing particularly well? And then my related questions on GBM are if you can a little about how trading has gone in April. And also it looks like expenses the comp ratio's just ticked up a bit. I wonder if you could comment on that.

Bruce Van Saun – *Chief Financial Officer, RBS*

Okay. I'm sorry; I heard the first question which I'll respond to. Maybe I'll ask you to repeat the second.

Leigh Goodwin – *Citi*

Sorry, I'll do that again then. Just related to GBM, I've got a set of questions around Insurance as well, but I just want to focus on GBM, with if you like three bits to it. One is it looks like there's a strong performance in credit, and I wondered if you could just talk about that, and I'm presuming that's the US mortgage book. The second is just wondering whether the strong performance of the first quarter is continued into the second, and the third question was around compensation ratios and cost ratios, because it looks like that's ticked up a bit, and I wonder if that's signalling a trend for us, or whether it's to do with the deferrals and those sorts of technical effects.

Bruce Van Saun – *Chief Financial Officer, RBS*

Yes, sure. I guess that your first question on mortgages as it relates to the whole credit line, mortgages is a good element there, so we had I think good flows and good interest level in yield products, and so US mortgages performed well in the quarter. But it would extend beyond the US mortgages that line to encompass good flows in asset-backed securities that were traded here in the UK and Europe, so it's pretty broad.

In terms of the continuation, if you look at the trajectory that we had last year for GBM, we had two eight in the first quarter; I'm talking top line. It went to about I think one nine, one six, and one six for quarters two, three, and four, and so we end up I think off to a good start as we need to be, because Q1 seasonally should be strong. In the rest of the year I think the we have, relatively weak (year on year) comparisons, because the (2010) environment was a bit challenging, and so how the rest of the year plays out will determine if we get towards that £8 billion target. In April so far, clearly there's a bunch of holidays, but I would say performance was broadly okay.

And then on the compensation side, I think the comparison with a year ago is a little tough, because we got off to such a strong start, that we accrued a lower percentage number, which as the year got tougher, we increased the percentage to get to what we thought we needed to pay, which worked out to be around 35%. That's about the level that we're accruing for cash, and there's about a 1% bump relating to deferred compensation: they put the number in at 36%. So the compensation ratio is I think holding to what it turned out to be for the full year last year, with the exception of that 1% bump. But when you look at the comparisons, we ended up back-loading that compensation accrual over the course of 2010.

Leigh Goodwin – *Citi*

Okay. So the full year 36%, is that a reasonable level to be thinking about now?

Stephen Hester – *Group Chief executive Officer, RBS*

Obviously is depends on our results and the competitors' results, because you'll see most of the competitors…

Bruce Van Saun - *Chief Financial Officer, RBS*

Creeping up.

Stephen Hester – *Group Chief Executive Officer, RBS*

… creeping up likely in the 40s.

Leigh Goodwin – *Citi*

And that's true, yes.

Stephen Hester- *Group Chief Executive Officer, RBS*

But it's our best guess for now.

Leigh Goodwin – *Citi*

Okay, thanks. That's helpful. And then just on Insurance, it looks like the improvement there has come through, as you mentioned, in lower claims. Would you expect the claims ratio to continue to improve? Are we still seeing a residual impact in Q1 from those sorts of bodily injury issues and from any of the weather-related type things that were mostly in the fourth quarter? Or do you think the first quarter is broadly where we would expect to think in terms of claims going forward?

Bruce Van Saun – *Chief financial Officer, RBS*

No, I think we are in flight on underwriting improvement in the business, and that's changing the mix of customers that we're serving which ultimately results in improved claims performance. We also have a bunch of claims management initiatives in place, which I think should help to manage the ultimate size of various claims. So I think there's still running room in terms of claims. We also

are aggressively re-pricing certain parts of the book. We're working on expense initiatives to rationalize the base, which continues. So if you look at the ROE in the business now, it's nice to be in a profit, but it's still at a 7% ROE and the goal is to get that up over the coming quarters, to somewhere in the mid teens, and so we would hope that if we execute the plan well, you'll see continued positive movement across really all categories, claims included.

