The Royal Bank of Scotland Group

Interim Results June 2009

ANALYSTS PRESENTATION

held at the offices of the Company

280 Bishopsgate London EC2

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Presenters

- **Sir Philip Hampton (Chairman)**
- **Stephen Hester (Group Chief Executive)**
- **Guy Whittaker (Group Finance Director)**

THE CHAIRMAN: Well, good morning, ladies and gentlemen, and welcome to RBS Half Year Results.

Slide – Re-building Standalone Strength

Today's presentation will be somewhat fuller than usual. You will recall that in February Stephen Hester set out the initial conclusions of the strategic review which had been launched a couple of months earlier. Essentially that work has been refined and developed in the ensuing months both for the Group as a whole and in detail for the constituent parts. So today you will see the shape, size and direction for RBS over the next few years.

You will also, as Stephen indicated in February, see much more disclosure so that performance of the business can be measured and judged by Shareholders, both Government and private, as this business is put back into shape.

Although you will have much more clarity today, that is of course very different from certainty. Whilst some of the more extreme outcomes for banks generally and RBS in particular appear at least less talked about than they were a few months ago major uncertainties do of course remain from things that frankly none of us have experienced before, such as the continuing massive activity of central banks in different parts of the world, notably the Bank of England yesterday, the Asset Protection Scheme which remains in negotiation, and of course more importantly than anything the shape of the global downturn.

I will make one final point in my opening comments. There have been lots of distractions the like of which I frankly have never seen to the management team here in recent times, both the management team and indeed all RBS employees. I think they have dealt with these extraordinarily well, we are clearly now moving into a next phase with a focused team with the last appointment, the last major appointment, announced today, I think a very clear strategy which has been reinforced over the months and the whole business knuckling down for the long term job of focusing on our customers. Through that we will re-establish the standalone strength for our Shareholders.

There is absolutely no doubt that this will be very tough and very challenging, but there is also no doubt that it will get done, and Stephen's job today will be to explain to you exactly how.

<u>Slide - Agenda for today</u>

If we just go on to the next slide. This is what today's programme is. Stephen is going to go through the highlights and then perhaps most importantly today the vision, strategy and performance targets, implementation being an absolutely critical challenge, the APS that you are all generally familiar with, and then challenges and market trends. Then Guy of course will take you through what is actually a formidably complex set of half year results with the core and non-core disclosures made for the first time.

So with that, over to Stephen!

MR. STEPHEN HESTER (Group Chief Executive): Thank you very much, Philip. Thank you everyone also for coming.

I sympathise with you. I don't apologise, but I sympathise with you having to absorb all this information. I am afraid it will get even more complicated when we actually have an Asset Protection Scheme to overlay, but I hope you will agree notwithstanding the time it is going to take you wade through that this will help you and helping investors understand us and look to future, and I think that is to the good. Particularly for a company which needs to attract more investors as we encourage our Government Shareholder to sell down.

And echoing, if you like, Philip's message, the core message from today is that we are optimistic, we are positive for the future of RBS, we are confident and we are putting that confidence into hard targets: that we will re-build value, we will get out of risk and we will serve our customers. But we are also going to remind you in an inconvenient way that this is a marathon and not a sprint.

Slide -1H 2009 Results - Business highlights

So in terms of highlights, obviously we have done quite a lot in the first half of this year, starting clearly in January with the disclosure of RBS's true position which had our share price at 10p per share. Unfortunately they weren't awarded to me at that price! We have obviously changed the Board and management comprehensively.

Philip referred to our new Finance Director appointment today, which I am thrilled with both in terms of the individual and to complete the team. But I also want to say, as I did in the release, that Guy Whittaker here who is with us for two more months has really done a phenomenal job over the last 9 months in supporting me absolutely through thick and thin in producing what I think is a formidable set of disclosures and financial actions.

The plan we are going to talk about, the Asset Protection Scheme, and of course where it not for all of that stuff simply 'business as usual' would have kept us pretty busy.

Slide – 1H 2009 Results – Financial highlights

You will see that the bottom line in terms of our financials is £6 billion of profits in the core bank, £9 billion of losses in non-core, because of the one-off liability management gains that sums to zero, and underlying that strong income trends but matched by obviously high impairments and write-offs. We have made good progress on the balance sheet and Guy will of course go over those in more detail. And I think all the rest of it on the slide is self evident.

Slide – RBS Strategic Plan

So let's just talk about the plan. Now clearly what we are announcing today actually is really reconfirmation of what we set out in February. But February was what I described at the time as 'back of a fag packet' – not that I smoke! – but 'back of a fag packet' strategy. We have spent a massive amount of time making sure we are confident that it is the right strategy and then cascading it in literally thousands of sub-plans across our organisation to make sure it actually adds up. Of course the world will not turn out like this but it is the best job we can do for now.

I think you really need to see our strategy in these three parts. We have a risk and over-reach problem, which is what brought us down and we will fix most of that through the wind down of non-core, and that's a vital activity. We have got people focusing on doing it exclusively, we have made huge strides so far but the difficult stuff lies ahead of us.

Our second job, in addition to getting out of our risk and over-reach, is to recreate Shareholder value through customer focus in our remaining core businesses and that is in itself a massive restructuring job. Every single one of our businesses needs retooling, not because they are terrible today but because they need to be better and the future will look different in some of these markets, and so that is, if you like, our vehicle for value creation.

Then across the whole firm we need to make RBS different, we need to make it culturally different. We need to make it strategically different. We obviously need a change of management, and of course then we have something like the Asset Protection Scheme which cuts across. So these interlocking strands are really the key to our strategy and what we are trying to do and why we think that it will be successful.

<u>Slide – 2013 Vision for RBS</u>

The vision of course like all visions has a bunch of 'motherhood and apple pie' in it, but it is carefully crafted with a lot of thought behind it in terms of what we have to do. We plan to stay a universal bank. We plan to be stable. We believe that these profitability targets are required to achieve that. We believe that risk profile needs to be in this sort of category and there is a huge amount of extra data on that.

We believe in blending. We obviously have more volatile businesses in the investment banking. They need to be anchored by a higher percentage of more stable businesses in commercial and retail. Every single one of our businesses is knit together in a thoughtful way, not just in synergistic cost and revenue terms, but in terms of funding, usage funding production and so on.

And we've talked I think a little bit about the management hallmarks that we believe the new RBS needs to have.

Slide - Targets we have set

Now normally I would consider it foolhardy to put out the targets that we are doing today, and it probably is, but I think that such was, if you like, the erosion of confidence in RBS and such is going to be the complexity of our financials for a few years that we have to overcome natural reticence and give you a clear road map and also give our, if you like, public policy audiences a clear sense of accountability in terms of what we think we can accomplish.

We first of all do that at the corporate level here. Remember our two jobs are: get risk down, make us stable, safe and standalone and get Shareholder value up, and so I divide our targets into these two categories. We take, if you like, the worst point in 2008 in our reporting cycle, on the left, where we believe we can get in 2013. Of course these are only targets, the world will work out differently. If we are lucky we will out achieve them both as to time and amount but that is all ahead of us in terms of experience.

