



## **Interim Management Statement Q309**

### **ANALYST AUDIOCALL**

Friday 6th November 2009

#### **Presenters**

- **Stephen Hester (Group Chief Executive)**
- **Bruce van Saun (Group Finance Director)**

**Operator:** Good morning ladies and gentlemen. Today's conference call will be hosted by Stephen Hester, Group Chief Executive of RBS; please go ahead Stephen.

**Stephen Hester:** Good morning everyone, thank you very much for joining us. May I welcome Bruce Van Saun, who is here for the second time this week on a conference call, as our new Finance Director and he will shortly be taking you through the highlights of our Third Quarter operating performance which we're talking about today.

Could I though, first of all, just simply to start draw your attention, not only to the release itself, but also on our web site, to the extent that any of you have not caught up with it yet, are a series of slides which are designed to help navigate through some of the complexity more swiftly. We won't be talking specifically to any of them, but they're there for your help.

The other thing that I hope that we get credit for is, as you will see, there is voluminous disclosure. I believe that we are best in class in disclosure terms and we see this as an extremely important way of helping the rebuild of RBS in markets. We want you to feel comfortable, that if there

is something that is relevant and important for you to know, that you will know it and that we minimise surprises, positive and negative through that policy. An investor friendly outlook is absolutely at the core of the way we want to behave going forward.

Let me make a few remarks before we get into the numbers in respect of the Third Quarter. I think that the first starting point is that we are crystal clear as to what we have to do. We have to restore RBS to standalone strength. We have to serve our customers well. We have to restore strong profitability in a vibrant commercial success story and all of that will rebuild shareholder value; and of course also protect the heavy stewardship we have in respect of State funds and our job to get the State out of RBS, but out at a profit.

I do believe that the results that we are announcing today - while of course complex as they will be for quite a lot of Quarters to come, given all the moving parts in our business and the huge changes we are wroughting on the business - the results show both why we are confident that we can do the job we have set out for RBS; why the businesses which form the rock of the foundation on which we are rebuilding RBS do merit the confidence and the support of Government and all investors; that we are making progress towards our goal and there are some important straws in the wind in that regard, in today's announcements; but also, as I have always and repeatedly said, this is a marathon and not a sprint and the legacy that we bring into this task will take time to work through.

On the positive side, every single one of our businesses, despite the immense changes going on at RBS and the external pressures, is stable or growing in its customer numbers and customer satisfaction.

In addition to that, the operating performance of our core businesses is becoming increasingly predictable; we are becoming increasingly confident that when we pull a lever that we know what's going to happen as a result. Clearly this is not an on/off switch; it doesn't happen overnight, but as the new management team get traction, as we start to understand how the business responds, my confidence and that of my colleagues of what we can do with this, is qualitatively growing.

There are some important positives in the results. We are seeing a plateauing of impairments; of course in fact impairments have gone down

sequentially Quarter-by-Quarter, but we're calling a plateau relative to the first half run-rate. Although we see that plateau as extending through next year, if the current progress in the world economy and key matrices around, not least real estate markets, were to continue, we would expect the next movement to be down, albeit not for some Quarters and of course, there will be Quarterly volatility in impairments.

We also have positively surprised ourselves in being able to arrest the fall in net interest margins earlier and at a higher level than we had thought. Again, we see and hope for a plateau in this area for a while, although as interest rates go up, we're quite conscious that margins do over time, need to go up further as we go through.

Additionally, we are making good progress in restoring our financial strength. Deposits are rising, as we said they would, and we are outperforming the market. Our loan to deposit ratio is coming down, partly as deposits rise and partly as loans fall in non-core offset by some new lending, particularly in the UK. There are very big strides being made forward in liquidity and term funding and general safety of the balance sheet. This will take years, but I think really good signs going forward.

I know that you will want to spend some time as we go through this call on the capital position. Clearly, in today's results, for all the good things, here's a reminder of why we needed the Asset Protection Scheme and the associated capital raised that went with it. In that sense, we still regard this week as a landmark week for RBS, as a week where despite the penalties from the EU, we took a major step forward in the ability to deliver our plan and were given the tools to do that job.

With respect to APS, we reiterate that we are supportive of the restructure of APS. As we gain increased confidence in RBS and in the external environment, we see the chances of a stress scenario having receded, although we still need APS to pass it technically from an FSA standpoint. We are not expecting to draw down the contingent capital; we are not expecting to hit the first loss; we are not seeking to be more conservative on our outlook of impairments. Therefore, a less powerful but much cheaper scheme, we believe, will ultimately be to our shareholders' advantage.

Now, we are very conscious of the increased dilution inherent in the EU penalties, in addition to the B-share issuance. We will work as hard as we can to minimise that dilution in the out years of the plan, by which time we hope to have capital surpluses, which are available for distribution in one form or another to reduce dilution; but clearly that is in the future.

In the near term, as you will see from our Quarterly results, we do see an inherently hostile RWA or regulatory environment, which we need this cushion to get through. The vast majority of the bad things on RWAs are in non-core and will disappear as we wind down non-core. Indeed the majority of them are covered by APS. But nevertheless, pro-cyclicality of RWAs and different calculation methodology is coming from the regulators, lay behind some of the cushion that we felt we needed, in particular for the next two years, and you'll see some of that in the Quarterly results as we move through.