Leigh Goodman – *Citi*

I think the previous guidance said to expect getting on for £300 million for the year from Insurance, it feels like that guidance needs to be upped a bit. Is that correct?

Bruce Van Saun – *RBS – Chief Financial Officer*

Well, what I said, it wasn't really the guidance for the year. We said that the underlying run rate in the second half of the year was probably £270 to £300 (million) if you stripped out some of the items like bad weather or prior year reserving. And so that's what we thought we had coming into the year and I think that's now manifest itself in first quarter results. Seasonally Q2 is usually a little stronger because the weather tends to be quite good. If you look out your window you'll perhaps notice. But with the progress that we hope to make on the rest, yes, I would say if we ended up doing a 67 number on average for the rest of the year that would be a disappointment.

Leigh Goodman – *Citi*

Yes, okay thanks guys.

Operator

Your next question comes from Tom Rayner from BNP Paribas. Please go ahead.

Tom Rayner – *BNP Paribas*

Good morning chaps. Could I have another question on GBM please? On the revenue in the first quarter, the last couple of years you've seemed a little bit more skewed seasonally to Q1 than many of your peers. I just wondered if this is something that you acknowledge to be the case, and whether you expect that to remain so? It sounds as if you thought that comparisons for Q2, 3, 4, were not as challenging given what happened last year. Could you comment on that and maybe on revenue margin trends in some of the key product lines please?

Bruce Van Saun – *RBS – Chief Financial Officer*

Well, I'm not sure that it would be the case that we're more pronounced seasonally. Our biggest activity is FICC (fixed income currencies and commodities) and it's flow trading in FICC. And it is a fact that at the beginning of each year investors tend to place their bets and put money to work. And so that's why I think historically we've tended to have relatively bigger first quarters. I think the rest of the year flows out of general risk appetite in the markets, volatility in the markets and other factors that are really market dependent. What we saw through a good part of last year was that risk appetite waned and people stayed cautious and kept cash on the sidelines; if that's not flowing into the markets and people are not actively trading that's going to hurt. So our hope is that we see a little more steadiness and levels of activity and we cannot see the kind of drop that we saw in the second half last year. But of course that's very hard to predict that.

Stephen Hester - *RBS – Group Chief Executive*

I think on your broader question on margins, you know, it continues to be the case that in a number of product lines across Investment Banking margins continue to be under threat both by prospective regulation clearing and all that sort of stuff, and by technology. Which is why I think everyone is investing a lot in technology to try and create some sort of offset, [for example] process more volume with narrowing margins and to do it cheaper. So frankly I think real top line growth is going to continue to be quite a struggle in this industry as well as the issues of dealing with the capital intensity that's coming down the pipe. So we're working pretty hard, we still think there's a good chance of staying above the cost of capital if these things come in. But that's really taking all our focus rather than thinking that this is going to grow a lot.

Tom Rayner – *BNP Paribas*

Sure, because the ROEs obviously are quite attractive in Q1 at 20%, nearly 21%. I mean, I guess you can't sustain that, but, I mean, could you give us any more colour on what you think?

Stephen Hester - *RBS – Group Chief Executive*

Obviously the BASEL III changes that hurt the investment banks in particular, come in at the end of this year and then the end of the following year and thereafter. And so the declines in ROE from just the calculation methodology, are spread out over the next handful of years and the issue is how much of that can be clawed back. And as we've said, we're hopeful that we can claw back to around the cost of capital and we're going to aim to claw back to better than that, back to our 15 that remains our aim. But we acknowledge that there's a lot of work for everyone in that part of the industry to accomplish that journey.

Bruce Van Saun – *RBS – Chief Financial Officer*

Yes, and just as a point of reference, the ROE was a full year last year when we did £7.9 billion of revenues, and a 55% cost to income ratio was about 17%.

Tom Rayner – *BNP Paribas*

Sure, okay thanks. Could I just have one more please just on sort of risk element in lending which I'll call NPLs. But if my maths is right, if I take Ulster out of Core, it looks as if in Q1 the ratio went up 3.2 to 3.4, is that a level, I guess, that given the economic environment you're comfortable with, that sort of trend, 20 basis points a quarter, if I've got my maths right that is? But could you comment on that please?

