Q2 2010 Results

Analyst conference Call

held on Friday 6th August 2010

Presenters

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

Other Participants

- **Cormac McCarthy (CEO, Ulster Bank)**
- **Brian Hartzer (CEO, UK Retail, Wealth & Ulster Bank)**
- **Paul Geddes (CEO, Insurance)**

Operator

Ladies and gentlemen, today's conference call will be hosted by Stephen Hester, Group Chief Executive of RBS. Please continue to hold and your conference will begin shortly. Please press *…

Philip Hampton - *Royal Bank of Scotland - Chairman*

Well good morning, ladies and gentlemen, and welcome to our RBS' half year results. Before I get going, could I ask everybody to switch off their mobile phones now because they crackle around the mics and ring otherwise. Of course, in our case, these quarterly results, unlike most other banks. Despite the fact that these are quarterly results, we've nevertheless taken the trouble to produce more than 250 pages for you, so absolutely tons of information; Stephen and Bruce will weigh up a few of those tons in a moment. Before we get there, I've just got one or two things that I'd like to say.

Firstly, it's very clear now internally, and I hope externally, that we can see more sharply the quality of the Core businesses in RBS. We've had now two consecutive quarters of operating profit over £2 billion, and perhaps equally important in relation to the Core, we're now down to a one to one funding ratio, which was our aspiration for the whole Group.

The Core has really a group of very fine businesses, long established, well positioned. We have lots to do to improve them, but it is getting done, and it's getting done at a good speed.

Secondly, of course, the Non-Core is a key point of differentiation between RBS and most other banks, not because of its nature but really because of its sheer size. It is being very well gripped. It is very well focused, and it's ahead at the moment of pretty ambitious targets that were set for it through run-offs and disposals.

And of course, this week, after months of unrecorded work generally speaking, a series of transactions have been crystallized and you can see really how much effort is taking place I hope in the Group.

I think it's a great achievement to be back in profit ahead of our own expectations, frankly, and I think the team, obviously we've got Stephen and Bruce here and the rest of the top team in the front row before me, I think they're doing an absolutely fantastic job in execution and delivery of what we hope and expect is the right strategy to turn RBS around.

It is, of course, vital that we make a return on the massive amounts of new capital that the Bank has had. Making that return is inseparable from being a healthy and safe bank, but to make that return, we know we have to run the business efficiently and support our customers effectively. I don't necessarily believe that all banks have thought that way, but that is, I think, the view that is cascading throughout RBS. And we're determined to keep up with both of those things, serving our customers effectively, and making sure that we run the business efficiently.

And finally, just one thing. There's been a fair bit of speculation this week about where banks are most appropriately domiciled. The RBS Board has thought about this from time to time and I can happily confirm that the thoughts have taken about a nanosecond. They, I believe, are supported also by our controlling shareholder, UK Financial Investments and the UK Government, that we will stay firmly domiciled in the UK, and headquartered in Edinburgh.

Thank you very much, and over to Stephen.

Stephen Hester - *Royal Bank of Scotland - Group Chief Executive*

Well, there goes my hopes of an expat allowance and nice rental and so on as a way to make some money. Thank you very much, and I add my thanks to those of the Chairman for you to take the time here at nearly in the middle of August, and the normal pattern between Bruce and I; I'll go over, if you like, a few of the business related things, and then Bruce will take us through the figures and obviously open to as many questions as you'd like. And I think that what we believe with all the shortcomings of understanding there's only three months at a time that we're reporting what we believe that we are reporting is really good progress on the three key objectives that we have.

The first is always about our customers; are we basing this Bank on the rock of satisfied customers, customer franchises that are strong, customer franchises that want to be with us and where we're doing good things for them, and I believe the answer to that is, yes, and that the evidence continues to mount that not only are they strong, but we have the potential to advance them, and you will see something about that here.

The second is are we getting, are we peeling back the bits of onion, that that obscured what's inside, what's really good; are we getting rid of the risk positions, and so on; terrific progress you'll see in that area.

And then the final bit is the ongoing Core, the new RBS being built in a way that we can believe in the future when the economy and our efforts had time to both apply, produces a satisfactory, attractive level of sustainable profitability within the context of that risk profile and that customer service. And again, while that's in some senses the slowest of the things that we have to do, we believe that the direction is positive.

Around all of these things, will continue to be all sorts of accounting volatility and other sorts of things as different businesses go up and down and markets do different things to us, but we do think that underlying, steady path can be seen in the numbers here, and we expect that to continue.

So just a few little headlines on the business side; in terms of the Core business, the key feature of the quarter is really the engine of this Group for the next few years, which we expect to be the improvement and recovery of the Retail and Commercial businesses that are two thirds or so of the total, and steady state, which we think is a distinctively positive mix compared to the other two alternative extremes doing their stuff. GBM suffering quarter-on-quarter with what happened in the markets, but in line with the industry, and we need to continue to expect that kind of up and down; and our job is to make sure that, if you like, we're trying to keep up with the Buggins, with the other people, wherever the industry fortunes will take us.

The customer franchises I've talked about; the risk coming down nicely, we'll talk more about that. We did come out first quartile in the stress test, and whatever carping you might want to say about the stress test, none the least, there was a relative ranking in there and we certainly wouldn't have been first quartile 18 months ago in that outcome.

Costs are doing what we said they'd do. We have reaffirmed our strategy, our strategic plan. We've had a year to look at it; the Board is behind it, and we're making good progress. And when you see that in terms of just the absolute headline of the numbers, and again, Bruce will really talk about these more, operating profit in the Core looking flat; of course, when you strip out fair value of own debt, it's down, which is the function of the Investment Banking volatility; and ROE again hitting our notional target, but probably not as good as that if one's fair at this juncture; still work to do on that. The NIM, a bright spot, and a bright spot not least because it continues obviously performing well. Cost management performing as we said it would, cost income ratio improving.

Credit profile in line with our outlook for the year, which was that impairments would gently fall versus last year. That's still how we see it, and we can talk further about some of the things that make it more gentle than a different sort of business mix, but nevertheless roughly behaving itself. The funding of the Core Bank in great shape; loans to deposits better that some of our competitors feel that they're able to do; and also pro-cyclicality and risk quality not happening to us anymore, so flat RWAs.

And then the bigger picture, the if you like the risk that we have to improve around the Core business doing well; whether that's impairments coming down, loans to deposit of the whole Group coming down as we sell off bits of Non-Core, both deposits and loans in Non-Core. The asset reduction schedule going well; the Core Tier 1 we've talked about; and the TNAV, tangible net asset value, up a little bit because of liability management.

We put these out simply to say that obviously until the regulators will stop moving round on exactly what the rules will be operating on in 2013, some of these targets have got to be taken with square brackets, but fundamentally, the sort of shape of the Group that we aspire to and put out last year is the shape we still think is appropriate and we believe that we're making good progress and are ahead of every target for this stage of the journey on where we should be; whether they be risk targets or return targets.

And it's simply just… this is simply to remind you, because it's very important with all the different noise around assessing the parts of RBS, that fundamentally, the three things that this plan is all about is reengineering and improving the Core businesses that is the ongoing driver of our value against which a multiplier can be put; Non-Core, which is in a sense a book value reduction as we get out of all the risks, management stretch and the different things, and then cross-cutting initiatives that make this believable as to whether we improve the strategy, the management, the culture and the general operations of the Bank in a way that I believe we are in fact doing.

So within, if you like, those key tasks, just a quick slide; it's quite busy. I won't go through the detail, but it's simply to make the point that in pretty much every one of our franchises, we're stable to improving, notwithstanding all the noise and pressures that could sometimes lead you to conclude differently, whether that's in Retail or in Wealth or in US, and so on and so forth as we go through. We can do much better. We must do much better. Of course, improvements in these sorts of things take an awful lot of time before they've visible and show through, but I think we can see that we are building on rock and not on sand, and that's encouraging.