So, I think that in closing my remarks, we do expect to continue to have this pattern of profitability in core and losses in non-core. We expect that to go through next year. Our actions are improving the underlying profitability of core, but it will take time for them to show through and it will need economic recovery to reach the targets that we have set out. Nevertheless, I do think that we are upbeat about our ability to do this and we are getting on with the job.

With that introduction, perhaps I could hand over to Bruce, to take you through some of the highlights of the performance in the Quarter.

**Bruce Van Saun:** Thanks Stephen and good morning. The Group reported an operating loss of 1.5 billion in Q3 compared to 3.5 billion in Q2. There are three drivers to the 2 billion smaller loss; first, impairments were lower by 1.4 billion; second, the movement in fair value for own debt was a smaller charge, by 500 million; and third, credit market write-downs and associated derivative exposures in non-core, were smaller by about 500 million.

On a pre-provision basis, after adjusting for movements in own debt, the Group turned in a profit of 2.2 billion in the Third Quarter of '09 and that was up from 2.1 billion in the Second Quarter and it was down slightly from 2.3 billion in the Third Quarter of '08.

But the good news is that our businesses have had a solid footing through a difficult environment. Our staff remains engaged and we're continuing to serve our customers well.

Looking across the Divisions, positives in the Quarter include improved performances from the UK Retail and Corporate Divisions, compared to the Second Quarter, primarily as a result of lower impairments along with stable net interest margin.

GBM is also performing according to our expectations. Negatives in the Quarter include widening losses at Ulster Bank and Citizens, reflecting growing credit impairments; more on the Divisions in a few minutes.

On a consolidated basis, our Q3 net interest margin of 1.75% was broadly flat, compared to the two previous Quarters and slightly better than previous guidance. The good news here is that we have made progress in improving underlying asset margins in all Divisions. In UK Retail our mortgage performance has been very strong and in UK Corporate, we've seen improved pricing on new originations.

Deposit margins in sequential Quarters are stabilising, but are still down year-on-year through the impact of benchmark interest rate cuts in the First Quarter.

Offsetting the asset margin improvements however, are increased costs relating to higher liquidity buffers and greater term funding, which we expect will continue over the next few Quarters. Overall, we are guiding to broadly flat margins over the next couple of Quarters, with improving trends beginning thereafter.

Non-interest income was up in the Quarter, one billion sequentially, reflecting better trading results due to improving securities valuations and smaller hedging losses, as well as less of an adverse impact from tighter spreads on RBS own debt.

Expenses were well controlled; we are well into the implementation phase of our 2.5 billion cost saving programme, with 1.5 billion of benefits in our current run-rate. The cost to income ratio improved in the Quarter from 66% to 59%. Using the adjusted cost to income ratio, which nets insurance claims off of income, we improved to 70% from 78%.

We will continue to seek to expand our expense initiatives while funding the investments necessary to upgrade the Group infrastructure and to grow our business franchises.

Impairment losses were lower in the Quarter, at 3.3 billion; as a reminder, Q2 had some large “tall tree” impairments in the 4.7 billion charge. Many of these impairments were in the none-core Division and latent loss provisions were boosted in UK corporate by around 500 million. These factors were much less pronounced in the Third Quarter. There were, however, increased impairment losses in Ulster and in Citizens, reflecting the difficult economic environments they operate in and a continuing reserve build at Citizens. We expect that the impairments outlook over the next few Quarters may continue to include some lumpy impairments, although overall we’re seeing signs of stabilisation, as Stephen mentioned.

Next, let me briefly give you deeper highlights on divisional performance for Q3 versus Q2. We saw improved performance in UK Retail, driven primarily by a slight fall in impairment losses. Despite regulatory and economic pressures, we have an improving outlook for this business as we begin to implement our strategic plans, which focus on streamlining our operations and deepening customer relationships to deliver more value.

Wealth profit remains stable versus Q2, with good asset growth and margin widening, offset by compression of deposit margins. UK Corporate had a very good performance in Q3, with higher margins and lower impairment losses. This business also feels like it has stabilised, with an improving outlook as economic conditions strengthen. GBM posted underlying income of 2.2 billion, adjusted for fair value of own debt in the Quarter – slightly higher than our expectations in a seasonally quiet period, with strong performance in the rates area, balanced by quarterly declines in currencies and commodities, which reflects lower market volatility. GBM incurred one large impairment, which accounted for most of the 272 million charge for bad debts in the Quarter; absent that, it was a very strong Quarter. We continue to see GBM performing at levels above, or at least consistent with our planned targets.

GTS operating profit before impairments was up slightly, as income was stable and expenses declined. Deposit performance in both domestic and international cash management was strong, with a five million increase in deposits in the Quarter.

Ulster Bank's performance reflects the very difficult economic environment in Ireland and the resulting high impairment charges and lack of new business volumes. We expect these conditions to continue for the foreseeable future and we focussed on improving our operating efficiency there.