Bruce Van Saun – *RBS – Chief Financial Officer*

Yes, I think the way I'd look at it broadly is that the NPLs went up by £2.4 billion overall. And £2.2 billion of that was Ireland. So, there's very little movement outside of that. In UK corporate

there's still a bit of normalising going on. Except for that I don't see much happening in terms of continued rises.

Tom Rayner – *BNP Paribas*

Okay, thanks very much.

Operator

Your next question comes from Rohith Chandra-Rajan from Barclays Capital. Please go ahead.

Rohith Chandra-Rajan – *Barclays Capital*

Morning, just a quick question on the Non-Core third party assets please. The £13 billion reduction in the first quarter it looks like very good progress versus the full year target, looks like about 30%. I'm just wondering in terms of the mix, it seems to be dominated by a natural run off of seven billion. I think you previously highlighted £12 billion for the year. So, I guess as we move forward then, are you more reliant on agreeing more disposals through the rest of the year and how are you thinking about the full year pace run down, are you still sticking to £42 billion?

Bruce Van Saun – *RBS – Chief Financial Officer*

Yes, we have… I think that's right to spot that, that there's likely to be from here a little bit of a tilt towards disposals in the mix. In the beginning of the year if you put away the pending backlog, we came into the year at 138 and we had £12 billion of backlog. We said that reduction target was to get to 96. So, it was going from 126 to 96 or 30. And probably 17 of that was going to be disposals and maybe 13 was run off. So, we have hit some of the run-off number in the first quarter. And that just isn't naturally smooth, it could be lumpy based on when there's maturities coming up.

We have still remaining £7 billion of asset sales that are signed, so effectively that 125 that we printed is 118. So, we have to go down about 22. And I think you'll see, in the mix, more asset sales, probably two thirds and one third run off from here.

Rohith Chandra-Rajan – *Barclays Capital*

And the asset sales that are signed, the £7 billion, is that just the residual from the £12 billion that you had already agreed at the end of last year?

Bruce Van Saun – *RBS – Chief Financial Officer*

A good chunk of that is what was already pre-agreed. And so kind of two big ones, there's still more in Sempra to novate and move off of our books. There's also the project finance transaction that we announced with the Japanese bank, and there's still more of that to novate. So probably 80% to 90% of the seven relates to things that were carried over and the balance is new stuff. And probably two thirds of that would go in Q2 and maybe the balance in the second half.

Rohith Chandra-Rajan – *Barclays Capital*

Okay, and I guess that's probably the driver of the relatively low disposal costs in the quarter that they haven't agreed a lot of new deals?

Bruce Van Saun – *RBS – Chief Financial Officer*

Yes, I mean, we pointed out in Q4 when we took relatively high disposal losses that when you sign transactions you effectively now have a sale that marks it to market. So, if you were doing loan accounting and then you sign a transaction, you put it on a market basis. And so that accelerated some of those losses into Q4 of last year.

Rohith Chandra-Rajan – *Barclays Capital*

Thank you very much.

Operator

Your next question comes from Michael Helsby from Merrill Lynch. Please go ahead.

Michael Helsby – *Merrill Lynch*

Morning guys, just a couple of questions. Firstly I think Stephen you mentioned at the top that a lot of the balance sheet measures that you're targeting you're kind of almost 21 months early out of your target. I was just wondering from a growth perspective in the Core business, now where you are, does that change the way that you view the growth opportunities that you've got and the leverage in the balance sheet, or is that something that's more market driven and demand driven and hard to influence? And I'm thinking along the lines of, you know, moving up the LTV curve slightly in the mortgage market as an example. Secondly on Corporate bad debt, Lloyds are guiding towards a deterioration in UK SME, non-property commercial loans, I think, over the rest of the year and into next year. Is that something that you're sort of watchful of and if you could give us an update on what your forward basis indicators are across the UK? I'm just mindful of the incoming austerity which clearly people are very worried about.