Now going through not exhaustively every one of our divisions, but just a few to try and give you a flavor that we do see underlying some of the volatility in the numbers, some of the key things we're trying to do to these businesses are going in the right direction. And so if we take one of our finest businesses and franchises, our UK Corporate business, of course, we've had to lop some off this last week, but we think we… although that will impact us, we will get over that, and you'll see it continues to be the case that both in the SME end, what we call commercial, and in the bigger end of corporates, our customers perceive us ahead of our peers if you like in satisfaction indices. We're working hard to support them; 100,000 new start-ups, 105,000 in the last 12 months. Our SME market share, which is where obviously all the political sensitivity is, up slightly, showing again we're trying pretty hard to demonstrate our support.

In the bottom left, one of the key things, the key mistake we made in this business really was we confused balance sheet growth with success, and the way we got it was lending too much to commercial real estate. And so although we must support all of our customers and drive this business forward, we must change the mix, and you can see already, notwithstanding it's very hard and very slow to change the real estate bit of this mix because of the nature of the market, that we are having success in a loan book that overall has risen a bit over the last year, that actually the trends are even better, that real estate is coming down in absolute terms and is part of the mix; this is even before we talk about Non-Core; and that non-real estate businesses are being supported in increasing amounts.

In the top right, another thing this business did was blow its balance sheet up and use… and eat up wholesale funding in doing it, yet we have one of the world's finest corporate deposit, natural deposit franchises in our relationships. And so we've been doing a fantastic job in really improving the quality of this business by selling both sides of the balance sheet to our customers, and you can see that the funding gap, the ability of this business to fund itself from deposits and not call on wholesale short term funding has been really improving, not only as we make loans, but as the deposits that our customers entrust with us increase; and we're pleased with that.

I should also note in passing, for the four months that have passed of this fiscal year, which is the period relevant for the government lending targets, we happen to have hit in corporate for the first time the lending target on that four-month period. I say happen to, obviously, because if there had been demand for more we'd have done more, and if there was demand for less we'd have done less; but as it happens, we have hit it in that four-month period.

And then again at the bottom, obviously, all of this has got to translate into something that will encourage shareholders to want to have their capital invested in us. The margin's, despite as yet no help from interest rates, are moving forward in a gentle way. They're not where they need to be, because you can see they're not even back to their previous peaks, and we're going to have to hold a lot more capital than we did at the previous peak, but it's going in the right direction.

I think it's also… no, I think that's all for that slide. On Retail, again, each of these same sorts of format. Franchise top left in decent shape, gaining share, gaining customers across the most important product areas for us. On the right hand side, the quality of funding really going well. In other words, although we're taking market share in mortgages and beating our lending targets for mortgages, we're keeping up on deposits as well and being able to fund that growth with growth in deposits as opposed to being reliant as some of our competitors are on the vagaries of the wholesale market. Of course, there's a huge technology switch underway in retail banking, and we're participants in that, bottom left. And then in the end, the bottom line is recovering in a nice way. Part of that is, if you like, margins, although they're still not back to where we needed to get them too; cost control, where we have particular need to get our cost income ratios better in this business and we've made a good start on that; and then impairments beginning to come down as well.

US Retail and Commercial, that's a little bit of a mix. Of course, the two previous ones I've gone over in the UK. And again, I think we can say all the similar things. Early signs that we're making some improvements on the franchise on the customer side in our refocused Core. We're making particular progress on deposits. It was always a rich deposit franchise, but on improving the quality of those deposits, bottom left. The market shares are behaving themselves, and the margin is beginning to go up.

A slight cautionary note about the US. There is a little bit of a stalling evident in the US economy. In the second quarter, you've seen a number of people saying that, so there's a few little nerves about. Whether in fact the trajectory continues in the way that we'd like it to, but it's certainly too early to say it isn't going to, but just sort of note that warning. There certainly is no ability to grow balance sheet in the US right now. The demand just isn't there, whether it's on consumer or corporate, and we have to watch that carefully. But anyway, I think so far on plan in all the different ways it has to be.

GBM, well, the numbers will bounce around as we said in line with industry. To remind you, we've always said that at this stage of our strategic plan, a quotes, normal year, would be £8 billion of revenues, and we'll have some times when we're higher than that and some times when we're lower, either for seasonal factors or for whether the markets in good shape or not. That still remains our view. Of course, typically, the second half is weaker than the first half. We'll see whether that's how the markets treat us this year in the next few months. But I think what we can say is that although these fluctuations are the nature of the industry and we've taken out fair value of own debt, our franchise, our business is resilient.

We are very focused on GBM being a completely different business than it was before; not a balance sheet heavy. The balance sheet has halved, the risk management is transformed, the management are working in a completely different way. Of course, it's still an investment bank, but I think we feel that that surgery and that change in orientation has been a big accomplishment, and now we need to get the solidity of some quarters of operating smoothly, get the people settled down, and move forward within whatever the external environment will give us.

We're investing heavily in the back office of this business, both for risk and control and client service reasons. I think that's an important thing for us to do. We've traded the unpredictable markets well; no losses in any group during that period, which I think is encouraging in terms of our risk management, and we continue to perform in the leading groups in the areas where we have, if you like, product and client specialty. And what's clear is that the balance sheet is not only half its original size, but it's more liquid; less loans, less stuck positions, a completely different approach to aged inventory, and so on. And so what we are really focusing on from this point, apart from the embedding of those changes is trying to make to start making some renewed progress in what I would call the underlying client franchises of our key areas and making sure that the leverage, which is really big with the rest of the Group, particularly groups like UK Corporate, even Retail Citizens, is kept strong and deepened.

So talked about the Core franchises and the progress there; a little bit on the risk side. We're on target for our rundown in Non-Core. In fact, we think we might be able to accelerate a little bit ahead of schedule in the second half if that goes to plan. And we're not doing it by picking some sectors and getting rid of them first and leaving the really scrubby ones. The bottom left slightly busy set of pie charts shows that we're making progress right across the portfolio in Non-Core. And in addition to assets running off and assets being sold, 22 country disposals, the EU mandatory disposals, and hopefully we'll have another announcement to make quite soon to fill that out.

Funding and liquidity; well, these things tend to go hand in hand. As Non-Core runs down, we use less short term wholesale funding. That was the key thing that knocked us over a year and a half ago, and that's reducing in a very pleasing way towards our long term targets. The same is happening in our loan to deposit ratio. And, of course, the refinancing wall that everyone panics about for UK and other banks in the coming years, we are -- while we are of course affected by wholesale markets, we have plenty of things we want to do in terms of term finance, what we have that some other banks don't have is a natural offset to, in particular, some of our maturities, the government guaranteed maturities, and so on, which is the rundown of Non-Core, and that continues to put us in a healthier position in terms of our need to access these markets relative to the gross amounts that would otherwise be involved.

Of course, as we look at there, no presentation would be complete without doffing the hat to economic and regulatory impacts. It remains the case that what we see with nuances around the world is consistent with gradual economic recovery continuing globally. That doesn't mean to say that's definitely going to continue to be the case, but that is the picture that we are still seeing. It is absolutely vital in our view that tough fiscal action and reduction and other economic imbalances is an important ingredient from the authorities in allowing those growth prospects to be healthy and continuing the will to recover, but we all know that confidence is volatile, whether in markets or in businesses, and will be an important determinant, both in the short term and the medium term of the path of recovery. And it's clear that as of today, customers are cautious, whether it be in taking out extra borrowings from our Retail and Commercial businesses, or whether it be in the volumes that underlie the market revenues. And I think that that's something that hopefully we'll see changing, but we'll all see that changing together.

Low interest rates in the near term clearly help impairments. In the medium term, their normalization will be important, not only because it's only allowable if the economy is to recover, but will be very important to banks who need to rebuild their margins, and the target levels will only be achieved as interest rates normalize.

So so far so good, relative to our plan on the economy, and although there are some clouds on the horizon, we feel that they are ones that we can cope with for the time being.