Citizens had a difficult Quarter, with impairments increasing and margins on deposits still at compressed levels. Nonetheless, the NIM was up five basis points sequentially, given pricing strategies on both loans and deposits and business volumes are starting to build, reflecting early signs of economic recovery in the US; so we definitely see some bright spots at Citizens.

RBS Insurance increased its reserves against bodily injury claims by 175 million, as a result of an ongoing actuarial review; but we saw increased volume in policy numbers and in customer numbers, driven by strength and success of our variance. We expect to selectively increase our pricing in both Q4 and in 2010, to help offset these claims.

The non-core division reported better results, albeit with an impairment loss of two billion in the Quarter, which reflects property and construction provisions and continuing topping up of corporate provisions. Importantly, the non-core area has continued to meet its run-off objectives with respect to its portfolio.

Now let me direct my comments to balance sheet metrics. Total puttings were roughly flat on a constant currency basis, but we saw some good trends across our funding and liquidity metrics. For example, the proportion of wholesale funding over one year in duration, improved from 47% to 49%; our liquidity pool increased by 19 billion to 140 billion and our loan-to-deposit ratio improved by 220 basis points to 142%. Deposits grew sequentially by eight billion against the backdrop of highly competitive market conditions.

Our tangible equity per share increased by 1.4p to 59.4p as positive movement in the value of AFS Securities and other comprehensive income, more than offset our attributable loss for the period.

Our RWAs increased by 47 billion sequentially, with monoline downgrades and the resulting impact of procyclicality accounting for about 30 billion of the increase.

The good news is that about 60% of the overall increase is picked up in APS. Although currency movements also increased RWAs by about 10 billion, the impact on capital ratios of currency movements is very small as we are pretty well hedged. We do expect further procyclical impacts in Q4 and we are slowly reduce the size of our capital relief trades. Now, they've fallen by 18 billion this year so far, from 60 billion of RWA release to 42 billion; having said that, the run-down of non-core will be providing an offset.

One last point on RWAs, once we enter 2010, our movement to Basel II at ABN Amro is expected to increase RWAs by approximately 40 billion, which has been factored into our forward capital needs assessment.

Credit metrics and reserves reflected difficult economic conditions seen in our major markets. REILs rose further in the Quarter to 35 billion from 31 billion at the end of June, albeit the pace of increase has moderated compared to the upward movements of about 6 billion seen in each of Q1 and Q2.

Provision coverage has remained broadly stable. The value of property collateral has benefited from stabilisation in prices, which has helped moderate the provision increase. Our early warning indicators, in terms of future impairment losses, also seem to have stabilised over the past few months. Our capital CT1 ratio declined to 5.5% at Quarter end, evidencing the need for the HMT capital injection and the new APS cover. Our pro forma estimated core Tier 1 ratio of 11.1% at 30<sup>th</sup> September, gives us the ability to withstand elevated legacy impairment losses over the next 12 months, maintaining robust ratios in 2010.

We now have a strong capital base upon which to execute our plan and we believe that our cash flow generation will be significant in the later years, with the combination of better execution and a stronger economy,

leading to a strong recovery in performance. The mandated divestitures will add to our capital flexibility.

Rest assured, we will be good stewards of that capital and we will seek to reinstate coupon payments, ordinary dividends and share repurchases, as soon as practicable.

Let me conclude my remarks by saying that we remain highly focussed on making progress against our planned metrics and we view 2010 as a year of execution. We have a big challenge ahead, but we are committed and we are up for it. With that, let me hand it back to Stephen.

**Stephen Hester:** Bruce, thank you very much. With no further ado, let's hand over to any questions you might have.

**Operator:** Thank you. Ladies and gentlemen, if you would like to ask a question, please press the \*key followed by the digit 1 on your telephone keypad. We will pause for just a moment to give everyone an opportunity to signal for questions. Your first question comes from Jonathan Pierce from Credit Suisse; please go ahead.

**Jonathan Pierce:** Morning All. I've got a couple of questions on the RWAs and then a third one on the liquidity buffer. First two are really connected; I was wondering if you could give us an idea as to whether the 40 billion incremental from the ABN Amro migration includes the further transitional effect of including stress [bar] and IDR into market risk requirements? And secondly, if you could give us just an overall steer of what we should be thinking about now on risk weighted assets for next year, because there are clearly a lot of moving parts. A lot of those moving parts are very big and I think it would be extremely useful for everybody if we could get a sense as to what you think RWAs might do next year overall?

**Stephen Hester:** I'm afraid we're going to disappoint you. We hope that we can give much better guidance at our Full Year results. And the few different moving parts around why we're not giving it now is, first of all we need to finalise the agreement with regulators on moving from Basel 1 to Basel II with ABN Amro and actually knowing whether that is 40 billion or some other number, so that's just our current central guess, but it could be quite a lot different, potentially.

We also want to get a stronger handle on the impact of what you might call Basel III, which doesn't come until 2011, but we want to make sure that we're managing our business next year to minimise that impact. I think we'll have better numbers on that then. Because APS changed quite a lot in the last few days, the extent to which the RWA increases are covered by ABS we expect to be considerable, but we haven't really worked that through in detail yet. For all of those reasons, it's hard for us to give good guidance for next year at this juncture.