Stephen Hester - *RBS – Group Chief Executive*

Well, on the subject of growth I would say that we've positioned our balance sheet faster than we thought so that we are free to take advantage of our customers wanting more credit from us in our core markets. Unfortunately at the moment they don't seem to be wanting much more money from us, so we've got some growth capacity that the market is not demanding from us right now. What we're not going to do is depart from our conservative risk appetite to chase this. I think it's too early and too dangerous a part of point, and in any event I don't want to have that reputation. So we might just go slow for a while, but we certainly have that fire power if we need it. That said, although the balance sheet is in good shape, we've got to continue to run down a Non-Core from a risk perspective and although the capital ratios are in good shape, with both BASEL II and APS and whatever the Banking Commission throws at us I think we're going to need to keep

conserving capital through this year and next rather than spending it on a whole lot of balance sheet expansion to accomplish our goals. Do you want to take the credit one?

Bruce Van Saun – *RBS – Chief Financial Officer*

Yes. So, on the UK corporate in particular, the SME we had, I think, a flattering of result in the first quarter, there was a latent reserve release. If you look back to last year we had a gently falling trend and the number kind of averaged around £175 million of impairment in UK Corporate. I'm not uncomfortable with kind of going back to that range and then seeing gentle falls probably. The SMEs are generally late cycle in terms of credit losses and so we have seen an uptick in non-performers in SMEs. And so I think that might become a bigger percentage of the overall impairments in UK Corporate. But we have seen continued improvement in the bigger corporate space which kind of offsets that. And so I'm pretty comfortable with the outlook for the UK impairments overall.

Michael Helsby – *Merrill Lynch*

Okay, thank you very much.

Operator

Your next question comes from Robert Law from Nomura. Please go ahead.

Robert Law – *Nomura*

Good morning everybody, I just have a couple of questions. Firstly on the RWAs which were certainly a lot lower than we were expecting. Could you comment on… a bit more detail on the slide 18 which shows that improvement and give us some indication, if you will, on where you think the year end might turn out on that? And secondly, could I invite you to make any comments that you wish on the effect of the ICB recommendations?

Bruce Van Saun – *RBS – Chief Financial Officer*

Sure, let me pull up 18 here. So, again we are continuing to seek to take risk down either through asset run off or hedging up various risks that we have on the books. So much of the reduction was simply that. The one kind of exceptional that occurred in the quarter was on certain markets positions which were moved from our trading book to the banking book because there was an extremely conservative result around those positions when it was put into the trading book and they're very illiquid and we are managing down over time. So that was the seven that you see in that rundown.

I think, on a gross basis, RWAs should roughly hold to slightly continue to fall given run-off, prior to the impact of the Basle 2.5 that comes in kind of the last day of the year. That's about £30 billion and we'll do the best that we can to offset that impact but I think we've got a good jump on it here in the first quarter.

Stephen Hester

Robert, on the ICB, I guess we don't have, there's still a pretty broad range but the way we're sort of thinking through it is relative to the synergies of universal banking that we've put in our submission to the ICB. Subsidiarisation looks likely to allow us to retain the revenue benefits of the Group, to retain most of the cost benefits although we think there will be meaningful costs, not least disruption in implementation. But the major hit that we expect to take from subsidiarisation is in the funding and capital efficiency of the Group which is, if you like, part of that overall synergy.

What we can't yet quantify is exactly in what measure and by how funding costs will rise and the amount of capital that we have to keep will rise. And we'll have some choices around the balance of funding costs, i.e. what rate, what target rating we have and what capital we keep. And of course, there are lots and lots of flavours of subsidiarisation they're still working through. So I think we can say unambiguously that we think that it's bad for bank credit, the rating agencies told you that. Subsidiarisation is bad for shareholder returns and is bad for customer disruption but it may happen anyway and we're working hard to try and make it happen in as digestible a way as possible.

Robert Law - *Nomura*

Thank you. And just as a follow-up to that, the capital hit that you see; do you see that in the ring-fenced entity or do you see that as capital that you're going to be required to hold outside the ring-fenced…?