On the regulatory impacts, again, you know as well as I do that there's still not anything definite to say. On the face of it, it looks like the whole raft of things that is designed to make banks safer, more capital, more liquidity, catching better calculations in the areas where banks… where the regulatory regime was not very well developed, I think those are broadly on path for a sensible outcome. The Basel process is working through. There are obviously still some quite important open items, but it seems both in terms of getting a timing that there's a sensible balance between safety and economic progress, and an outcome that is a sensible balance between making banks massively safer than before, but not utterly risk-free; if they were utterly risk-free then they'd never serve the economy; that seems to me broadly to be something that is going in a way that we can support and adjust to.

There of course is then a whole set of other more complex issues, size, shape, resolution regimes still to be thought through. We remain very clear that size and shape is a complete red herring, but obviously, others have got to be persuaded of that. And it's interesting as we look around the world at other countries reaching conclusions, and most notably the United States, that the real issue in this area lies not in size and shape but in resolution regimes and the way you deal with failure. And I think people like Adair Turner and Paul Tucker are on the same point, and that's certainly where we're focused, but I think there's lots of water to go under the bridge in this debate as we go forward. And in the meantime, of course, there are some things that are negative for banks; more capital, more taxes, but I think those are fair-dos in the context of getting to a point where banks don't enjoy implicit subsidies from governments anymore.

So that was really what I wanted to say by way of the business side. I'm very happy now to ask Bruce to take you through our numbers.

Bruce Van Saun - *Royal Bank of Scotland - Chief Financial Officer*

Thank you, Stephen, and good morning. I'm going to start off by looking at our quarter-on-quarter performance.

So on the revenue line we were down slightly. While net interest income performed well in the quarter, up 4%, our GBM revenues declined given a difficult second quarter trading environment. If you exclude the gain related to fair value of own debt, our revenues fell by roughly 10% versus the first quarter.

Our costs remained tightly controlled, almost unchanged versus a year ago, despite ongoing investment costs, and they were down 7% on the quarter. Impairments declined for the fourth straight quarter falling nearly £200 million. We benefited from a substantial recover in Non-Core, as well as improving economic conditions. Note that we posted an operating profit for the second consecutive quarter, although this was flattered by the gain on fair value of own debt.

The second quarter results were clearly noisy, with a number of significant one-offs as a result of the ongoing restructuring of the Bank, as well as accounting for volatile items such as the APS derivative. The most noteworthy items of these include on the positive side the gain on redemption of our own debt from the liability management exercise, the fair value change on the APS credit derivative, and then on the negative side, there were losses on some strategic disposals, and there were some one-off tax charges which are described more fully in the IMS.

Note that at the very bottom line, we posted an attributable profit for the quarter at £257 million, and our TNAV was up 1p per share to 53p.

Looking at the half year results, we swung from an operating loss of £3.4 billion last year to £1.6 billion profit this year, a £5 billion swing. Looking down the P&L, you see good income growth, cost control, and an improving impairments picture, and the bottom line for the half was about break even.

Breaking the results into Core and Non-Core, our Core results were up sharply versus a year ago, and were essentially flat versus the prior quarter. Relative to Q1, the positive net interest margin trend in Retail and Commercial, and good cost control helped offset lower GBM revenues, the increased insurance claims, and a modest uptick in impairments. In Non-Core, the reduced operating loss in the second quarter produced… was the result of good income levels in a tough environment, as widening credit spreads led to an improved trading result on our banking book hedges. Costs fell 10% in the quarter, reflecting the successful completion of several business disposals. A slowing of impairments in the corporate sector, and a sizeable one-off recovery drove Non-Core impairments in the quarter.

Looking at the divisional performance at a high level, Retail and Commercial had a very solid quarter, with all divisions posting PBIL growth up 20% overall as a result of 4% revenue and a 3% decline in costs. Operating profit was up 49% for Retail and Commercial, given stable to improving impairments in all divisions save Ulster. These businesses are gaining momentum as the economy strengthens, which needs to happen in order for us to hit our planned targets. While GBM performance lagged the first quarter given a tougher environment, its performance was in line with peer group, and the business continues to be resilient.

Scanning through the divisions in a little more detail, UK Retail and UK Corporate both posted another solid quarter of results. Revenues in NIM increased across both businesses, with the NIM rising faster in UK Retail. Our costs remained controlled, with UK Corporate seeing a 2% underlying cost reduction. Impairments were stable in UK Corporate, while UK Retail saw a decline in the quarter due to lower arrears volumes and improved collections performance.

Wealth showed progress in the second quarter, with positive operating leverage, but deposit competition remains tough, and our international business is working through some challenges.

Note that GBM delivered underlying revenues ex fair value of own debt of £1.9 billion. That's pretty good performance considering the increased risk aversion in the markets which reduced customer flows. Costs were managed tightly to offset the decline in revenues relative to Q1, and our cost to income ratio ex the fair value of own debt was 53% in the second quarter relative to 46% in the first quarter.

The third quarter to date has started off a bit soft, so we remain cautious on near term revenues, but confident in the outlook over the planning horizon as the franchise remains stable and strong.

GTS posted a solid profit and good growth in the second quarter as average deposits were up, which powered net interest income. Ulster is showing improvement at the PBIL level, but impairments remain elevated given the challenging property market in Ireland. Note we have decided to exit the property development lending segment in Ireland, and we will swap a £6 billion portfolio of loans into Non-Core at July 1 for a comparably sized portfolio of residential mortgages. Details on this can be found in Appendix 5 of the IMS.

US Retail and Commercial saw a second straight quarter of bottom line profit. Quarterly revenues accelerated into Q2 as both NII and non-interest income saw good growth. The NIM improved again, although loan demand remains weak. Costs fell due to one-time pension credit, while impairments were down slightly versus both prior periods.

Insurance continues to struggle with higher rates of bodily injury claims relating to prior years. This is an industry-wide phenomenon that will take some time to adjust to. We've taken another significant boost to reserves to reflect the impact on our historical book. That said, we are taking steps to de-risk the business while improving pricing, the cost base, and claims handling. It now looks like we won't achieve full year profitability in this business until 2011.

Turning now to the Group's major P&L categories, we were pleased that Group NIM rose 11 basis points in the quarter to 2.03%, with R&C NIM growing by 14 basis points as improved asset margins continued to bolster performance. A positive day variance added 3 basis points of this. Note that we picked up about 3 basis points overall at the consolidated level, as we received a full quarter benefit from concluding our hedging program on the December capital injections, which is now baked into the run-rate. Our current expectation is for Group NIM to rise modestly over the rest of 2010, excluding any GBM or Non-Core volatility. That said, there are lots of moving parts to the balance sheet restructuring, which makes precise forecasting in this area particularly challenging.

Group operating expenses remain a focus for the Group. Our cost reduction plan has delivered over 85% of our £2.5 billion cost reduction target, and that's created capacity to make investments which strengthen our business franchises. The principle driver of the Q2 sequential quarter reduction was lower variable compensation tied to the lower GBM revenues.

In Non-Core, costs declined by 10% on the quarter as the division starts to see the impact of headcount reductions associated with disposals of businesses.

Looking at impairments, the Core division impairments remained stabled in Q2, to modestly improving across UK Retail, UK Corporate, and US R&C. That said, Ulster is now at a 3.1% impairment rate reflecting Ireland's weak property market, while GBM saw a moderate increase based on a small number of single name provisions. Core provision balance has increased over the first half, with provision coverage of REILs now at 53%.

Non-Core impairments were stable at 4.5% of loans in the quarter. Impairment levels benefited on a relative basis from no large individual cases, and a significant recovery of about £270 million. Non-Core provision coverage increased in the first half to 39%, and note that that's lower than Core, given there's more secured real estate loans in Non-Core.