Our central view would be that RWAs would increase in the Fourth Quarter, but by a much lesser amount than they did in the Third Quarter and that next year they might be stable with the exception of the ABN Amro transfer; but I have to tell you that you should put very limited weight on that guidance at this point.

[Audio] of course what I'm really meaning is, when assets come down in non-core offsetting procyclicality, it remains to be seen whether that is what happens.

**Jonathan Pierce:** That's useful guidance, thank you; but just to be clear, when you say stable next year ex-ABN Amro, is that also ex any further impacts of the stress [bar] and the IBR requirements?

**Stephen Hester:** I think what you're meaning, forgive me if I'm getting the terms wrong, is the stuff that comes in 2011; you won't see that next year, you'll see that at the beginning of 2011, although we will try and give guidance on as we go through next year. The areas where we see it hitting most, is conduits, securitisation and the credit derivative area. A lot of that is in non-core and we hope to make very good progress, particularly in CDPCs next year in getting rid of those. So I'm hopeful that we will do a lot to get rid of some of those impacts, but also we need to be clearer with you about what we expect them to be, even though we expect them as a 2011 item.

**Jonathan Pierce:** Very useful, thank you; the last question on the liquidity buffer. Can you give us a feel as to what proportion of the 140 at the moment, is Government bonds and cash; and what proportion of the eventual 150 you would think would need to be in Government bonds and cash?

**Stephen Hester:** We are at the moment thinking, that our Government bond portfolio might end up being about 60 billion and that we would be getting there between now and 2013, but front end loading a fair amount of that progress. We've been building in the Third Quarter; we'll build further in the Fourth Quarter. From memory, we think we'll be half way through that by the end of next year i.e. at around 25 or so.

**Bruce Van Saun:** I think we'll be probably around 20 billion at the end of this year, building towards 25-30 by the end of next year, on our way to 50-60.

**Jonathan Pierce:** Very useful, thanks a lot.

**Operator:** Your next question comes from Jon Kirk from Redburn; please go ahead.

**Jon Kirk:** Morning everybody. Actually just a follow-up on that last question; is 60 billion of Government bonds enough as part of your liquidity buffer, because the FSA as far as I can see, seem to be focussing almost exclusively on that form of liquid asset. Am I wrong there?

**Stephen Hester:** You're right to say we won't know until next year where the FSA come out in liquidity. I think it's important to note that our liquidity definitions are quite broad and so you're not necessarily thinking apples and oranges; so it's our best stab ahead of the FSA actually publishing what they want next year.

**Jon Kirk:** So the 60 billion is your best guess of what you think they'll ask you to do?

**Stephen Hester:** Yes

**Jon Kirk:** You mentioned that in terms of cost cutting, you are about 1.5 billion run-rate already; that presumably compares to your 2.5 billion target. And if so, given that we are relatively early on into your plan, do you think there's any possibility that you might be willing or able to extend that target?

**Bruce Van Saun:** I think we're certainly making good headway against the plan that we've already put forward and we're looking at other

opportunities – for example, we have a drive in our non-staff expenses looking to tighten some of our vendor expenses and the rates we pay for things and the demand for some of those things. We think the pot potentially could go up and we'll probably have more to report on that in February when we release the Annual Results.

**Jon Kirk:** Great thanks, and then just one last one. On GBM, I guess I'm interested in personnel issues really. I think Stephen you were quoted in the press as describing your staff as sitting ducks at the moment, given the remuneration controls that are coming in. I note also that the revenues were down quite sharply in the Third Quarter versus the second. Can you just discuss the issue of personnel; I guess level of motivation is one thing, but also whether they really could be poached away?

**Stephen Hester:** By the way, a question was put to me that contained those words, but I did not use those words. I have been very clear all year and I don't restrict my remarks to the investment bank; one of the single biggest business challenges we have is to motivate, keep and attract good people in what is the biggest restructuring ever done in a bank. That goes for every single one of our business divisions and that driver takes enormous amounts of management time; it's why we have prioritised a strategic plan; it's why we put out a vision; it's why we put out targets; it's why everyone increasingly knows their role, what they have to do. I have to say in the round, we are being successful. In the round, the solidity and progress in our customer numbers, in all the customer satisfaction, everything else tells you, that we are really doing very well and our staff is frankly doing an heroic job in the face of all the reasons they would have not to; so I prefer to see this as a glass three quarters full.

However, all of that said, our task is not being made easier and there are all sorts of reasons why it could be dispiriting to work for RBS that we are trying to overcome. We have lost people across our business this year, in a way I have described as damaging, but not yet destructive. I am hopeful that we can keep it in the damaging but not destructive area and we are working hard to do that. I am specifically in the investment bank, but my comments go for all our businesses. I think that our people are doing a fantastic job; the management of the investment bank, the whole management group are really doing a fantastic job in restructuring that bank, in fundamentally changing it for the future, in pursuing client flow activities. I'm very proud of them and I'll be fighting hard to make sure that

they know that they have my support and that of my colleagues, in doing that job.

So I can't tell you there aren't risks there, but so far we've dealt with the risks and we will try to keep doing it.