Stephen Hester

Well, I think it's both. We've been quite clear that we think that double-A rated target banks would be aiming for Core Tier One ratios, look at JP Morgan, look at the US banks, under 10%, let's call it 8 to 9%. So both in the ring-fenced sub and in the un-ring-fenced sub, which will have to carry higher capital ratios for the loss of diversification that's gone, in both areas the capital ratios will be higher than I think they would otherwise be.

What we don't know yet is by what amount and whether funding costs are also higher and I think there's lots of work and detail to go through yet. We also, of course, don't yet know what the final piece of the Basle work that will come out this summer in the third quarter will be, which will set the true comparator as to where the capital ratios would otherwise need to be.

Robert Law - *Nomura*

Thank you.

Robin Down - *HSBC London*

I had a couple of questions but I think one's already been answered on the corporate impairment but could you just give us a little bit more colour on the GBM margin movements? Do you now think that we're at a sort of normalised level of margin areas, the sort of compression on the learning side now sort of completed or is there more to go for on that kind of front?

Bruce Van Saun – *RBS – Chief Financial Officer*

It's very hard, probably the hardest area of business that we have to focus on the margin is GBM and that's because there's money market activity runs through that line and which makes it inherently volatile. I would say that, if you look at a kind of longer-term perspective, that margin has been coming down. Part of that reflects two things; one is that risk appetite is lower and so we have brought down the size of our loan portfolio that we keep in GBM to drive cross-selling and we've also been more, I think, conservative in who we want to lend to. So the spread on that book has come in over time.

The other aspect is we've also been lengthening the maturities of their funding profile and so that's also had an impact. So the backdrop is, there's volatility on that generally but if you look at the longer-term trends, it's continued to come in. I'd say we're through a good chunk of that, as Stephen indicated, we feel that we've made quite a few risk improvements and I don't see significantly greater tightening of spread on that lending book for the near term and the terming out of their funding has largely occurred, they're in pretty good shape in that dimension as well. But having said that, I'd hazard to guess where it could be next quarter or the next quarter, just given some of that volatility around the money market activity.

Robin Down - *HSBC London*

Right, thanks.

Edward Firth - *Macquarie*

Yes, good morning everybody. Just, if I could just quickly pick up on Robert's question about risk-weighted assets, is the seven billion that you talk about, is that the asset reclassification that you referred to in the Non-Core? So is that a big part of the £25 billion fall?

Bruce Van Saun – *RBS – Chief Financial Officer*

Yes. That's the item number two in the bullet point on slide 18.

Edward Firth - *Macquarie*

Okay. And my second question is, then, in terms of the average weighting of the Non-Core portfolio, should we expect that to be broadly static now going forward or are you going to expect more of these sort of reclassifications?

Bruce Van Saun – *RBS – Chief Financial Officer*

Well, there's cross-currents that will take place there. One is the Basle changes. We've indicated the impact of (Basle) 2.5 and 3 to be about 100 billion across the Group and around 60 of that sticks into GBM and 40 comes back to Non-Core. The portfolios that it sticks to in Non-Core are in the process of being run down and we will continue to look for opportunities to accelerate that rundown but you'll have that occurring at the end of this year and at the end of 2012 as Basle 2.5 and Basle 3 come in.

So there is, I think, a likelihood that this thing goes quite a bit north of one to one as things get phased in, but, our challenge is to continue to manage that back towards, a one to one relationship and manage the absolute size of it down and hit the target of 30 to 40 billion in 2013.

Edward Firth - *Macquarie*

Great, okay, thank you.

Operator

Your next question comes from Arturo de Frias from Evolution, please go ahead.

Arturo de Frias - *Evolution*

Hi, good morning. Two questions please, both related to ROE performance, the first one in the UK, the second one in the US. In the UK I'm starting to have the impression that the ROE progression which has been very strong so far in Retail particularly and also in Corporate could be starting to peak. I am saying that, because if I look at Retail the loan loss ratio is already

relatively low at 70 bps, the margin is high at 4%, cost income ratio might improve a bit more, but, probably not miles from where we are.