Slide - Core Bank - Divisional targets & plans 1

Now I am not going to go through these slides because they are mainly for you to read afterwards, but every single one of ongoing core businesses, as I mentioned, has got a fundamental restructuring plan and we have set out here targets for, if you like, the three most visible financial return metrics for those businesses: the ROE, the cost:income ratio and the loan to deposit ratio, both for three years and for five years time, which I think will give you a huge amount of fun in reverse engineering what you think our financial forecasts are.

Be careful with it, because you may over interpret, but anyway I hope that will give you a sense both of where we think things will be difficult for longer than you might have thought and where we think we can get the businesses. Again I hope we can do better than this but these are not either easy targets to do and so I think, as I say, I'll leave you to read them as you go through.

Slide - Core Bank - Divisional targets & plans 2

The same for the other businesses in core!

Slide - Non-core asset run-off targets

Now non-core can't be ignored, but of course our non-core targets are fundamentally different, and that is to say non-core is something we have to get out of at as fast a pace as is consistent with Shareholder value and with the other constraints that are around us. So I have no clue whether that will be what we are presenting here but this is the best crack we can make at it.

You will see that actually we made very good progress in the first half of this year, some of that is flattered by foreign exchange movements but nevertheless we are on our way, the division is up and running. This is roughly the profile that we are aiming for if markets are favourable and if the Government gives us the right permissions on the Asset Protection Scheme we might do better and vice-versa.

But importantly, on the right-hand side of the slide, we have shown you some of the moving parts; again, I am sure it won't exactly work out like this. First of all, understand that this can get worst because in these there are a whole bunch of committed lines that could get drawn down to make our task harder and there are a whole bunch of people who have got low maturities who won't be able to make them, where we are going to have to roll-over those loans because just putting them into bankruptcy will waste everyone's time and lose value.

So the picture will get worst and at the same time we will try and make it better through asset sales, run-off, and crucial to making this we believe will be the ability to accelerate the rundown of those assets covered by the Asset Protection Scheme probably through either sale of those assets or securitisation if the scheme goes through its first loss and it becomes close to a AAA.

Now we would need Government approval for that, they haven't given it to us. I believe they would in the future but I can't tell you that they will, and so there is a risk factor in there. But I think it is just important for you to start understanding some of the pluses and minuses and ins and outs of this job as we go through it.

Slide - RBS Group 2013 - Binding disciplines

Now across as I mentioned the third component, core business, non-core is then cross-cutting disciplines and rationale for the Group. You will see here, we could make this a very long essay, but four of the most important. Each business we have must be attractive in its own right and I set out at the very beginning last October the tests that for me define that; we repeat them here.

Each of our businesses must have strong linkages across the Group. We must function as one bank and we must maximise synergies of all kinds. Each of our businesses we believe in the core mix we have selected has complementary strengths.

We think it would be a mistake to retreat solely back to the UK; that would give us an absence of growth and an over-concentration in one geography that we think would not be good for Shareholder value, but of course the UK is a source of enormous strength for us which we intend to robustly defend and improve.

We don't want every one of our businesses exposed to the same credit cycle and some of our businesses like GTS and the insurance business give us some protection in that regard.

Funding: one of the most crucial things that we all get out of the crisis in the last year is, how do you fund the bank and how vulnerable is that? And again we have businesses like our wealth business and our GTS business that are big providers of funding to some other businesses that are big users of funding, and then some like Citizens in the US that is well matched already. And similarly you can read the other sorts of issues on complementary.

But I do want to be clear, by having businesses that are valuable in their own right that exploit synergies and that are complementary the Group should be more valuable than the individual businesses on their own. And that's what we believe will be case once we have re-established performance and credibility.

But there will be no sacred cows, this is not a business mix that we are in any way religiously or emotionally attached to, and if the world changes or different circumstances present themselves we will of course react rationally with an eye to stability and Shareholder value.

Slide - Update on implementation 1

The next two slides basically say that we have done a lot in the last 6 months, whether it be the strategy and plans [or] setting up the non-core division and beginning to run that down. You have seen this week the first of our Asian disposals successfully announced, and congratulations to the team who have been working on that very, very complex activity.

The Asset Protection Scheme I am going to talk about a little bit more in a second, so I will skate over that.

Slide - Update on implementation 2

Obviously risk management a huge amount going on in that area, and Nathan Bostock who has joined us leading that. Obviously some of the progress will take time as we actually get out of risk processes but in terms of culture, in terms of new kinds of limits and in terms of the macro targets we have set out already a revolution which will bite progressively in the coming years.

Expense reduction or efficiency remains crucial. The £2½ billion programme that we announced is well underway, £600 million of that in the first half.

And then human capital: we've talked about renewal of management but this is of course a massive issue for us. We will not recover successfully if we don't have, attract and retain good people who are well motivated. There are all sorts of reasons why that is difficult, indeed our turnover, the losses of our top-performing people doubled in the first half versus the past, and it is for exactly that reason we are very clear we are going to pay our people competitively in a form that leads the industry in terms of being responsible with deferrals and claw-backs.

But we must attract and retain good people. I believe we can. We have lost people but it is damaging as opposed to destructive and I think we can hold it there, but that's of course ahead of us.

<u>Slide - APS Overview</u>

Let me just update on the Asset Protection Scheme. Again I won't really read through this slide because what we are really saying is that the essence of what was announced in February remains on track. We present today some refinements of the portfolio around the margin, 5 or less than 10 per cent has changed as we have refined it, and there will probably be a few more refinements in the next few weeks. We are still aiming for autumn in order to get it accomplished.

In terms of, if you like, some of your accounting issues, we were originally thinking we would amortise the costs over seven years, we probably think five years is more likely; the quicker it stops distorting our P&L and so on the better.

We have increased the estimate of the tax cost. Don't read too much into that because none of you will quite understand how we are moving profits around our internal group, and do understand that part of that is that the fees associated with APS and indeed the tax losses are not themselves tax deductible and so that makes then number bigger than you might interpret. But of course who the hell knows anyway because we can't really predict our results with that fine accuracy.

We have represented the updated pro forma impact on core Tier 1 which assuming the £19½ billion of "B" shares and the scheme roughly in its current dimensions gets you just over 5 per cent additional to core Tier 1 which is pretty much the same as we said at the end of the first quarter, that holds in reserve the £6 billion contingent "B" shares; that doesn't take account of that in that calculation.

<u>Slide - APS Implementation - Anticipated timeline</u>

Now, as I mentioned, we are aiming for autumn. There are basically three hurdles between us and bringing this over the line. The first is just finishing all the very complex technical stuff that we have to do. An example I give in the Shareholder letter is that we have to provide regular reporting on 1 billion data points to the Treasury in relation to this scheme. What they are going to do with that billion I don't know but that's what we have to do and that's just taking time to get the systems to do it.

The Treasury needs to complete its evaluation of our assets, its due diligence, which is nearly completed. I am sure we are headed for a bit of an argy-bargy around the margin on terms. I believe it will be around the margin but I can't prove that, we'll find out, and so we will see where we end up on that.

Then the EU is very important. The EU needs to approve the scheme. They have to look at two things: basically they have to look at viability - is our restructuring plan going to do the job? I believe it will but we need to make sure they're persuaded of that.