We continued to believe that overall impairments peaked in the second quarter of '09, and we believe the underlying credit trends should continue into the second half, assuming gradual economic recovery. Our leading indicators, REILs and cases transferring to workout, are trending slightly favorable, with commercial property being the area of greatest concern.

Lastly, turning to the balance sheet, we continue to make progress against our key objectives. TPAs fell 6% in the quarter due to deleveraging in GBM and excellent progress in Non-Core rundown. Our balance sheet ratios remained strong. The TCE ratio is at 6%. Our Core Tier 1 is at 10.5%, and leverage ratio is holding steady at 17 times.

The detail of the second quarter Non-Core asset reduction is shown here on this slide. The £20 billion headline number for the quarter breaks down into £8 billion of asset sales, primarily Asia branches and corporate loans, and runoffs totaling another £6 billion spread across the CRE, the corporate and the markets portfolios. In the second half, we may accelerate the pace of disposals from Non-Core, given a very strong pipeline of potential transactions. So there could be an uptick in disposal losses associated with this strategy which will be considered in light of the benefits of risk reduction and accelerating our deleveraging.

Bottom line, at the half year mark, we remain very comfortable that we will achieve our full year targeted reduction of Non-Core TPAs (ex Sempra) of about £40 billion, and we could do somewhat better.

Work continues on improving our funding and liquidity positions, and here again we've made very good progress. The Group's loan to deposit ratio has improved to 128% at June 30 given Non-Core's asset reduction, while the Core loan to deposit ratio is now very close to our one to one target. We were able to tap the markets for term funding during the quarter as our distribution capabilities enabled us to perform well across product type, geographies, maturities and currencies. As at the end of July, we had issued £17 of term funding, about 70% of our original full year target. And note that the wholesale funding over one year has risen to 57% from 53% in the first quarter, and we will continue to stay very focused on this.

RWAs increased by £13 billion, driven mostly by NV transition impacts, and a market-related event risk charge in GBM. Our Core Tier 1 ratio remains robust at 10.5%. The impact of the quarter's increase in RWAs was partially offset by the liability and management exercise we carried out during the quarter.

So let me conclude here with a few comments. We have a long list. I'll just maybe focus on the top and the bottom ones. I think what's particularly noteworthy here is that our Core R&C franchise is showing momentum, which has benefited our first half results, and will also certainly benefit our future outlook. And then on the last thing, again, I think we are tracking very well against our strategic plan. We're meeting or exceeding all of our targets.

So with that, I guess, Philip, you may want to take some questions.

Questions and Answers

Philip Hampton - *Royal Bank of Scotland - Chairman*

Thanks, Bruce. Absolutely. If you could announce yourself, name and which organization you represent, if any before you start, that would be great. Who's going to go first? Right in front of me.

Michael Trippitt - *Oriel Securities - Analyst*

Good morning. It's Mike Trippitt at Oriel. Just on the margin, your guidance about modestly rising over the rest of the year, I just wondered if you could maybe extend your view out a bit beyond that; whether you see a fundamental change in pricing of risk; whether you could see margin expansion beyond this year. I'm not asking for specific forecasts on the numbers, but just in general terms the trend, or whether you would expect in a rising rate environment that we're back to usual of asset yields getting squeezed and more competition.

Stephen Hester - *Royal Bank of Scotland - Group Chief Executive*

Well, obviously, strategically, our margins have in the end be wider than they were to finance a near doubling, and maybe even more than a doubling of equity capital to be serviced by those margins. At the moment, it feels like asset margins have got to where they need to get to, and the missing ingredient is the rebuild of liability margins which need to be accompanied with interest rate rises. Obviously, if interest rates were to stay down for a long period of time, then you'd have to return to asset margins as your only source of getting adequate profitability. So I think those are the moving parts. I don't know, Bruce, whether you…

Bruce Van Saun - *Royal Bank of Scotland - Chief Financial Officer*

Yes. No, I think that's accurate. The asset margin phenomena has been pretty consistent throughout the year, and we expect that still has some life to it. At some point, we've always said there's a passing of the baton from the asset margin side over to the liability margin side to continue the positive progression on the NIM, but I think as Stephen said, if rates stay lower for longer, the offsets to that would be going back to the asset side and then also looking at your cost base. We're committed to getting to the targeted ROEs that are in the plan.

Philip Hampton - *Royal Bank of Scotland - Chairman*

I knew you would add the cost base, Bruce.

Robert Law - *Nomura - Analyst*

Thank you. Robert Law, Nomura. Could I follow that on, please, on both the margin and the cost side? Do you think, and I notice the second quarter margin was up on the half year so that's leading to the margin expansion in the second half, do you think you'll still end the year with an exit margin that's higher than the second half?

Bruce Van Saun - *Royal Bank of Scotland - Chief Financial Officer*

I'm sorry, higher than the second half?

Robert Law - *Nomura - Analyst*

Yes, so in your projections, do you think you're going to have negative margins…?

Bruce Van Saun - *Royal Bank of Scotland - Chief Financial Officer*

I think the second half margin will be higher than the first half.

Stephen Hester - *Royal Bank of Scotland - Group Chief Executive*

You mean the second quarter? The fourth quarter?

Robert Law - *Nomura - Analyst*

Will they continue to build through the year?

Bruce Van Saun - *Royal Bank of Scotland - Chief Financial Officer*

Yes. It's a confusing question, I'm sorry, the way it was phrased.

Robert Law - *Nomura - Analyst*

Well, apologies for that. And then on your cost indications, can you outline where you are on the cost reduction target you've set and how much is that you've now realized in the second quarter?

Bruce Van Saun - *Royal Bank of Scotland - Chief Financial Officer*

Yes, we have baked in about 85% of the program, and so there's still some room to go. Effectively, you're not seeing significant reductions in absolute expenses, you're seeing those held flat to slightly down, because we are in the midst of a significant reinvestment program behind our business. We're spending £6 billion of… on major projects to basically strengthen the business franchises across the whole Group, but the cost program has provided nice capacity to be able to fund that.

We do have further initiatives underway to basically expand the target of the original program, and so there may be more to report on that as we go through the rest of this year.

Philip Hampton - *Royal Bank of Scotland - Chairman*

Why don't you just move it along, Robert?

Peter Toeman - *HSBC - Analyst*

The Non-Core business has actually had quite a good quarter in terms of running off assets and keeping impairments within an acceptable level, but I wondered, obviously, you had a good background for UK commercial property, and I wondered if you'd give us some idea of the sort of sensitivity of commercial property prices that are Core, would that greatly change the impairments that would come out of Non-Core affect the speed at which you make disposals?

Stephen Hester - *Royal Bank of Scotland - Group Chief Executive*

Well, there isn't a direct relationship in the sense that we make impairments as required by IFRS when someone stops paying his interest, or something like that, with low interest rates; you know, the bouncing around of the underlying asset price doesn't immediately feature into impairments in either direction, although obviously it feeds into your recoveries if something does go bust eventually.

In fact, the… I would say our major exposure on real estate is less the extent to which the real estate loan to values are underwater relative to our loans plus provisions. It's more what you might call the mezzanine level, the refinancing risk, because you… if something was… let's make it simple. If something was 100% loan to value, in theory, if you've got the time to sell the property you get your loan back, but you can't refinance it at that level, and so there's a material, if you like, refinancing risk, and therefore you're staying into these things longer in addition to the swing-around in the loan to value itself which hasn't been a crucial driver of losses on these things.

So that's sort of the dynamic, which is why we and all other banks in every recession play real estate long. It's the smart thing to do. And that's why the pattern of our impairments is likely to go down a bit more slowly than some others, because we have a higher real estate component of the things we did wrong, which is a late cycle provisioning, timing, even though, as I say, the trends continue to be in our favor, and you can see that we do continue to reduce our real estate exposures, but it just is not going to happen fast.

Bruce Van Saun - *Royal Bank of Scotland - Chief Financial Officer*

And I would add to that that of the impairments in Non-Core, about 75% to 80% of the number in the quarter was associated with commercial property, so that's really where we're kind of taking the pain.