**Jon Kirk:** OK thanks

**Operator:** Your next question comes from Peter Toeman from HSBC; please go ahead.

**Peter Toeman:** Morning. Two questions: first of all, margin, the guidance if indeed it is guidance, has changed quite radically, because in the First Quarter you were talking about a margin I think below 160 basis points and now we're seeing stabilisation at 175. I wondered if you could tell us what the main changes are that brought about this change in your thinking. The second point is I appreciate you give us numbers for the contraction of the bank in asset terms, but you haven't given us the numbers in WRA terms. Going back again to the beginning of the year, you were talking about a 250 billion reduction in WRAs. We have 140 billion coming through the APS scheme; so would I be right in thinking that above and beyond the APS scheme, that over some time scale there should be a further 110 billion of WRAs to come off the balance sheet?

**Stephen Hester:** Just on the second one, I think you are - if you don't mind me saying - barking up the wrong tree. The RWAs and APS are relevant in terms of temporary capital relief, but once we get rid of APS which I hope will be before the end of our planned period, that will become irrelevant. The principal vehicle for RWA reduction is the non-core division. Clearly, if you are performing our RWAs, you have to look at the RWAs that are in non-core, which are obviously presented in these results. Now clearly, they are going to go up and down with procyclicality, up and down with sales.

In terms of the margin change, let me ask Bruce to address that.

**Bruce Van Saun:** On the margins, I think there are two things that we're seeing that have been positive relative to expectations. The first thing is just on asset margins; those have been expanding and we expect that to

continue. So I think reflective of the higher cost of capital for banks we're seeing an ability to price new originations both at individual level as well as the institutional level, with greater spread; that should continue.

The second thing is we've seen an improvement in our overall wholesale funding spreads – our spreads have tightened. So I think the one-two combination there leads us to have some confidence that we can keep the margins around the zip code. There still is the offset, the reason you won't see it improve right away is, as we mentioned earlier, we have to continue to build that liquidity buffer and as we increase the percentage of Governments in that liquidity buffer, that serves a bit as a drag. We also are extending maturities in the wholesale funding and that also serves as a bit of a drag.

You have on the one hand the positive asset margin outlook continuing; on the other hand a bit of an offset coming from our balance sheet measures.

**Stephen Hester:** I think the other point that I would make is that we have strong deposit franchises and they have been outperforming the market. Although of course deposits are more expensive than they were, the continued reduction of our loan to deposit ratio and the continued good behaviour of deposits, I think is a positive feature of the inherent business strength of RBS.

**Operator:** Your next question comes from Manus Costello from Autonomous Research; please go ahead.

**Manus Costello:** Good morning, Everyone. I also have some questions on the net interest income line please. Could you give us an idea what the average coupon is on the hybrids that you are going to be deferring and what you think the total annual interest saving will be on that deferred interest first of all?

**Stephen Hester:** We're just scabbling for the answer.

**Bruce Van Saun:** I would say the coupon is in the 7% range and the total amount of savings would be £700 million.

**Manus Costello:** Am I right in saying that on the B-shares, you don't have to pay the coupon until you start repaying that hybrid?

**Stephen Hester:** We never have to pay the coupon on the B-shares until we pay ordinary dividends and then there's a formula. That isn't to say that we won't do it soon, but we are also banned from doing it until we're paying some more senior ones as well. There's a grey area in the middle, but we're not doing the B-shares yet either.

**Manus Costello:** But there is - between that 700 million of annualised interest saving and 1.8 billion of B-share coupon payment - there is a very substantial hump coming at some point down the road when you've returned to profitability and think about paying ordinary dividends. And I wondered how you are thinking about dealing with that; and I wondered also if any of your margin guidance includes the benefit that you are getting from the deferral of the hybrid coupons.

**Stephen Hester:** The coupons come below the line, so I don't think we've got those in our margin; but in terms of the hump, the best way out of the hump is for you guys to move our share price to 65p and then we'll never pay them. We will try and give you the evidence to support that move.

**Operator:** Your next question comes from Arturo De Frias from Evolution; please go ahead.

**Arturo De Frias:** Yes hi, good morning. I also wanted to try to understand a bit more the change in guidance in risk weighted assets, because of procyclicality. Last time we spoke about these, which I think was in H1 results, the guidance that we got was more or less, if I remember correctly, around 10% growth in risk weighted assets due to procyclicality. I'm excluding from this, the potential increase in RWAs because of ABN, because of course that's a completely different thing. If I look at the risk weighted assets increase that we have seen in Q3, annualised it is probably about 20% growth because of procyclicality. I wonder what has changed between H1 results and now that has doubled the procyclicality driven growth. Is it unexpected deterioration in credit quality; was it unexpected PV migration – what is it exactly? Thanks very much.

**Stephen Hester:** Arturo, I think when you strip out the FX effect and the monolines, our guidance hasn't changed. The monoline downgrade was a

very lumpy thing which will disappear when the monolines disappear and maybe I'm speculating here, throw some light on the financial engineering that one of our competitors did, to avoid it.

**Arturo De Frias:** One-offs excluded and hopefully the monolines is the last large one-off, so maybe we should still think about around 10% growth, due to PV migration?