And then secondly, they look as if they want to take a crack at our domestic market shares as they have done in the other banks, Fortis and Commerzbank and so on. They are particularly focused on our small business market share, we are in the middle of discussions on that so it is premature for me to know the result, and there are some obvious issues around customer disruption as well as our own disruption that we are trying to minimise.

That basically where we are on Asset Protection Scheme. My take is although you must read all the caveats and so on and so forth, all sort of things go wrong, my take is that it will end up getting done, it will end getting done in more or less the same economic power as you are all expecting but there will be some stuff around the margins. I hope it remains around the margins, there is a risk it isn't, but I think it is likely to be around the margins.

<u>Slide – Challenges and opportunities</u>

So challenges and opportunities, well, look we have just put five key things here. Implementation, we might do it well or badly but it is a massive – massive! – thing that we are undertaking. Wholesale funding risks, steadily reducing, actually fast reducing in some respects but we will remain vulnerable to conditions in wholesale market until we get non-core properly wound down.

Clearly the economic environment might go better than we are expecting, maybe we are caught in the trap of being too cautious. This is a self-help plan, we are not relying on markets bailing us out quickly so maybe things will be better faster, but of course the converse could also be true. Non-core again could go better or worst than we think but will be vital both in terms of balance sheet and, if you like, book value as we go through. And it is self-evident that the regulators and Government are going to be crucial to all banks as we going forward.

Slide - Macro risks update

This slide, although slightly repetitious of a couple of things tries to just kind of update on, if you like, leading indicators on some of the key risks factors.

Loan losses: I am very nervous about saying anything about loan losses because I know how topical it is for people to be calling the turn or not calling the turn. Look, the simply fact is the data set is not complete enough or long enough for any of us to really tell you with confidence exactly where we are in the turn, or even whether or not we have turned what the trajectory of travel from that point is.

What's clear is that the world has got big problems to overcome and if they are technically overcome quickly there is a long tail of working through a hangover in any event, and so I just think it is important to have some balance in this process. And, as a result, if impairments follow the pattern of past recessions they are likely to stay high overall for two or three years.

They may not follow the pattern of past recessions but, if they do, look back to the early ‘90s before you get too carry away about how quickly they will come down, even if they start coming down. However, all of that said, you will see graphs later on that the flow of bad debt into our recovery units is markedly slowing at the present.

The leading economic indicators I don’t need to talk to you about; you know what they are currently saying, and there certainly are some reasons, at least as Philip said, to think that the stress test scenarios are becoming less likely. Where we are in the range of central scenarios I am not going to make bold prediction on.

Wholesale funding: getting materially better. Our reliance on central bank discount windows has halved in the last 3½ months. We have started unguaranteed term funding, as have other banks. Our liquidity, if you like, our day survival on liquidity, has markedly gone up over the 6 months. So all of that is good.

But we must understand that these are fragile abnormal markets by reference to history, the spread costs remain high which has obviously margin implications, and clearly there are storm clouds out there around sovereign ratings in particular which can impact all banks who are beneficiaries of a sovereign rating halo of one sort or another.

Interest margins: well, obviously what banks do, as you know, is sit in the middle of people with money versus people who need money and clearly there what we have experienced is a major shift of power away from borrowers who benefited from oodles of money over the last two decades in favour of people with money, that shift of power disguised by absolute interest rates, and banks are sitting in the middle. So happily all banks are being able to increase asset margins at faster or slower rates depending on the nature of the product and the markets you're in.

That's being offset, currently more than offset, by the combination of lower savings margins, although I think our Quarter 2 run rate should be much more stable on that. Clearly there are hedges that run off on free interest balances – I am sure Guy will talk about these things – funding liquidity and so on and so forth. Guy will talk about the margins more, so I won't go on about it.

And then finally, regulatory. My view is it's going to be five years before we really know what the new regulatory regime is because every regulator is going to be very cautious about doing things without international consensus and that doesn't happen quickly. So I think we all know the direction, it is going to be a while before we really know the end point, and we'll have to see.

<u>Slide – My Take on H1 Results</u>

So just before handing over to Guy, I think some of this I have said already, but my take on the numbers is, firstly, a positive and optimistic take. Everywhere in the world our customer franchises are intact, none of our major businesses have lost customers, which is pretty good considering the kicking that we were taking.

I think the GBM rebound, even if it is volatile in terms of how it works through as all investment banks are, when you think of the restructuring that GBM has also taken on, is pretty creditable. Our banking businesses of course are being hurt by recession but we can already see the actions taking hold that will ultimately overcome those trends. And the balance sheet and funding issues, early days but big strides.

But we can't wish away our risk vulnerabilities; they are there. Impairments will stay high for a while. I hope other write-downs, monolines and so on, start moderating sharply but I think you will be able to see very transparently our progress against those issues.

So with that, Guy, perhaps you could take us through the numbers. Thank you.

MR. GUY WHITTAKER (Group Finance Director): Thank you very much, Stephen, and good morning to all of you. I would like to take a few minutes now to run through the highlights, the financial highlights, the risk highlights and the balance sheet highlights of this morning's Company Announcement.

<u>Slide - Group - H109 Results</u>

Income grew 27 per cent to £14.8 billion; costs of £8.7 billion, up 4 per cent, after claims pretty much flat year over year. We recorded a profit before impairment losses of £4.2 billion, that's up threefold from this time a year ago. Impairment charges were up markedly to £7½ billion, that's five times the first half of 2008 and up 25 per cent from the second half of 2008, resulting in an operating loss of £3.3 billion.

Record gains in the first half on extinguishment of own liabilities as well as disposals of the Bank of China stake and Linea Directa; in total these raised £4.2 billion. After deducting restructuring costs, integration charges and the amortisation of goodwill and intangibles we recorded a profit before tax of £15 million, and after paying preference shares, minority interests and a goodwill write-down of £300 million related to assets in our non-core Division we recorded a billion pound attributable loss for our Shareholders.

Slide - Group - Income

As I said, income up 27 per cent to £14.8 billion, really driven in the first half very much by the growth in trading income within GBM. We saw declines in net interest income as funding and liquidity costs rose as well as deposit floors in the low interest rate environment pressuring liability margins.

We saw a decline in non-interest income on lower fees, some losses on asset sales as well as in this case for comparative purposes the absence of prior year gains. You will recall in the first half of 2008 we took a £600 million gain on the sale of Angel Trains.

Income did benefit from foreign exchange movements to the tune of £600 million and in Other items there is a mixture of big ups and downs. We recorded, as you'll recall, £5.9 billion worth of write-downs in the first half of 2008. This year I am happy to say was £4 billion better than that, but it was offset by adverse movements in CDS hedges and the fair value of own debt.

Slide - Net interest margin drivers

On net interest margin, we saw a fall in Group margin from 2.08 to 1.69 per cent. The general themes across our businesses were wider front book asset margins not yet compensating for the deposit floors for the cost of term funding or for the increase in liquid assets that we are holding. GBM numbers rose on a strong money markets performance as well as some benefit from the internal allocation of some of their cost to other Divisions.

And you can see the non-core net interest margin falling quite markedly as it took up a significant share of the term funding, consistent with the nature of the assets in that portfolio. The outlook we put out at the end of the first quarter was for 1.60 per cent guidance for the full year and we are sort of reiterating that guidance this morning.