Philip Hampton - *Royal Bank of Scotland - Chairman*

Go to the back.

Manus Costello - *Autonomous Research - Analyst*

Morning. It's Manus Costello from Autonomous Research. Could I just ask a few questions about your liquidity portfolio, please, which you took down this quarter? I was just wondering why it came down this quarter, and why you think it has to build to a higher level despite a lower balance sheet for the end of your target period, so you're going to £150 billion despite having a lower funded balance sheet at the end of that period.

Secondly, I wondered if within that £150 billion target that you've got, would you be including the unencumbered collateral which you currently include in your liquidity portfolio, or is it just purely liquid assets, treasury bills, etc?

And lastly, could you give us some idea of the kind of drag on NII, which you think the pick-up to £150 billion might bring for you?

Bruce Van Saun - *Royal Bank of Scotland - Chief Financial Officer*

Yes, sure. A lot of questions in there. First, the decline sequentially was really… there were three components to that principally, the decline of £27 billion. And £16 billion of that related to the NV, so we were working through the demerger and the separation of the NV, and we wanted to maintain a high cash balance through that process. The actual separation took place on April 6, so once we were kind of separated and we had the kind of proper regulatory framework and rating agency framework in place, we ran down that excess liquidity and just paid down some short term wholesale funding. So that was £16 billion of the £27 billion.

The second element of that was we are in a process of continuing to pay down some of the government support facilities so the CGS and the SLS we paid down £4 billion during the quarter, and then the last £4 billion, there was £4 from foreign exchange, so some of that was exchange related. So that gets you to £24 billion of the £27 billion. That's principally the drivers.

In terms of why £150 billion, that was our target initially that we intended to have short term wholesale funding of £150 billion, and we wanted that to be offset completely with a liquidity portfolio of comparable size, so when we… Stephen and the team, that was before I got here, designed the strategic plan. It was oriented towards having a balance sheet that would secure… and a business mix that would secure an AA credit rating, and so that was an important element of the construct.

So moving back from £137 billion to £150 billion is not a very challenging thing to do. I think we'll stay kind of around this zip code for the next… you know, for the foreseeable future.

The thing that could cost us money is inside that liquidity portfolio, we have a portfolio of government bonds in the UK Plc that are designed to meet FSA criteria around liquidity, so it's really the most liquid of the government bonds. That portfolio is today at about slightly over £25 billion. The target is to have that £50 billion of the £150 billion, so that's another £25 billion to go over the next three years, three or four years, and there's roughly a 50 basis point to 75 basis point give up in spread for when you release other kind of securities with a spread to go back to treasuries, and so you can factor that in. But that's kind of in the guidance we give you around the future NIM.

Stephen Hester - *Royal Bank of Scotland - Group Chief Executive*

We do include enabled collateral as liquidity.

Philip Hampton - *Royal Bank of Scotland - Chairman*

Hand over here.

Raul Sinha - *Nomura - Analyst*

Hi. It's Raul Sinha from Nomura here. If I can first ask you to talk a bit about Ireland and Ulster Bank. There's been a sequential rise in margins which is quite strong, and probably a bit surprising given the outlook for the economy as you describe. Can you talk about your lending appetite versus demand in both Northern Ireland and in Ireland?

And perhaps if you could talk about the Non-Core division, the swap that you've made; what were the NPLs against the loans, the property development loans, and perhaps maybe the income against the mortgages that you've swapped back in.

Bruce Van Saun - *Royal Bank of Scotland - Chief Financial Officer*

Okay. Maybe Cormac takes the first one and I'll take the second one?

Cormac McCarthy - *Ulster Bank - Chief Executive Officer Ulster Bank*

Just on the margins, we've taken action over the last 18 months to price up the market in Ireland. It's generally characteristic and characterize in the South by the state banks who have been, shall we say, encouraged not to increase pricing where we haven't had that stress. So we've managed to increase our pricing over the last while.

As well, we've seen a little bit more moderation in deposit pricing, although still at the top end. So it's a combination of improved pricing and a bit of moderation in deposits. So we've seen a stabilizing of margin, and we think into the next 12 months/18 months, that should continue.

We have benefited by cost of funds as well on the wholesale side, because the curve has worked in our favor on tracker mortgages too, so that can flip a little bit, but the action on pricing has been the most encouraging thing, and we think at stable levels we're at now, that should hold for the next six to 12 months, but the market is still very uncertain and very volatile.

As regards your question on lending, we're supporting our existing customers, which is what you'd expect us to do, but with a peak to trough fall in GNP of 25%, it's not a market characterized by huge demand, and you can see there are portfolios amortizing, notwithstanding the fact that there is a lot of stress out there.

So supporting existing customers, we will do some ocean going trades for ocean going companies, GBM type deals for international companies, but the domestic market is very, very subdued and will continue to be so for some time.

So our approach is very cautious. As Bruce has said, we're exiting the speculative commercial development market for good because it's not a market that we see creating any value into the future, and that will allow us to focus on things that make sense.

So we have seen margin stability off the back of pricing. Deposits continue to be difficult, although it's moderated, and while demand is subdued, and you'd expect it to be the case, there are some opportunities to do some decent business, but we expect our portfolio to amortize down over the next 12 months/18 months.

Bruce Van Saun - *Royal Bank of Scotland - Chief Financial Officer*

And to the details on the transfers, I think if you look at Appendix 5, we've laid that out quarter-by-quarter, half-year-by-half-year exactly what the balance sheet impact is and what the P&L impact is. So in order to adjust your forward views, you can see that. Obviously, the credit quality of the portfolio that's transferring to Non-Core is going to mean the impairments picture will improve in the Core for Ireland, and it will be a bit of a drag until we work through the cycle on this in Non-Core.

And then the net result of this is the kind of asset allocation on the balance sheet post this transfer means that in Ireland, we'll have more of a kind of individual or consumer-focused business with mortgages and personal unsecured, and then we'll have corporate as another big element, and we'll have a much reduced investment property portfolio and we'll be out of that more speculative property development.

So I think we still like the Irish market. It's very painful go through these losses here, but it is a concentrated market, and we think that government is putting the right policies in place to get the market back on its feet, it's just going to take a while.

Philip Hampton - *Royal Bank of Scotland - Chairman*

Over here.

Tom Rayner - *Barclays Capital - Analyst*

Yes, thanks very much. It's Tom Rayner from Barclays Capital. Could I just ask you your comments about the baton passing on from the asset margin to the liability? Could I ask you to refer those comments to the UK specifically? Because clearly, one of your competitors thinks that asset repricing has got a lot further to run in the UK, particularly on the mortgage book? Yet you describe conditions on the UK savings, I think, as intensely competitive, and everything would seem to suggest that that competition is going to get higher going into next year; various things that are happening and not easier. So could you comment on that sort of switch from asset margin to liability margin for the UK specifically?

Stephen Hester - *Royal Bank of Scotland - Group Chief Executive*

Well, obviously, all of us have got a crystal ball and no one's going to see it's perfectly clearly as it goes through. If we take the different components, the evidence so far is that corporate asset margins are flattening out; in fact, in the odd place have come in slightly; and so at the moment, it feels like apart from the working through of front book margins to the remainder of the back book in Corporate that there isn't currently an increasing trend in new business. And then obviously you've seen we've been very successful in improving our corporate deposits.   Although there's a bit of margin drag from that it hasn't been huge and higher interest rates would be the next piece.

On Retail, again, clearly there's an element of front book and back book still to go, but some people have had a different business mix with more trackers than us in their mortgage book, and so I think it may be that we have repriced some of our mortgage book faster than some people because we didn't have so many trackers holding us back. I don't know; it's hard for me to know what's in other people's books, but that's just a guess. But I would say mortgage margins are not on the front book particularly increasing at this juncture, which is the main driver of profitability. And savings, you know, it's competitive but we're somewhat stable.