**Stephen Hester:** I do think it is right to understand that there can be quite a lot of volatility around the RWA number; not because the underlying business is in any way volatile, but because weird things ... there is a huge change in small credit migrations, particularly as you go towards the default area. The monoline is an example, there could be other examples like that, or similarly if we were to commute some of the monoline exposure, you could have that change bounce back in the opposite direction. Similarly, the Loss Given Default in all the secured books, real estate books, is highly sensitive to real estate markets and therefore it can have big RWA effects. I'm afraid this line could contain volatility and my main comfort to you is the overwhelming majority of volatility is assets that sooner or later we're going to get rid of.

**Arturo De Frias:** Another question and apologies if that was answered in the call you had two days ago, I couldn't join that. Am I right in thinking that the only main reason why you still have the APS is because of short term RWAs relief? Because as you said in your opening remarks this morning, you don't expect to hit the 60 billion new first loss level and I tend to agree with you, that it's a very, very high first loss level. If we exclude the impairments release, the only major component that is left in the APS, is RWAs relief; is that right?

**Stephen Hester:** Let me be clear; the reason why we have the insurance policy and the accompanying contingent capital is to pass the FSA stress test, which is an economic scenario we do not expect. Were it not for the FSA stress test, we would not have either of those two things.

**Arturo De Frias:** Okay, that's very clear, thanks very much.

**Operator:** Your next question comes from Christian Hantel from WestLB Mellon Asset; please go ahead.

**Christian Hantel:** Morning. A question on capital; your core Tier 1 ratio was falling down to 5.5%; and your trigger for the new contingency capital note is at 5%. Do you expect these new capital notes to be exchanged any time soon?

**Stephen Hester:** No, we don't expect them to be exchanged ever, unless something goes very wrong with the world economy.

**Christian Hantel:** OK thanks.

**Operator:** Your next question comes from Leigh Goodwin from Citi; please go ahead.

**Leigh Goodwin:** Thank you, good morning Gentlemen. Two or three questions if I may; the first one on GBM revenues. I was interested in your comment Stephen that they came in, in the Third Quarter, slightly ahead of your expectation, allowing for seasonality. I recall your guidance as broadly that the second half would be in line with the Second Quarter annualised so to speak. Is there any change in that guidance now; in other words if you've beaten on Third Quarter expectations, do you think that we should be thinking of something slightly better than you were previously guiding?

**Stephen Hester:** What I was trying to say for the second half, although many of you didn't listen very careful in all of them, was I thought a second half run-rate of two billion a Quarter sounded about right. In fact we did 2.2 billion in the Third Quarter, before the fair value of own debt. The second half would normally be slower, not always, but normally because of Summer and Christmas; and so next year's run-rate I expect to be lower than this year's, but higher than that.

**Leigh Goodwin:** But you're not changing your guidance then for the second half of this year on the basis of a strong Third Quarter?

**Stephen Hester:** I think a two billion Fourth Quarter would be a central expectation; it could be higher or lower as we all know.

**Leigh Goodwin:** Ok that's fine for the first question. Second question was on insurance; I noticed there's quite an increase in claims, and saw a curious statement on the motor business; so what's been driving that, increase in

bodily injury claims. Is this a sort of temporary blip or do you think some significant change has taken place?

**Stephen Hester:** If I'm blunt, we messed up; driven in part by bloodthirsty lawyers and in part by a recession, there is a spike across the industry in people making bodily injury claims in the motor book. As the biggest motor insurer that's hit us. Frankly, management distraction and so on and so forth meant that we didn't spot it earlier. We're doing a huge amount of work on the claims side and we're re-pricing the bits of the book aggressively that are affected; and it would be our objective that by next year, this spike is overcome through that combination of actions, although the Fourth Quarter will be very similar to the Third Quarter.

**Leigh Goodwin:** Ok that's very helpful thanks. My third question was just on the outlook, when interest rates start to change for your various businesses, it's sort of a philosophical question, lots of moving parts; but I wondered if you could tell us in two critical areas in relation to your margin and in relation to GBM revenues, whether you would envisage a gradual rise in rates, maybe through the second half of next year, to be a positive factor for your business or negative?

**Stephen Hester:** Positive; at the moment, we've kept our forecast that rates don't rise until 2011, but if rates rose earlier we believe that we will make more out of deposit spread expansion than we will lose in other areas.

**Bruce Van Saun:** I would say in particular in Citizens and the Retail businesses, we're pretty asset sensitive at the moment. So, those deposit spreads would widen; so an earlier rise to rates would benefit us in 2010.

**Leigh Goodwin:** Thank you very much, that's very clear.

**Operator:** Your next question comes from Robert Law from Nomura; please go ahead.

**Robert Law:** Good morning, Everyone. My question is to do with the risk appetite within GBM. You've given a lot of disclosure today, but I haven't got through the measures as to what's gone on there. Could you comment on your appetite to grow the asset base, the various measures of risks within GBM? I'm thinking about this against the background of obviously regulatory change, Government views on whether banks should

be doing that sort of thing and obviously also linked in with the EU requirements for you to divest of Semptra.