Slide – Group – H109 costs road map

On costs, we saw an increase of £300 million to £8.7 billion; at a constant FX basis costs fell 5 per cent or £400 million. Now the cost reduction programme of £2½ billion that was announced in the first quarter remains on track and we recorded £600 million of benefits in the first half.

Group headcount is down around 8,400 since the beginning of the year, of which 6,400 relate directly to the cost reduction programmes. However, the cost of deposit insurance both here and in the United States cost us around £200 million over the first half of last year.

Our cost:income ratio improved from 72 per cent to 59 per cent. On an adjusted basis, if you look at costs divided by income less insurance claims, it came down from 86 to 68 per cent.

Slide - Group - Credit quality

On the credit portfolios, our loans and advances came down from £700 million to £610 billion, about half of that related to FX movements and around half through de-leveraging of the balance sheet. Non-performing loans rose £12 billion in the first half and now stand at £30 billion or roughly 5 per cent of our loans and advances.

The impairment charge in the first half of the year was £7½ billion, up 25 per cent from the second half of last year; £700 million or so of that related to AFS securities re-designated in the third quarter of last year. Credit charge is now standing at just over 2.2 per cent of loans and advances.

Our provision coverage at 44 per cent was in line with the first quarter but down around 6 percentage points from the 2008 year end levels and principally due to a higher proportion of our non-performing loans being in the corporate or secured areas which have driven the increase.

The bulk of the impairment charge was in non-core, £5.3 billion with £2.2 billion against our core divisions. About 70 per cent of these credit charges and the write-downs would be covered by the Asset Protection Scheme.

Slide - H109 Results - Core and Non-Core

In line with the strategic plan announced at the end of the full year results, we have undergone a major restructuring of the Group in the second quarter to divide it into its new operating units, and for the first time in the 200 pages or so you can disclosed our new core and non-core divisions.

They will show, if you recall, from the first slide an operating loss of £3.3 billion. That really is made up of two parts, our core divisions which contributed a £6.3 billion profit and our non-core division with a £9.6 billion loss, and I would just like to take a few minutes to go through the highlights of each of those.

Slide - Core performance

Slide - Core - Income

Within the core divisions income grew 25 per cent to £17.8 billion, driven by very strong trading performance in Global Banking & Markets. Reduced margins and fees in Retail and Commercial Banking was more than offset by the strong trading performance. If you look down the table you'll see central items year over year reflect the absence of prior year gains on the fair value of own debt as well as some IFRS volatility recorded in the centre.

We saw foreign exchange benefits to income of the tune of £1.2 billion in the first half; on a constant FX basis our core businesses grew income by 16 per cent. We have had a couple of questions just on quarter on quarter sequencing of that, particularly around movements in fair value of own debt and I will just highlight those for you.

If you look into the numbers, page 3 of Appendix 2 in the announcement, we saw roughly a billion pounds swing in the fair value between the first quarter and the second quarter, and a 'give back' in the second quarter as credit spreads narrowed.

The impact of that on divisions, it added £650 million to headline income in GBM in the first quarter and took £500 million off in the second quarter, and in the Group centre it added £350 million to first quarter income and took £500 million off the second quarter numbers.

<u>Slide - Core - GBM underlying performance</u>

Stephen mentioned GBM performance, and what we have tried to do here is give you a slide which illustrates the underlying performance of the business, and out of that we have removed the effect of those fair value adjustments as well as the impact of previously disclosed trading asset write-downs in the 2008 numbers.

You can see really a run rate through 2008 in that, between £1.6 billion and £2.3 billion, a very strong first quarter, a strong second quarter, and I think we are guiding to more normal expectations for the second half of the year, and we'll leave you to deduce what those are from this illustration.

<u>Slide - Core - Impairments</u>

Core impairments rose 18 per cent versus the second half of 2008 and now charged off the running at 91 basis points of loans and advances in the core portfolio. We recorded £143 million of AFS losses as well.

The key drivers of growth here in the UK retail, the UK corporate and Ulster portfolios, a function of rising unemployment on the personal unsecured portfolios and the cards portfolios as well as property-related exposure everywhere. The Asset Protection Scheme will cover roughly two-thirds or so of these losses.

Slide - Core - H109 Divisional performance

Notwithstanding that, the core divisional franchises we think are in strong shape. Profit before impairments, as I mentioned earlier, at £8½ billion are four times the impairment charge in the first half of the year; a core operating profit of £6.3 billion is up 33 per cent at a headline level, 23 per cent at constant FX, a big contributor obviously GBM of £4.9 billion, but contributions of half a billion from GTS, half a billion from our Retail and Commercial Banking businesses around the world and £200 million from RBS Insurance.

Slide - Non-Core performance

Slide - Non-core - Income

In the newly formed non-core division, we recorded a loss of £9.6 billion, a combination of both negative income as well as significant impairment charge. The negative income of £3 billion principally a function of write-downs and provisions against monoline exposure, CDPCs and various elements of the credit and credit trading portfolios no longer core to the Group. We also saw losses recorded in this division on CDS hedges principally from narrowing spreads in the second quarter.

Again just sort of going back related to the first quarter numbers, we saw around £2.1 billion of losses recorded in GBM in the first quarter. Those numbers are now in the non-core division as an additional £1.1 billion worth of write-downs, excluding the CDS hedges recorded in this division in Q2, if you are trying to track old GBM to the new non-core division.

The pro forma donating divisions are shown to be helpful. Clearly with management now having moved we would not be planning to continue reporting on the donating divisions on a going forward basis, as this is just to help you in managing the transition.

Slide - Non-Core - Impairments

Total impairments of £5.3 billion are up 30 per cent from the second half of 2008, including £600 million of impairments on available-for-sale securities. The biggest contributor is from the former GBM portfolios of £3 billion. The biggest contributors to growth in impairments come from the UK, from Ulster and from the United States, all again as I mentioned in property and property-related exposures. The Asset Protection Scheme covers around 75 per cent of these impairment charges.

Slide - Non-Core - Run-off

We made good progress over in non-core running down the balance sheet, as Stephen mentioned, £325 billion to just over £230 billion. Just over $40 billion of that was related to revaluation gains on derivatives coming down over the course of the period, about £50 billion was in third party asset reductions, FX accounted for £14 billion of that, the balance on write-downs, run-offs, disposals including Linea Directa and the Bank of China. Earlier this week, as was mentioned, we saw a partial sale of our Asian businesses; that is not included in these numbers.

Slide – Risk management

Slide – Portfolio quality – Core overview

From a risk point of view, we saw credit migration in the first half of the year downwards consistent with the economic cycle, average portfolio quality moving down from 3.9 to 4.5 on this 1-10 scale that you have here; within the core divisions average credit quality at 4.2, distributed as shown. Around 15 per cent of our credits are under heightened monitoring, predominantly within GBM, and about half of those relate to corporate exposures, about half of those relating to financial institutions.

Slide - Portfolio quality - Non-Core overview

In the non-core division, not surprisingly, a lower overall average quality at 5.3, again the distribution shown for us, and not surprisingly again a higher proportion of those, 30 per cent, under heightened monitoring of which about a quarter are financial institutions and three-quarters are corporate exposures. Over 10 per cent of this portfolio is our non-performing loan book.