But I don't know. Brian Hartzer is here who's running the Retail business and, Brian, you might want to add… we've got a mic, hopefully.

Brian Hartzer - *Royal Bank of Scotland - Head of Retail Branch Network*

Thanks. The only thing I would really add to that is we are looking at the combined margin overall, and so if we start to see more pressure on the mortgage margin, then obviously deposits will have to offset that and vice versa. So it's something we're managing dynamically, I think, but Stephen's summary is pretty good.

Michael Helsby - *Bank of America Merrill Lynch - Analyst*

Thank you. It's Michael Helsby from Bank of America Merrill Lynch. I've got two questions, if I can. Firstly, on insurance, clearly, another big reserve hit from bodily injuries. And I note your comment that you still expect to be loss-making for the full year. I was just wondering if you could give us a little bit more color on how far through you think you are on the bodily injury. I thought you were a bit further ahead than what you obviously were. And also, I note from an Industry perspective, there's a hell of a lot of premium inflation, particularly, in motor, and yet when I look at your numbers, I know there's mix changes because of premium numbers, but it looks like there's only 2% premium inflation year-on-year, so I was wondering if you could just comment on how you see the premium cycle evolving in Direct Line’s book.

And I've just got a second question on profitability that I can come back to.

Stephen Hester - *Royal Bank of Scotland - Group Chief Executive*

We thought we were a further through as well, but Paul Geddes is here running the Insurance business. Perhaps he could take a crack at those.

Paul Geddes - *Royal Bank of Scotland - CEO Insurance Business*

Yes, thank you. I think the first comment to make is the split of the strengthening. You can take some guidance from the split of between current year and prior year's. So in terms of the actions we took, particularly in Q4, so we took a bit of price in Q3, a lot in Q4, and actually, even more in Q1 and Q2 this year. That will obviously work its way through in terms of the new book, but the new book performance is obviously more pleasing than the old book. You can take that from the split of the prior year to current year.

The rate changes we've taken are, I would say, ahead of the industry. The obvious offset is the mix changes as you replace young drivers at £1,500 with less risky drivers at £400. Obviously, that's a major offset. We've also taken a profitability review of our business and taken some policy volume out, so we've taken overall 7% of motor policies out, 6% own brand, a bit more in brokers and so that's another offset. So you've got in one direction price rises, mix, and policy numbers in the other direction.

In terms of further unknowns, I guess just to bring one to light, with the vagaries of the degree to which courts award big bodily claims as kind of annuity streams called PPOs or lump sums, it's a very imprecise science. There's only about 100 claims in the industry at the moment. It's a very sensitive percentage on the back book to that sensitivity, so that's a trend we'll continue to watch, but we have a deep analysis on bodily injury, and we obviously think we've taken the right number, albeit there are a couple of other trends we still need to look for.

Stephen Hester - *Royal Bank of Scotland - Group Chief Executive*

So I think bringing it together, our… we are very clear that we want and believe that our Insurance business, like all our businesses, can get to 15% plus ROE, and part of that is getting behind us this risk side. There's a huge amount of action that we're going to take on cost, accelerated from where we otherwise were. Some announcements have been made in that regard. And then there's the repricing and mix issues that we've talked about. It's also worth noting though that aside from motor, which of course has been obscuring everything else, we've gone from number two position to number one position in the UK in home insurance, which is, I think, a very good thing for the business to have been able to do in that period as well.

Philip Hampton - *Royal Bank of Scotland - Chairman*

Sorry, go ahead.

Michael Helsby – *Bank of America Merrill Lynch*

Thank you. If I take out the gain on own debt and look at your half year performance, it looks like you've done about £1 billion of operating profit. And if I take all the messages that you're giving on trends, clearly, margins are still going up sequentially by quarter. I hear what you're saying on clouds on the horizon but certainly all the credit metrics at the moment still look positive, so I get the impression that bad debt should be hopefully with a fair wind lower in the second half than the first half. So I guess you've been reluctant so far to give any guidance… well, to break from your expectation that you're going to be loss-making for the full year, so I'd just like to invite you to give us an update on that, and whether the… you know, is what we're missing in terms of your reluctance to break into that sort of message, is it to do with the disposals that are coming through in Non-Core? Do you expect some big losses to come through there?

Stephen Hester - *Royal Bank of Scotland - Group Chief Executive*

Well, as I say, I think the moving parts are on the one hand Retail and Commercial, which I think we have a reasonable view will continue in line with the recent trends, albeit with a slight slowing in the rate of margin expansion. The Investment Banking business where, you know, take your pick, whatever you think's going to happen to industry revenues, but normally the second half is worse than the first, just the seasonal basis. And then in Non-Core, if we were to anticipate, if we were to accelerate disposals, you could get more disposal losses in Non-Core, but there's an if, there's a possibility there.

And then the big swings on accounting items, you know, you have a great irony that you have two big positives, frankly, that are meaningless; fair value of own debt and the APS treatment in the second quarter when the environment was worse; if the environment gets better, they could swing to two big negatives that would be equally meaningless, but you know, if you were playing the odds, you would say they would be negative in the second half; you know, our spreads are narrower now, for example, than they were in June. So just playing the odds gives us that kind of balance, but as you can see, there are a whole… in a sense, it tends to be the things that are out with control or that are in line with what we're trying to do and reduce risk that will create the negative and therefore I don't think speak to the long term value of the Company or what we're trying to do but nevertheless can speak to the headlines.

Arturo de Frias - *Evolution Securities*

Thank you. Arturo de Frias from Evolution. A couple of questions, please, the first one on business mix. If I look at your ROEs, Retail is now 19% almost having doubled quarter-on-quarter, which is quite remarkable, and Corporate is also 15% improving, it seems quite clear that the trends are going to improve going forward so we will have close to 20% ROEs on those two divisions not too far from now. On the other hand, we have GBM, and if I exclude the gains in own debt, I think the ROE in GBM is around 14% and H1 is the best half of the year. So this is a mid to low teens ROE and it might get more to the low teens than to the mid teens.

Against that background, I would expect you to grow as aggressively as quickly as possible Retail and Commercial and limit the risk weighted assets and the capital allocation to Wholesale or to GBM, but the anecdotal evidence that we hear is that you are growing GBM even more quickly than Retail and Corporate and you are hiring.

So my question is, why are you growing… why do you want to grow GBM which is a business that in most likelihood is going to depress the Group ROE rather than help the Group ROE?

Stephen Hester - *Royal Bank of Scotland - Group Chief Executive*

Well, I thank you very much for your question. I would urge you to ignore anecdotal evidence because anecdotes are normally not reflective of accuracy. But taking the two in turn, internal ROEs are tricky, because we don't have a settled regulatory environment; we're keeping much more capital than we're actually putting out in our internal ROEs, so don't take them as gospel, because frankly, if we had to stand alone in any of those businesses, they probably need more E than we're allocating which is why there's a bunch of unused of E at the centre.

But setting that little carp aside, if we could expand our UK Commercial and Retail business faster, we would have done so but no one wants to take our loans who can pay them back. And by the way, it's the same in the US franchise, so the issue on expansion in our Retail and Commercial businesses is waiting 'til the point in the economy when people want loans who can pay them back. But in principle, the money's there; we're happy to do it, obviously, subject to lending to people who are going to pay us back and to similarly in the other product lines.

And we have made it a very important feature of our strategy that we do see RBS, while being a universal bank being one where two thirds or more of the Bank is in retail and commercial businesses without some of the observed volatility of Investment Bank, and we think that that's a positive distinguisher for us and our strategy.

That said, the investment banks are clear diversifiers. That was nowhere better seen than actually over the last 15 months. You have to run them so they don't blow up, so we have some work to do to make sure that that doesn't happen again. We think we're on the right course, and many investment banks didn't blow up so it clearly is doable; we just need to do it ourselves. And we do believe that investment banking can only exist as an industry if it gets to the point where it's able to make 15% plus ROEs. Now, of course, it's at the epicenter of the most change in funding and leverage and attributed capital and pressure from regulators, compensations discussions, all of these sorts of things, and so there's a translation, but I think we're very clear that anyone who runs an investment bank, you know, can't be accepting a permanent position if one were to arise of substandard returns. But that said, the key is to run an investment bank better.