**Stephen Hester:** The biggest bit of our VAR is what I always call 'misleading VAR' that sits in non-core around the credit books and so on that we've closed and are in the process of exiting, which frankly ought to be accounted as banking books because they're traded as a misnomer. The risk in the ongoing core investment bank, obviously it moves around in response to opportunities in markets but it is overwhelming in pursuit of customer flows and therefore I believe the antithesis of the popularly conceived casino epithet.

We are, of course, are watching closely the change in regulation. It is quite obscure in its specifics and will be, I think, for at least a year. All people with investment banks may have big or small adjustments to make in business models as the regulatory picture becomes clearer. However, what I do know is that the overwhelming majority of what we do is really now pretty plain vanilla, meat and potato customer facilitation, done, I believe, in a skilled and intelligent way; and so in that sense I would not see our revised risk appetite undergoing major changes. Obviously the disposal of commodities, while not being a huge bit of GBM particularly when you take out the minority, removes a different kind of risk from us albeit one that so far we've been managing well.

**Robert Law:** So you wouldn't see that the regulatory change and actions by your shareholders/regulator and the authorities including the EU, as effecting your ability to generate revenue further than what we can see from the Semptra sale?

**Stephen Hester:** I think that everyone who owns an investment bank has to have some square brackets around this subject until exactly what the regulators do is clearer. I wouldn't for one second encourage you to feel a degree of certainty about this, other than it's not obvious to me why we're affected differently. In fact, given that I think we're more at the meat and potatoes end we *may* be affected less in core as opposed to non-core. Certainly I'm sure that there'll be business activities that are materially impacted by change in regulation; I mentioned some of them earlier on as examples.

**Operator:** Your next question comes from Tolu Alamutu from Bank of America; please go ahead.

**Tolu Alamutu:** Good morning. I have a question about the preference shares and other Tier 1 instruments; well two quick questions actually. First off, when will you be able to provide a definitive list of the securities that will be impacted by the EC's restrictions on coupons and dividend payments? Secondly, can we expect to see any more liability management initiatives from RBS, maybe similar to the exchange offers that you did earlier in the year? Thanks.

**Stephen Hester:** I would think we'll publish it in our prospectus circular that we need for the EGM on APS by which time we should have finalised it with the EU. On liability management, we're always open to liability management ideas. We are currently resistant to the idea of decimating our store of Tier 1 capital ahead of understanding how important Tier 1 is in the new regulatory regime.

**Tolu Alamutu:** Ok thank you.

**Operator:** Your next question comes from Mike Trippett from Oriel Securities; please go ahead.

**Mike Trippett:** Stephen good morning. The question really just follows on from Robert Law's point actually, on the overall balance sheet footings for GBM. They were down significantly in the Second Quarter; I know it's dangerous to read too much into this quarter-on-quarter, but I'm just trying to get an idea of whether you feel now going forward taking into account the Sempra position as well, but whether this is a base from which you will go forward in terms of growing the business.

**Stephen Hester:** It will bob around, not least the foreign exchange has knocked it up and a whole bunch of cash and things knocked it up in the Third Quarter. As I see it today, I would see it staying under 500 billion during the course of our plan; how much under we have to see.

**Mike Trippett:** In terms of the non-core book I just wanted to get your gauge of where you feel you are against the annual target now. Having said that, I've just seen there is a slide pack, but I just wondered if you could just give a bit of comment around it as to how you see the...?

**Stephen Hester:** At the moment, as you can see, we are on track to hit the full-year target that we have. I think the reality – I have to tell you – is that the non-core management team a) has been setting itself up in the last two quarters; and b) had been utterly snowed with landing APS. I would expect to revise our non-core targets in February...

**Bruce Van Saun:** Refresh.

**Stephen Hester:** ...okay refresh – better word; it's not going to be a threatening word. It is a) an assessment of market improvements if, indeed, those are sustained; b) more time to really know what we're doing and without distraction of APS in terms of the people; but c) obviously there is a small hole in the latter years of the run-down from APS securitisation which will no longer be possible and we have to determine whether we think that asset sales can substitute for that hole. I hope they can, but we just need to fiddle with that and we'll republish in February; but I wouldn't expect any dramatic changes.

**Mike Trippett:** Ok thank you.

**Operator:** Your next question comes from Simon Pilkington from Cazenove; please go ahead.

**Simon Pilkington:** Yes good morning. A couple of questions please on monoline CDPCs; I wonder first of all you if you could just give a bit more explanation as to why it was a 22 billion rise in risk assets. If I look on your tables of 95 and 97 of the release, your notional exposure is not that great and I don't see much movement between more highly rated down to sub-investment grade. It looks like there's some sort of [1250] deduction. I just wonder if you could give some explanation...

**Stephen Hester:** You're exactly right; it was the downgrade of I think it's one of the key monolines. It's either Ambac or MBIA, I completely forget between which one it was.

**Simon Pilkington:** It drops even below sub-investment; so it's a further drop within the sub-investment grade that's caused that?