Slide - Single name concentration exposure

We gave some disclosure at the full year around single name concentrations, which was deemed to be helpful. During the first half of this year we have revised and refined our approach, in many cases applying tighter limits depending on the individual credit grades of the underlying client exposures, and we have restated 2008 results for you on the same basis.

What you see is the volume of single name concentrations is about the same as we reported with the full year result, but it does include a greater number of names that we would capture under the revised methodology.

During the course of the first half, within that, we did see a slight reduction both in the volume of outstanding exposure to these concentrations as well as the number of cases involved. We would expect to see continuing but I think rather slow progress in this area over the coming months and years, and about 90 per cent of the names here are also covered in the Asset Protection Scheme.

Slide – Impairments outlook - Wholesale

In terms of outlook, we have seen a steady rise in impairments, of case load and volume, over the course of the last 12 months and reflected in the impairment charges, led by property and property-related sectors. There are signs certainly in the flow of numbers of cases and volumes of levelling. In Q2 I think it is too early to draw any conclusions about the longer term outlook. We remain very cautious on the outlook for credit and expect impairments to remain at elevated levels in the near future.

Just sort of looking out in terms of core and non-core, perhaps looking versus H1 for a slightly higher number coming through in the core divisions as the impact of the real economy on unemployment filters through in the personal books in the UK, in Ulster and the US, as well as continuing pressures in the corporate sector, but perhaps offset a little bit by some lower provisioning numbers in the non-core division on the greater sort of visibility and seasoning of the assets within those portfolios.

Slide – Funding & Capital

Slide - Composition of the balance sheet

In terms of balance sheet, we have made I think very good progress during the first half of the year, coming down £100 billion or so since the full year results, down importantly 23 per cent or over £300 billion on a funded basis since the peak in 2007, and on a nominal base including derivatives down over £600 billion in the last 18 months or so.

Tier 1 leverage was at 22 times, that's down from 28-fold this time a year ago; if you like your ratios the other way, it is about a 4.3 per cent Tier 1 leverage ratio. Good progress on tangible common equity to tangible assets, up at 3 per cent from 2.4 per cent at the end of 2008, and on derivatives quite a substantial drop with narrowing spreads, revaluation gains coming down from £980 billion to £550 billion, and those assets and liabilities remain substantially balanced.

Slide - Funding and liquidity

On funding and liquidity, along with reduction in balance sheet size we saw good measures taken in the first half to strengthen both our funding and our liquidity position. Loan to deposit ratios came down from 152 to 144 per cent allowing the funding gap to come down by over £50 billion and now stands at £188 billion; with the disposal of Asia announced that would be around £178 billion, as reported in the Company Announcement.

Our wholesale funding with a remaining average life of over 1 year increased to 47 per cent of outstandings from 45 per cent, helped in that case by £5 billion of non-guaranteed, non-Government guaranteed unsecured issuance in the second quarter. Our stock of central bank eligible liquid assets rose from £90 billion to over £121 billion at the half year.

Slide - RWA progression

Headline RWAs came down by little over £30 billion to stand at £547 billion; efforts in de-leveraging were largely offset by the impact of pro-cyclicality in the downturn, reflected largely in our non-core and UK retail and corporate portfolios. We did benefit from favourable FX movements to the tune of £30 billion which net-net account for the principal amount of the decrease.

Slide - Capital progression

As a result of that, our capital ratios, our core Tier 1, rose from 5.9 to 6.4 per cent, driven on the upside by the preference share conversion earlier this year in January/February time, gains on redemption of own liabilities, offset by the attributable loss that I reported earlier, offset by the loss of minority interests from our co-investors in the Bank of China as that stake was sold down, as well as deductions which knocked around 20 basis points off that number.

A 6.4 per cent core Tier 1 as at June 30th, a Tier 1 ratio at 9 per cent and, as Stephen mentioned earlier, subject to Her Majesty's Treasury, the European Union and £19½ billion worth of "B" shares, we would expect to see an APS benefit in excess of 5 per cent to that. With that and with a few closing remarks before questions, I will hand back to Stephen.

<u>Slide - Our focus now - Execution</u>

MR. HESTER: Thank you very much, Guy. Well, I guess we have set out what we are planning to do and now fundamentally we have to get on and do it, so I think the agenda facing us of course is bringing APS across the line, but then it is basically implementing the plan and serving our customers and dealing with events, and I am sure there will be events to deal with. As I said at the very beginning, we are confident that at the end of this marathon we will have rebuilt RBS to both standalone strength and value.

We are very pleased to take your questions. Obviously, as usual at these, hand up and state name and institution for those of us who don't know. Over there! Oh Philip, do you want to? I'm so sorry!

THE CHAIRMAN: Don't worry!

Questions and Answers

MR. PETER TOEMAN (HSBC (UK)): I just wonder if you would provide some more guidance on the £9 billion to £11 billion of deferred tax payment associated with the APS scheme because at first sight it seemed to be suggesting that you are giving us an implied profit forecast for a loss of about £20 billion and I wanted to get your confirmation that isn't the case?

MR. HESTER: I think you should see it more as part of our discussions with Government and the outside world where we want to demonstrate that APS is not a 'free lunch', that the taxpayer in our view is unlikely to lose out, and I think that's the main context in which you should see it.

Of course, we don't know what the future will bring. As I mentioned earlier on, you also have no ability of knowing where we are going to put losses in our Group, as it were, and where they are going to occur, although clearly most of them will occur if you think of where our Non-Core assets are, the vast majority are in, if you like, the UK entities including all the GBM assets and so on.

Then finally, the amortisation of all of the fees and costs of APS are not planned to be tax deductible. Now all of these are subject to change, but I suppose I would mainly just say don't over analyse it.

MR. AARON IBBOTSON (Goldman Sachs & Co (UK)): Just a quick question maybe to you, Stephen, about how you see GBM in your 2013 vision. I guess you gave us ROE and cost:income targets but it doesn't give us any idea of the size. You are probably top 10 in the world if we sort of look at investment banking revenues year to date. Is that how you see it in 2013 as well or is it a much smaller part of your Group as you allude to? Thank you.

MR. HESTER: Thank you for asking the question. I suppose I never want either to have as our goal or to be measured in sort of where we are in a revenue league table or even a size league table. To me what's important is our competitive strength in the markets in which we compete, and so not just with respect to GBM but with respect to everywhere you won't have seen a single reference to a size ambition.

What our ambition is though is to be top tier in the markets we compete in and therefore it is a matter of complete indifference to me what size GBM is compared to other people's investment banks. It is a matter of great interest to us as to whether we are top tier in those segments of the investment banking market in which we compete, and the answer to that is in the vast majority "yes" and it will get better, but we are of course not competing in M&A and US equities and so on and so forth as we go through.

Now at a rough guess, and it is very rough because it depends on all sorts of things, I would have thought that GBM is unlikely to be much more than a third of our Group in steady state and I feel that sort of two-thirds/one-third balance is roughly desirable given the volatility that investment banking presents, given the if you like, the funding issues that it presents, but on the other hand given the growth, opportunities, sophistication and profitability benefits that it brings.

So I think we are going to be able to be very proud of our investment bank, but in the same way as every other part of our Group we are competing in markets we select and we are not competing based on gross size.

THE CHAIRMAN: Third time lucky down here!