Now I wish we had been hiring and expanding the Investment Bank on one level, but actually, we've been hiring to replace people who've left us, and we're net down, and we continue to fight with this issue which is still destructive but not destabilizing; whichever way round of those, we're coping with it. We'd rather not have it, but it's one of the inhibitors to our progress as we go forward. But you saw that the Investment Bank I think performed in line with the industry, despite reducing its balance sheet and having a balance sheet that's half the size it was before. The headcount has not gone up in the Investment Bank. We do have the ambition to strengthen its businesses; to strengthen its client franchises, but that's not in terms of diversifying into new business lines or countries we're not in, it's in terms of doing a better job in the things where we're already good, and any business we own, we want to be strong and successful whilst paying attention to the overall balance.

Unidentified Audience Member - *Evolution Securities*

So just a small follow-up on that one. Am I right in assuming from your words that you do expect the Investment Bank to generate ROEs above 15%, despite the (overtalking)?

Stephen Hester - *Royal Bank of Scotland - Group Chief Executive*

The Investment Bank has exactly the same minimum hurdle target as the others. We want to make more than our cost of capital. In fact, we allocate more capital to the Investment Bank than we do to the others in calculating that because of its perceived greater volatility, although obviously, regulatory changes will impact that. But, yes, it has those targets, but obviously, if at any one moment a business doesn't meet your targets, you then try and be rational as to why not and what you have to do. So Ulster isn't making our targets, but that doesn't mean to say that we're saying, okay, let's close Ulster Bank down. We think we'd lose more money that way. It says, okay, well, how do we get it back to its targets and we would behave rationally in all the businesses we have, but we can only have businesses in our Core that we think we can get to the point where they recover their costs of capital. And we will keep doing surgery on businesses until they do, whilst taking account of the element that is economically driven.

Unidentified Audience Member - *Evolution Securities*

Okay, thank you. The second question, much quicker one; RWAs, I'm a bit confused. You said that you are not being hurt anymore by the pro cyclicality, but RWAs are flat when TPAs are down 6%.

Stephen Hester - *Royal Bank of Scotland - Group Chief Executive*

That's really… sorry, go ahead.

Bruce Van Saun - *Royal Bank of Scotland - Chief Financial Officer*

There's two elements that we've highlighted in terms of the increase. One is the FSA has, I guess, worked out that we need to put an event risk charge, and some of the other banks are dealing with this too, market risk related event risk charge into the capital calculation. That was about £8 billion of increase. And then also the last vestiges of the NV and the relief trade roll-off, in the NV cost us £5 billion.

So it is a paradox. There were some other things with kind of TPAs down that benefited RWAs, but the principle reasons they were net up were those two factors.

Stephen Hester - *Royal Bank of Scotland - Group Chief Executive*

And I think that still, to be honest, regulators everywhere in the world are still tweaking away at models and RWAs, so there's sort of what you might call regulatory drag on everyone's RWAs as the regulators try and push them up in lots of little corners, even if the underlying pro cyclicality isn't going against you. So I think we've still got 18 months or so before the regulators settle down in the way they're calculating RWAs in the micro, as well as whatever changes in the macro world.

Philip Hampton - *Royal Bank of Scotland - Chairman*

Anything else? No. Well, why don't you just move it to the side then?

Jonathan Pierce - *Credit Suisse - Analyst*

Thank you. Can I just follow up on the RWA question actually? There's clearly a lot of moving parts here, and I guess in the second half you'll still see some Irish pro cyclicality, some capital relief trades rolling off. Can you give us a feel for where the second half RWA number could move?

Bruce Van Saun - *Royal Bank of Scotland - Chief Financial Officer*

I think by the end of the year, broadly stable would be what I would say.

Jonathan Pierce - *Credit Suisse - Analyst*

Broadly flat, okay.

And the second part of the question is again looking for some guidance this time on the tax charge if possible. It's obviously quite big in the second quarter of the year, and there's obviously a lot of lumpy items in there. Can you help us out on the dynamic between any potential further DTA write-downs, but in particular the losses in lower tax subsidiaries versus profits elsewhere? Could the £800 million go up on a quarterly basis from where we are?

Bruce Van Saun - *Royal Bank of Scotland - Chief Financial Officer*

Well, I think we've spotlighted about £300 million of that was more one time in nature, so there was some impairment of Irish DTAs, and then there were some non-deductible items for tax associated with some of the disposals. So that really… that was the one time in nature. Having said that, we've tried to detail… we do have losses in Ireland, and we have losses in the NV where we're not assuming the tax benefit on those losses. And then where we're making money, either in the UK or the US, the tax rates are higher, so there's kind of an adverse mix shift.

I think on the Irish situation, there's not a lot we can do. We just have to kind of wait that one out, so there's no structural solutions there.

With respect to the NV, ultimately I think there's some structural fixes to move more business back into the Plc into the UK, which will shrink the loss there that we're not taking a tax deduction on. So that's more of a kind of business mix and structuring issue which we're working towards.

Jonathan Pierce - *Credit Suisse - Analyst*

Okay. So all in, if we take the £800 million and knock the £300 million off the £500 million, should we be assuming that sort of run rate per quarter?

Bruce Van Saun - *Royal Bank of Scotland - Chief Financial Officer*

It's hard to give you an effective tax rate because it depends on where the income is and what the mix of where that is, so I think it's going to be a hard number to actually put into your models and forecast. And you can come back to Richard and we can kind of try and show you the parameters around that, but you're going to have to look at different scenarios of income levels and how that income is distributed across the legal entities of the Group.

Philip Hampton - *Royal Bank of Scotland - Chairman*

Any more questions. Right in the middle. Sorry, I beg your pardon.

Bruce Packard - *Seymour Pierce - Analyst*

Yes, Bruce Packard at Seymour Pierce. Yes, I understand what you're saying about GBM that you're not going to close it down, but it does strike me that it makes your job much, much harder, and you could do something like spin it off, because even today we've got Sky interviewing drunken traders, who I'm sure you're going to tell me don't work at Royal Bank of Scotland, but it just strikes me that it makes your job much harder. And everyone says, oh, well, there are lots of management synergies, but it's very hard to see from outside. So maybe your thoughts on that, perhaps.

Stephen Hester - *Royal Bank of Scotland - Group Chief Executive*

Well, you've got to be a little bit careful about some of these things. I appreciate you're hunting for some IPO fees, and I'm sure you have good credentials should we float it, but you know, I could wish we didn't have Ireland; I could wish we didn't have Commercial Real Estate in the UK; I could wish we didn't have SBO in the US. I mean, there's not one of our businesses that I couldn't wish… you know, that hasn't given us headaches through the crisis and shouldn't have been managed better with hindsight.

But we went through an extremely careful strategic planning process in deciding what our best recovery plan was. We do it every year. We've just done it again a year later looking at every option, whether the disposals, spin-offs, restructuring, prospects for the business, and our plan represents the best route for our three constituents, namely customers, people who care about our safety and security, and shareholders, through the obstacles and realities of business that we face. And we continue to believe, picking the specifics of GBM, that the Investment Banking business, A, has very powerful things that it does for customers, including customers across the Group. You know, it's very interesting some of the political noise about it, but I can tell you, governments wouldn't finance their deficit without investment banks; analysts wouldn't have a job because there wouldn't be a stock market without investment banks; companies wouldn't access the bond market without investment banks; schools and hospitals wouldn't be built without investment banks; securitizing PFI programs and farmers wouldn't hedge their EU support payments without investment banks. So there is a whole set of socially useful activity that is completely ignored which is synergistic across universal banks, which is why pretty much every investment bank in the world is a universal bank model, with the exception primarily of Goldman, and a positive business case that can be made if you manage them well for diversification and return on income within context.