**Stephen Hester:** Yes.

**Simon Pilkington:** Right, so we could see more of these, it's what I'm driving at.

**Stephen Hester:** There's only one other big one.

**Simon Pilkington:** Would that be similar sized for you?

**Stephen Hester:** I don't have it at my fingertips, but let's assume it is for now. By the way, in due course we expect to be out of those exposures.

**Bruce Van Saun:** We're working on commutation of some of those exposures as well.

**Stephen Hester:** The CVAs we hold against them mean that the P&L risk is rather overstated by risk weighted assets now but that's just one of the vagaries of this risk weighted asset regime. On CDPCs we actually have pretty much hedged the entire exposure and so while there will be further losses as those hedges run off, it's no longer an uncapped exposure.

**Simon Pilkington:** Is that why they have been taken out the APS?

**Stephen Hester:** Yes.

**Simon Pilkington:** Excellent; thank you.

**Operator:** Your next question comes from Damian Regent from UBS; please go ahead.

**Damian Regent:** Yes good morning. I have a couple of questions please on corporate deferral. The first one is on the availability of distributable profits; I understand that at the half-year you had, on a consolidated basis, something like 7 billion. It's quite important for bondholders because I think a lot of your securities are misplaced securities as long as you have distributable earnings. I would assume that you expect to start 2010 with a positive distributable earnings that bought the RBS and NatWest level. Can you please confirm that?

**Stephen Hester:** As I said, I want us to make our proper statements on the all coupon deferral and so on with the circular, so I don't want to prejudge that. You might expect us, though, in the context of the B-share issuance

to use the cash box methodology which replenishes distributable reserves. You can take no assurance until you read the prospectus as to exactly where we are on that.

**Damian Regent:** Thank you.

**Operator:** Your next question comes from Steven Hayne from Morgan Stanley; please go ahead.

**Steven Hayne:** Good morning. A question in terms of the regulatory change coming in potentially in about 2011. I think the discussion of doubling of market RWAs and I noticed your market RWAs have gone up to 62 billion; that was 46 at the end of '08. I think you used to guide that around 50-ish billion of incremental RWAs because of that change. Is there any change in that guidance or should I continue to assume about 50 billion of extra?

**Stephen Hester:** I don't believe we've ever given you guidance on that and, as I said, we plan to give you guidance in February and I don't want to give you false guidance so I'm going to ask you to wait till February.

**Steven Hayne:** OK thank you.

**Operator:** Thank you. Once again, if you wish to ask a question please press \*1 on your telephone keypad. Your next question comes from Robin Down from HSBC; please go ahead.

**Robin Down:** My question's already been asked.

**Operator:** Your next question comes from Wolfgang Rothmaier from DWS Investments; please go ahead.

**Wolfgang Rothmaier:** Good morning. Three questions from my side; first, you might have been becoming aware of the Moody's ratings release on Ulster Bank where information is given that Ulster Bank, contrary to former guidance by the Group, would not be participating in the Asset Protection Scheme. I have not seen this information anywhere else and would like to get some guidance on that one. Second question would be what rate of Core Tier 1 ratio would you regard going forward in the mid-term as being a well-capitalised ratio for the Group? Third question; with the initial APS

you were giving guidance on the contingent B-shares facility. What kind of new Government economic interest would be connected if the facility would be exercised? There's a new facility of 8 billion now and I would be interested to know what the economic interest of the Government would be should this ever be exercised. Thank you.

**Stephen Hester:** Ulster Bank: let me be very clear, there are substantial assets of Ulster Bank in the APS. There is a small element that had been removed because it is otherwise eligible for NAMA, the Irish Bank scheme. We haven't decided whether to put it in there or not, but it is only a small element of Ulster Bank that changed and we remain committed to the support of Ulster Bank as we have always been and as we are of all are subsidiaries. Our core Tier 1 targets were published in August for our strategic plan and we have no reason to change them. I've never calculated the Government share for the contingent because I don't expect it to happen. If it did, you should be thrilled at someone subscribing at 50p a share in a disaster scenario, but I don't expect that to be pertaining.

**Operator:** Your next question comes from Raul Sinha from Nomura, please go ahead.

**Raul Sinha:** In the context of disposals I was interested in the fact that you've taken 150 million provision for loss on disposals for the Asian branches this Quarter. Can we have some more colour on this sale and whether we might expect further loss in disposal from the Fourth Quarter?

**Bruce Van Saun:** I think that calculation encompasses estimated liabilities for the indemnity under the contract that we've negotiated on that. I think that that's pretty much through on Asia; we're currently working on some Latin America. I don't think that will get done in the Fourth Quarter, although we're working hard at it.

**Operator:** There are no further questions at this time. I would now like to hand the call back to Stephen for any closing comments.

**Stephen Hester:** Thank you very much for listening through this; we quite appreciate that there is a lot of data here. Of course Bruce and our IR department, Richard O'Connor and his colleagues are available to help guide you through the numbers as you digest them. I think I would simply

close by reiterating we think we have the tools to do the job. The job will be difficult; it is a marathon not a sprint, but we think we can do it and we look forward to increasing predictability as we go through the Quarters ahead. Thank you for listening.

**Operator:** Ladies and gentlemen that will conclude today's presentation. Thank you for your participation; you may now all disconnect.