MR. SANDY CHEN (Panmure Gordon (UK) Ltd): Just two questions if I may. The first is just a question on the impairment guidance. I know it is difficult to forecast, but looking at the Q2 on Q1 progression overall the impairment charge looks like it more than doubled from about 1.3 to 3 per cent for the Group and impaired loans obviously went up as well in Q2 on Q1 progression. Should we take Q2 more as our indicator of the trend line?

MR. GUY WHITTAKER (Group Finance Director): I think we lay out in the outlook, again one would expect quarter on quarter volatility. Given the pace of build up there were some incremental reserving against sort of emerging losses that was taken in Q2, so perhaps you saw an acceleration there which I wouldn't interpret as being reflective of multiply it by four; on the other hand, I think we are making no calls on it being the top. So I think when we said the outlook is for signs of levelling in Q2, but remaining at elevated levels, we would think maybe a sort of half over half comparators are a better indicator rather than quarter/quarter.

MR. CHEN: Great! Thank you. Then the next question that I had was more a broader question. I was just really looking at the de-risking versus the ROE targets in long term. You talked about bringing the wholesale funding reliance down by about £200 billion, lowering the customer loan deposit ratio from 144 per cent to below, well, say targeting 100 per cent. That seems to imply a significant degree of balance sheet shrinkage and would that put pressure on the "R" in the ROE target in the long term or how do you want to bridge that gap?

MR. HESTER: The primary vehicle for balance sheet shrinkage is Non-Core, so that's roughly the amount. In fact, we have got £200 billion of Non-Core left, that's your £200 billion of wholesale funding when we do that. So what that's telling you is that we believe in our Core businesses we can run pretty flat on balance sheet for a few years which will be balance sheet going up in some areas, like fulfilling our UK lending commitments, but we think there are some efficiencies, still more efficiencies, we can get in other areas, particular GBM on balance sheet, as we work through in a sort of more careful way where we are deploying our capital.

So I don't believe we will be constraining the Core businesses inappropriately as it relates to balance sheet and the concentration will be on fixing the balance sheet through Non-Core coming out.

All of that said, the world needs to get used to safer banks and safer banks means high asset margins than was once the case, although probably not higher than is now coming in on the front book, and I think the good news is that indeed those asset margins are being accomplished. They will take a number of years to work through, and then the liability margins will probably never get back to where they once were but an element of them will recover as interest rates rise once the cycle allows that.

Now in the loan to deposit ratio, if you like, one component is the loans coming down through Non-Core, but the other thing is deposits coming up. Now we in common I think with many banks had a business - I will exaggerate unfairly so, but to make the point! - where balance sheet was free, funding was easy and therefore you only did deposits if you made a lot of money out of them.

And we are moving into a different world where deposits of course we do want to make money out of but where they are a fundamental component of the safety of our bank, and so every one of our businesses is approaching deposit gathering with a completely different sense of urgency and focus and I believe the other bit of this, making us safer, is having a stronger deposit franchise.

Unlike some banks we are very well placed here. When you think of our franchises, our franchises in the UK and the US, our GTS and Wealth franchises, I think we have the ability to be strong deposit competitors on business quality, not just punting the marginal price and indeed the progress we made in the first half was on that basis. But that is something that everyone had better get used to!

THE CHAIRMAN: If we stay in that same row!

MR. JONATHAN PIERCE (Credit Suisse): I have got a couple of questions. The first is back on this deferred tax asset issue. Putting aside the fact you obviously have to give up your UK deferred tax asset, is your understanding that the APS fee would not have been tax deductible anyway or is it specific to you that you are not getting tax relief on the APS fee?

MR. WHITTAKER: That was our understanding from …

MR. HESTER: Don't know!

MR. WHITTAKER: … from the GAPS dialogue. I'm not sure what others have done - sorry!

MR. HESTER: There is one other thing, there is a nice little sting in the tail sprung on us that the deferred tax asset of £4.8 billion, we have also been told that as a price of APS we can't carry back taxes at 2007, which means our starting point is £500 million worst than we thought, £5.3 billion that we give up before we get into the future, which was not the agreement in February but we are being told what is required now.

MR. PIERCE: Okay, that's useful.

THE CHAIRMAN: If it's a fee that is discharged directly to the issuance it would be unusual if that was tax deductible.

MR. PIERCE: Okay. Thank you. Stephen's point there actually comes on to my subsidiary question within deferred tax. Can you tell what the deferred tax 'give up' was as at June so we can work up to your £9 billion to £11 billion in terms of future deferred tax 'give ups'?

MR. WHITTAKER: We've recorded, we actually had a tax credit of around £400 million for the first half of the year on the basis that the operating losses net of - well, the gains were tax free and the operating losses were sort of deemed tax recoverable – so we took a credit of £400 million in the first half on the tax line.

MR. PIERCE: Okay. Thank you. The second question is on the wholesale funding profile. Clearly you are going to have a lot less of it anyway in a few years' time. At the moment I think you showed 47 per cent of the non-bank wholesale funding is one year plus. Would you expect that number to go up or down from here in the process of reaching a normalised balance sheet?

MR. WHITTAKER: I would expect that to go up from a slow, steady progression.

MR. PIERCE: Great! Thank you.

MR. HESTER: The percentage to go up and the absolute number down.

MR. WHITTAKER: The percentage to go up and probably the absolute number to come down as the Non-Core business runs off over the next 3-5 years.

MR. HESTER: Our broad ambition is to maturity-match subject to treating a bunch of our Core deposits as longer term than they technically are, if I can put it that way.

THE CHAIRMAN: Robert!

MR. ROBERT LAW (Nomura International PLC): I have two questions please. Firstly, could you quantify what the total amount of state-backed funding is at present and how it has moved over the half year, and I am aggregating up all the various components to that?

MR. HESTER: We are not allowed to disclose. The Central Banks and Governments get very nervous about disclosing those things, so I don't think we are allow to give you that.

MR. LAW: That's why I am asking for the total as opposed to any of the individual lines.

MR. HESTER: Well yes, there was a total at one stage in our release and we were told to take it out, but we might be able to give a component of it. I think we can probably give the Government guaranteed funding, the term funding, can't we? Was that £20 billion?

MR. WHITTAKER: Government guarantee, £27 billion or £23 billion?

MR. HESTER: £23 billion.

MR. WHITTAKER: £23 billion currently outstanding under the Government guarantee programmes.

MR. LAW: And secondly, unrelated, can you give us some view of how the non-APS impaired assets have moved over the period and where they now stand? I am looking at your impaired assets on page 107, so how much of that is covered by APS and how much is not and some view as to how it has moved?

MR. HESTER: Well, unfortunately, we haven't given detailed disclosures on where APS was the half year and, to tell you the truth, that's just simply because our finance teams were so completely flat out doing Core/Non-Core quarterly, that we just didn't have time to get comfortable enough with the data to disclosure levels. So there's no really weird trends but I am afraid we just didn't produce it. We will in the future; we just didn't get there over the line, I am afraid.

MR. LEIGH GOODWIN (Fox-Pitt Kelton Cochran Caronia Waller (UK) Ltd): A couple of questions please. My first one is on GBM revenues and then I have a second question afterwards.