So there is a whole series of those issues. Then, of course, there is also the negative that it is true that all big groups have a diversifier. Now the other way of saying a diversifier is that any bit of a big group standing along loses some synergies, whether they be business synergies or credit rating synergies, which represents a destruction of value. And so all of these things, one's optimizing the positive case and the negative case in coming up with the strategic solutions. I think it is the case that the thrust of regulation over, let's say, a ten-year period, will be to make more feasible separation of different parts of banks than is today, but I think that will be a very, very multi-year exercise and will still leave you assessing what the profitability and return and diversifier, whether in terms of business line or in geography or growth and synergies will be.

So what we're clear about is our current plans are the best way through what we see today as the issues, and that's our job.

Philip Hampton - *Royal Bank of Scotland - Chairman*

I think Stephen's off the fence on that issue, as it happens. A couple more questions, because I think the beach can be smelt by some people in the room. Hand over there.

Aaron Ibbotson - *Goldman Sachs - Analyst*

Yes, hi there. Aaron Ibbotson from Goldman Sachs. So just a very quick question actually on your transfer of developer book in Ireland into the Non-Core, and I basically want to know if… I think you answered the question in the first quarter as well; if this is the last book being transferred, or meaningful book being transferred from Core to Non-Core, because I guess in order for us to view this Non-Core division as a NAV adjuster, as you said, Stephen, it's good to know if it's going to continue to have the problematic books being transferred into it.

Stephen Hester - *Royal Bank of Scotland - Group Chief Executive*

There's nothing else in our sight.

Bruce Van Saun - *Royal Bank of Scotland - Chief Financial Officer*

And there's very strict governance around making those kinds of moves, and this basically was a strategy change that was endorsed by the Board when we had our board meeting in Ireland in May, so this was not taken lightly.

Aaron Ibbotson - *Goldman Sachs - Analyst*

Okay. Can I just very quickly then ask a follow-up on the strategy in Ireland then? Because it strikes me as potentially difficult to run a corporate bank in Ireland if you're not doing any development lending. I'm sure there's nothing happening there now, but maybe in the future, so I was just thinking if you are reconsidering your sort of corporate presence in Ireland.

Bruce Van Saun - *Royal Bank of Scotland - Chief Financial Officer*

Well, the corporates who want to put up a new headquarters building, or when we're backing our corporate customers in terms of property related investments, we're not saying we won't do that, I think what we're saying is that what we won't do is back developers going out in green fields projects and speculative if-you-build-it-they-will-come type projects. So to be clear, it's the speculative element of development that we're exiting.

Aaron Ibbotson - *Goldman Sachs - Analyst*

Okay, thank you.

Philip Hampton - *Royal Bank of Scotland - Chairman*

Okay. There's a presumably Irish gentleman there with a green tie.

Leigh Goodwin, Citibank

Certainly I don't have the luck of the Irish in getting a question in. Actually, I have two, if I may, quite separate ones. One is on the US business, because you haven't really talked about that very much. And it seems to be taking a lot longer to turn that business round than the UK.

And I wonder if you can just talk through just how long is it going to take before we see a decent ROE in that business, and what does it need. I mean, we've still got a cost to income ratio I think 65%, and that's with a pension credit benefit, and ROE of 6%. It's sort of not really moving forward very quickly. I was just wondering what it takes really.

And the second question is on GBM and just the outlook and what you've seen so far in the second half, please.

Stephen Hester - *Royal Bank of Scotland - Group Chief Executive*

Well, as I said on GBM, all I can say is July was consistent with what we saw in the second quarter. You know, what August and September is we'll find out.

On the US two things to say. Actually, probably the most successful bit of GBM right now is in fact our US. There's a big bit of US activity in GBM which has done extremely well and continues to do extremely well.

With respect to Citizens specifically, which is I think was what you were meaning, you know, we are actually ahead of our own published strategic plan in terms of the timing of turning Citizens around. However, what is absolutely true is that the US environment is not allowing any balance sheet growth. In fact, the lack of demand for credit is, if anything, more severe than in the UK. If you look at the aggregate credit statistics in the US, bank balance sheets are shrinking faster than in the UK, and so that inhibits the ability to put on assets and also the ability to widen spreads which… I think because there's the same deposit liability and other sorts of issues. And unlike the UK where the credit markets were given a big boost in the United States and securitization and so on by the Fed actually supporting the credit markets in its quantitative easing program and allowing, you know, the mortgage market to be alive and so and so forth, the UK only bought gilts, and so the credit markets were left to their own devices here in the UK and therefore there hasn't been, if you like, that active securitization activity which meant that mortgages stay on balance sheets in the UK as opposed to being securitized. And because of the housing squeeze, that has been a source of accelerated improvement in the UK.

So it's those sorts of things, but I think Citizens is certainly not performing out of line with the comparable units of US regional banks. And you're absolutely right, what happens in the economy and then the paying off our own efforts still have a good way to go before we get to a satisfactory position. But as of now, all I can say is that we're on the target that we thought we'd be on.

Bruce Van Saun - *Royal Bank of Scotland - Chief Financial Officer*

And I'd add to that we are making significant investments in the business, both in terms of developing new products and better approaches to cross-selling, and we're starting to see some of that trickle through in non-interest income, but those results should start to build over time. We have significant investments in efficiency and so we'll also start to see that benefit the cost to income ratio. And then lastly, as Stephen indicated, the cyclical recovery in the US, when interest rates, when the economy starts to get healthier and interest rates rise, they have a very structural asset-sensitive position because their loan to deposit ratio is only 80%, so they have… they'll really get a pop on their NIM once rates start to rise.

Philip Hampton - *Royal Bank of Scotland - Chairman*

Any more questions? They will now need to be very good ones.

Rothith Chandra-Rajan - *Barclays Capital Analyst*

No pressure.

Rothith Chandra-Rajan - *Barclays Capital Analyst*

Yes. No pressure at all. I just wondered if I could get a better handle on the Non-Core run-off, so third party assets down £28 billion in the first half; a bunch of deals already agreed for the second half; you mentioned potentially proceeding ahead of plan for the full year. Is that just bringing forward plans that you would have had for execution in '11 and '12, or does it reduce the 2013 rump? So does it accelerate the whole plan, or is it just a timing issue?

Bruce Van Saun - *Royal Bank of Scotland - Chief Financial Officer*

It's more of an acceleration. So that's a… I think there's sufficient interest in the market, and we have a good handle on the portfolios and ways to accelerate some of these positions, and so it boils down to a question as to what's the liquidity discount you'd need to trade those assets today versus what you think that would be further down the road. And so far, at this point, we think there's reasonable interest at reasonable liquidity discounts, so we're working hard on bringing some of those transactions through.

Rothith Chandra-Rajan - *Barclays Capital Analyst*
And is that… so better on timing. Is pricing also then better than you might originally have anticipated in the plan?

Bruce Van Saun - *Royal Bank of Scotland - Chief Financial Officer*

You know, it depends. I guess you have to look at that asset class by asset class. I think so far, we've probably held our own, but again, the kind of… the view of risk appetite is kind of a jagged tooth scenario where sometimes things feel a little better than they really are, and then things feel a little worse than they really are, so we have to kind of trade through that in terms of sentiment and the impact on buyers' appetite to… sometimes they're interested but they won't do anything at all if the world feels really bad, and then if sentiment improves, they come back in.

And so I'd say I wouldn't give too much certainty that other than… I think we want to certainly lay the notion out there that there is a pretty good pipeline now. It does appear that risk appetite has improved post the CEBS stress test, and you know, we'll see where we go from there.

Philip Hampton - *Royal Bank of Scotland - Chairman*

One more brilliant question, or are we done? I actually think that was a great series of questions, so at the very least, you all understand what's going on here, so thank you all very much for coming, and have a great time on the beach.