So, am I right in thinking that the 26% ROE in Retail is pretty much as good as it gets? And then in UK Corporate you also have a very low impairment charge 40 bps and a very low cost income ratio, 41%, so, again, are we getting to pretty much the peak in terms of implementing ROE in both Retail and Corporate in the UK?

And then in the US the question has exactly the opposite direction. The 4% ROE that you have in US Retail and Commercial obviously remains quite low and it looks like there is a cost problem here that doesn't go away, the cost income ratio has been above 70% for pretty much the last five or six or seven quarters. Am I right, do you think there is a costs problem here, or, it's more a revenue problem because of low interest rates? And, if it's a costs problem, how you plan to address it? Thank you.

Bruce Van Saun

Sure, just firstly on the UK businesses. I guess, let's talk about the earnings possibilities in the business first and I think the UK Retail has had a very smart restoration of profitability; it wasn't long ago that they were making no money and they're now making that 26% ROE. I do think we have continued efforts underway to grow the business and make the business more efficient; we've put a lot of investments standing behind the business. So, I do think there is continued profit momentum in the business, but, you're right, as you start to see impairments get to more normalised levels and you start to see NIM which is slightly above four, the five year high in a higher rate environment was about 420 and, so, maybe there's, once rates rise, still some more there, but, you won't see, I think, the same early dips increase that you've seen going back a year.

The other wildcard that could [potentially] affect both retail and UK Corporate is going to be more growth in the UK economy which would lead to more loan growth and more deposit growth. That, also, would pick up RWAs and so would help earnings, but, it would bridle the continued expansion in ROE. So, I do think there is probably where we are now, even more relative growth potential in UK Corporate than UK Retail, but, I think they both have continued growth positive outlooks here and, so, we feel good about those businesses and I'd say ROE should continue to expand in both places.

In the US, the 4% clearly is a disappointment and, I think, it shows a couple of things. We had a fairly big hole to crawl out from, we were losing money and we continued to improve the situation, but, there's a long way to go to get from 4 to 15. When we actually try and assess what are the cyclical recovery when the US economy overall strengthens and interest rates go higher, what should be the benefit of that? We think our NIM has a chance to rise pretty aggressively; we've held an asset sensitive position there and, so, we'll certainly benefit from higher rates and some rolling off of some high cost fixed swaps. So, that's pretty powerful.

The impairment ratio to loans is still holding up around 75 bps, so, there's room to run to a more normal level of 50 bps. We have very little loan and deposit growth. We're starting to see some signs of loan growth in the loan pipeline building. Those drivers which are tied to improving US economic performance, when fully realised probably take the ROE up to an 11 to 12% range and then the question is how do we get from there to the target of 15 and that really comes from the management team doing a better job; blocking and tackling and making investments to make us more efficient, some of the things that we're a little ahead on in the UK than we are in the US.

And, so, I think you could look at it as, is it an expense problem because the efficiency ratio is high. If you actually modelled it out you probably garner more of the efficiency ratio improvement from revenue growth than you do from the jaws kicking in on the expense side.

Arturo de Frias - *Evolution*

Okay, thank you very much. Can I ask you to comment that progression, that ROE, that 15% ROE in the US, is that a two year story, do you think you can get there in a reasonably short period of time or we are talking about a much longer improvement period from where we are now?

Bruce Van Saun

The original plan had us getting there in 2013. I think, given the slowness to the US recovery, the jury's out as to whether we can get there in 2013 or whether it takes us a bit more time.

Arturo de Frias - *Evolution*

Okay, thank you very much.

Operator

Ladies and gentlemen that concludes today's Q&A. I would now like to hand the call back to Stephen for any closing comments.

Stephen Hester

Terrific, well, thank you very much. Again, I hope that we are right in your eyes in believing that we have delivered consistent progress in this quarter with the operating trends behaving themselves and with us working through our diet of risk reduction and the one-offs below the operating line. Look forward to speaking to you again in three months. Thank you, bye bye.

Operator

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