My first question is, it seems to me your guidance, if I am hearing you, is for a much weaker second half after the first half. I think you are telling us that we shouldn't expect impairments to necessarily be higher based on what you showed this morning, in other words it is down to revenues, and I think you are saying it is down to the Core revenues, i.e., flow business revenues and not just due to additional write-downs that are coming through.

So, first of all, I wan to check that I have understood that correctly and, secondly, why are your Core revenue flow businesses do you think weakening in a way that perhaps we are not seeing with some of your peers?

MR. WHITTAKER: I think, dealing with the first one, you have picked up the general mood. Typically in GBM if you look at the pattern of 2008 on an underlying basis the second half with the sort of July/August as well as December tends to be less revenue-generative than the first half. So you have to draw your own conclusions on the guidance, but we were trying to strip out the one-offs and give you a sense of what the underlying run rate was.

Clearly it is a business incentive to maximise the opportunities that are there, but I think we would say it was unrealistic to build expectations on what was an extremely strong first quarter and strong second quarter saying that's what we would expect the second half to look like.

MR. HESTER: On comparative performance, this of course is somewhat difficult because everyone gives different levels of disclosure. But as far as we can tell like-for-like business mix across the first half we were pretty normal for investment banks, which is to say we materially outperformed the pack in the first quarter; we may have slightly underperformed in the second quarter.

But you have to also understand business mix is important because we are obviously very dominated by fixed income revenues and those with bigger equity revenues, and then there are some people who report their GTS typed businesses in the investment bank, and then there are all sorts of swings on fair value of own debt and other things like that which have gone in different directions than us.

So I think if you work hard as we have done you find that the competitive differences are not that meaningful and I would not particularly expect them to be like-for-like business mix going forward. But, of course, none of us really know what the next two quarters will be, so in each quarter we'll see how we do. It would be pretty spectacular if we keep up given the amount of disruption that GBM has had. We have an ongoing massive restructuring programme at GBM, but so far they have been doing a great job.

MR. WHITTAKER: On the impairment number, I guess given all the caveats and uncertainties and difficulties of forecasting it and the potential volatility, but the indication of levelling would, as I said to Sandy's question earlier, half over half comparison with £7½ billion in the first half, you can draw your own conclusions, consensus numbers are somewhere between £12 billion and £17 billion centred around £15 billion. So I guess you have picked up that one correctly as well.

MR. GOODWIN: Thanks. Maybe if I could just press you a little bit further on the revenue side, just on the flow businesses, we are expecting maybe slower volumes, seasonal factors and so on in the second half, but have you seen much movement in spreads and could you give us some quantification of that?

MR. HESTER: John, do you want to? This is John Hourican, who runs GBM. Do you want to sort of have a crack at that?

MR. JOHN HOURICAN (Chief Executive Officer, Global Banking & Markets): We have absolutely seen spreads contract Quarter 2 on Quarter 1, and if you look at all the various bases that drive the spreads across the flow businesses they have contracted materially Q2 on Q1.

Our planning assumption is that as the market normalises the very high spreads that we saw through the foreign exchange and rates businesses in the first quarter and actually sort of contracting in through the second quarter will not repeat to create the environment in the fixed income space that would leave revenues at those super normal levels.

It is also the case, I would sort of re-emphasis this point – if you look at our GBM business we are less leveraged to the equity and M&A space than some of our competitors. So fundamentally you need to look at the fixed income components of our competitors to make a proper comparison, but spreads have tightened and we are presuming that those spreads will remain tight depending on the economic environment.

MR. GOODWIN: Okay, that's very helpful. Thank you very much.

My second question was, I just wanted to follow up this comment about the EU investigation. I know this is very difficult but you have sort of thrown this one into today that we may be looking at a break up essentially of your SME business, a very Core part of your business, and presumably there could be some Shareholder value implications from that? Could you give us any more guidance on how you think that might pan out from a Shareholder value perspective?

MR. HESTER: Well, of course, we do present for you the profitability of our UK corporate businesses in the pack. The larger amount of that is large corporate business, so only a relatively small amount of that is the SME business, and in balance sheet terms the SME business is not a big balance sheet consumer comparatively speaking.

So I think the issues around it are more likely to be business disruption, customer disruption, and while I think there will be a negative Shareholder effect if the EU continues in what they are asking I think that will be smaller than the negative customer effect.

MR. GOODWIN: That's very helpful. Thank you very much.

THE CHAIRMAN: Any more? You have obviously all ganged up in the middle!

MR. SIMON PILKINGTON (Cazenove): Two things really, the first off on the outlook for net interest margin. I see in the first half your net interest margin came in lower but it was primarily GBM that drove that and, in fact, if you look Q2 on Q1 your retail and commercial business have all shown an improvement. Should I expect a similar trend through the second half and also then any sorts of thoughts as you go into 2010?

MR. WHITTAKER: I think we've tried to put a few little helpful arrows on the slide which are sort of indicative of where we thought....

MR. PILKINGTON: Well, put it differently, why don't you expect the Q2/Q1 trend to carry through for the retail banks? What was peculiar that gave you that stance?

MR. WHITTAKER: The UK retail was about steady over the course of 2008 - if you look at 2008 it actually went up in the second half and then came down second half to 2008 versus first half of 2009.

In UK corporate you can still see tightening of margins there; similarly in retail and commercial business; Ulster slightly anomalous went up although as the funding mix changes there we would expect that to trend back down again. In GBM, in money markets of course we saw an extraordinary move in rates which I don't think we would expect to see repeated given where rates have now got to, and similarly terming out Non-Core funding.

Against that you have got the sort of constant drip to think about, which if you look at all the non-interest earning liabilities and the fact that they are typically invested out over, say, a rolling 5-year programme, as they drop off even if they were put on a few years' ago and yielding 5½ plus per cent, now would be going on at somewhere 3½-4 per cent, that drips in over time as well as maturing long term liabilities which were issued when spreads were 25 basis points and they are now being replenished at 200 basis points or so.

So there is a sort of constant chipping away reflecting the current environment that we are in and so we felt it appropriate to reiterate the guidance with a degree of caution. Now businesses are taking every opportunity to push out front book margin and over time that will play through, but I think we stick with this guidance for now and probably still pressures into 2010.

MR. HESTER: I think it would be fair to say that we probably feel we've done a bit better than we first expected on asset margins generally, some of which are immediately apparent and some of which will take time to work through. But certainly I think you should always ignore GBM when you are doing NIM frankly for any bank because you get just enormous noise from the particular way that money markets are behaving.

But if you look at the commercial and banking businesses, the liability side as Guy said, interest rates didn't really trough until well into the first quarter, so the second quarter is a more normalised rate for deposit margins but free interest balances are winding down.

So particularly our GTS business which has a lot of free interest balances because it is, if you like, money that's moving around the world, will suffer from hedges running off over a number of years. As Guy mentioned, the term funding peak costs is probably next year before the absolute balances start going down. So there are all these different things going on.

On the asset side, our mortgage book re-priced almost immediately in the UK because we have few trackers; in Ireland, it is all trackers so it doesn't re-price at all. So that's why you really have get 'into the weeds' and why hopefully we're being helpful in giving you divisional breakdowns of all of these things so that you can follow them.

MR. PILKINGTON: Thank you. Just one second question, more broadly on your outlook you are clearly cautious. I wonder if you could just share with us what your central GDP scenario is for 2010?

MR. HESTER: I think that our outlook is based off forecasts that would have been consensus about 2 months ago, and if you believe the stock market and the newspapers today maybe there is some upside. As I said earlier on at the beginning, it's our I think responsibility to plan on a conservative basis and if there's upside to be got then, you know, we'll see.

THE CHAIRMAN: Why don't you just move the microphone along!

MR. ARTURO DE FRIAS MARQUES (Evolution Securities): A couple of questions on the APS and then one more on risk-weighted assets growth.

On the APS, I think you said that the impairments seen in the Core divisions in H1 would be around two-thirds covered by the APS and impairments seen in the Non-Core division would be covered by around 75 per cent by the APS, and if I run that quick number that means around £5 billion of impairments covered in H1 by the APS.

If we kind of assume, and this is obviously a big assumption, that impairments are going to stay more or less in this crucial space for the next three halves or whatever, you will get to the end of 2010 without having seen any substantial impact on your P&L because of the APS, you could consume your first loans between 2009 and 2010. Is that a fair interpretation?

MR. WHITTAKER: I think that's missing the write-downs component as well. If you look at impairments in the first half of sort of £7½ billion or so, write-downs of £3 billion, something of that order of magnitude, and we make comments around 70 per cent of that being covered …

MR. HESTER: 70 per cent of the total!

MR. WHITTAKER: 70 per cent of that total, then that gets you to a 7-7½, sort of 8 - 7-8 right! - range will be a better estimate.

MR. DE FRIAS MARQUES: So do you already expect to see some possibility?

MR. HESTER: Clearly we are not going to make any predictions about how fast the first loss is going to be used up (a) because of the uncertainty and the economic outlook and (b) because APS is not yet finally agreed and it's a very political number to speculate on, but I under your analysis.

MR. DE FRIAS MARQUES: Then continuing with that one, if we think that by 2011 it's very likely you will be a substantial support from the APS in your P&L, why is it that your ROEs or your ROE guidance for UK retail and UK corporate seems so low? I know you say more than 1 per cent and more than 5 per cent but it is still a very low number. Is it because the Core part of your business, what is not passed to the APS, you also expect kind of sustained worst than cycle average?

MR. HESTER: Let me answer that. In retail, actually it will in both, in all of our Core businesses new loans by and large are not covered by APS – there may be a small amount of roll-overs that are dealt with – and clearly there is quite a lot of turnover of loans and particularly the higher loan loss loans, the unsecured lending, credit cards and so on and so forth, so in the Core businesses the coverage levels will start going down as new loans are written. That's one answer in terms of why your impairment counts might be out in the later years.

We also think that there are continuing headwinds. If we take the retail business, we think the deposit competition, as I have mentioned, will stay intense as the market rebounds whereas most of the asset re-pricing has already happened in retail land and happens very quickly so it doesn't flow through over time, and so we have a very major restructuring to do.

There are also some headwinds that we are expecting on certain fee lines, the PPI product has gone away, and no doubt there will be changes in the overdraft charging structure which we can all see ahead of us. By the way, this isn't that different frankly in our retail business in the US. Retail businesses, as we've said and Mike Gogan said as well, have a big restructuring ahead to re-tool for a future banking market.

We will get there but, as you see at the moment, we are saying we are going to get there in five years as opposed to in three. Might that be cautious? We'll see!

On the corporate book you have got some of the same, but on the corporate book the asset re-pricing takes longer to come through because the assets are generally longer, although again new lending is not necessarily covered.

I think we are probably being a bit cautious on how long impairments will stay high but we are looking back at the earlier '90s and so we'll see whether that remains the case, whether that's true or not, and again I think we expect liability margins to continue to be well competed.

MR. DE FRIAS MARQUES: Okay, that's very useful. Thanks very much.

MR. HESTER: Look, I hesitate to talk about 2011. I very much hope we can beat our ROE targets in 2013, but there is so much that is open there, that I think we believe these targets are very responsible and clearly we will try and beat them.

MR. DE FRIAS MARQUES: Okay. The other question was on risk-weighted assets growth. I think from all your Core divisions the one that shows the stronger risk-weighted assets growth is UK Retail. Is that new volume driven or maybe there is a big component from PD migration, pro-cyclicality, and given that you haven't discussed pro-cyclicality impacts, can you give us your view, your thoughts, on what is going to be the impact going forward? Thank you.

MR. WHITTAKER: Both were contributory, a sort of balanced growth on particularly mortgage lending as well as some PD migration which increased the risk-weightings associated with those. I think in one of the slides we highlight around £39 billion impact of pro-cyclicality in the first half of the year off an asset base of £550 billion, so whatever that is, 6½ per cent or so in the first half of the year.

MR. DE FRIAS MARQUES: That would annualise to 12 or 13 per cent, which is probably higher than most other banks are talking about.

MR. WHITTAKER: Although it reflects, PD migrations happens pretty quickly, doesn't it? I gave some indication of the credit migration we had seen in the first half. Again if things start to have levelled off then maybe the PD migration will be less strong in H2.

MR. DE FRIAS MARQUES: Thank you.

THE CHAIRMAN: Any more or do I sense holidays beckoning? Jonathan, you are back for a second bite?

MR. JONATHAN PIERCE (Credit Suisse): Yes. Can I just ask a follow up on this point with regard the APS, because I think Stephen raises an interesting point on how roll-overs are dealt with in APS, and your suggestion is that the APS probably won't cover most of these loans as they come up for re-financing, so effectively the assets in the Retail Bank, as you pointed to, will come out of APS and back on to balance sheet.

Should we infer from that, that actually risk-weighted asset growth in the non-APS businesses over the next few years will be pretty substantial as the £150 billion RWA benefit from APS rolls off and effectively transfers back to balance sheet?

MR. HESTER: Perhaps I could deal with that this way, crudely in Non-Core we don't expect to replace the assets, so hopefully the asset rolls off as APS rolls off. There will be a number of assets where there are maturity extensions because the borrower can't pay back but that will be involuntary as opposed to voluntary.

In our Core businesses part of the deal on APS, as agreed in February, was that there would be a level of roll-over allowed in our UK Core businesses, not on the other ones, to give us 'fire power' allowed under APS and still covered for the first five years of the period, so that there would be partial roll-over coverage which basically was giving us extra 'fire power' to make the lending commitments that we made.

One of the two areas where the Government are so far trying to 'row back' on what was agreed in February - one was the tax carry back and the other is the extent of roll-over, and that's still under negotiation - but irrespective of that point our 2013 targets are assuming that the benefit of APS in RWA has gone by 2013. It won't actually have gone, but as we get closer to that point we will start showing you in a sense an APS normalised set of numbers, because if something is going to go you'll want to understand what the bank looks like.

So, our ROE and other targets are what I'll call normalised, i.e., stripping out any remaining benefit on RWAs, and I think that's the way we should manage ourselves. You know, APS you should think of as a temporary scheme to cover us during the period that we can get back to standalone health; once we are in standalone health we shouldn't be relying on it anymore and it will be anyway tailing down. (A pause)

THE CHAIRMAN: Good, is that the lot? (A pause) Okay. Well, thank you all very much for coming, and thanks in particular to Guy for being here.

MR. WHITTAKER: Thank you.

(The proceedings then terminated).