



## **Announcement on the APS and State Aid Discussions**

### **ANALYST AUDIOCALL**

Tuesday 3rd November 2009

#### **Presenters**

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

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

**Stephen Hester:** Good morning everyone, thank you very much for joining us this morning, I'm very appreciative that a) that it's short notice and b) that you have a lot to digest, both from us and of course from Lloyds this morning.

I'm pleased to welcome to this call for the first time for you, Bruce Van Saun our new Finance Director; as you can imagine, he's bought into slightly more than he bargained for, having joined us just a month ago, but he's been an invaluable help in recent weeks and I am confident that that will continue, and you'll hear from him shortly.

As we normally do on these occasions, we plan to go through the highlights, both myself and Bruce, of what has been announced today. In some respects and no doubt frustrating for some of you, there is, in effect, a two-step series of announcements this week, which is to say that we have to coordinate with Lloyds and with the Government in making the

announcements on APS and EU today; our Third Quarter results will be out on Friday and it will not therefore be until Friday, that some of the detail around the assets under APS and other financial things to do with RBS can be announced, so today, we are going to have to stick to the major principles of what have been announced and now Friday we will try and feed you more detail, particularly in the light of feedback from you in the next couple of days.

Let me start with the principle issues, changes and things that we've announced today; Bruce will follow on with the financial dimensions.

I think the most important thing to say is that back in February, when we were figuring out how to recover from the collapse of RBS, how to make the institution vibrant again; it was very clear that we needed the support of APS in order to accomplish our goals. That support was given by the Government; it was on the basis of that, that we were able to move forward productively and we are, therefore, very pleased that the finalisation of that process with today's announcements and in the coming days following through on the detail, is the last major building block for our recovery plan. It is an essential major building block. We now have the tools to do the job and it's our job to get on with just that. All the rest in the end is detail. We now have the tools to do the job and that's what we're going to get on with.

We are very clear what that job is. That job is first and foremost to restore RBS to financial strength and stability on a stand alone basis, such that we are safe for the economies we operate in. We can support our customers well. The second aspect is indeed to use our strength to support our customers well. The third aspect is to rebuild value for all shareholders and within that to create the conditions where the State support can be profitably repaid and taxpayers exit from their support of RBS successfully. That is what we are focussed on; those three goals today, while in some respects making our job more difficult, is an essential way of moving forward to prosecute those goals, which is what we're doing.

Let me, nevertheless, now take you through some of the moving parts of today's announcements. There are in essence, two elements of the announcement: the final terms on the Asset Protection Scheme with the

Government and the Heads of Terms with the European Union in respect of State support.

The Asset Protection Scheme has always had two requirements from our perspective. That is to say, in the unlikely event of a renewed severe stress hitting us, we have to be able to pass the FSA's stress tests. While we believe that the chances of that event have materially reduced, our requirement to pass the stress test has not materially changed from that requirement that was set out in February. Therefore, the insurance element of the scheme remains by far the cheapest and in fact only available route, to pass those stress tests.

Secondly, because of the losses we make this year and expect to make next year and the associated increase in risk weighted assets from pro-cyclicality, we have a significant hole in our capital ratios for the planned event, which needs to be filled with permanent new capital and that was always the second part of APS.

As we have said in our statement today, we believe the chance of a stress case to be receding. We believe that there is increased stability in our base case; our projections of the base case in terms of impairments are plateauing, have not got any worse since we published our Half Year results in August. As to whether they will get better if the world continues its current trajectory, that's entirely possible, but for now we see at least a plateau.

As a result of market improvements since February and as a result of the actions that we have been able to successfully take ourselves, APS has been able to be restructured into a lighter touch scheme, both to the benefit of the Government and, we believe, RBS. The scheme size has been able to be reduced from £325 billion to pro forma £280bn, but in fact to around 240 billion, because since the beginning of the year, we have been able to achieve exits from a whole range of assets, which means that as of the end of September, it's more like £240 billion that is covered and again we'll give all those details on Friday.

In addition to insuring less assets, the first loss has increased materially to £60 billion from £40 and those two things mean that we do not expect, except in a stress case, to call on this policy to claim losses under it.

Offsetting the loss of base case protection, the fees have substantially reduced and we now have an annual fee - Bruce will go over the specifics shortly - and we get to keep our deferred tax assets.

We see that in the base case, as a neutral-to-positive for RBS outcome; in other words the losses that will no longer be covered are more than offset by the benefits in the fee and deferred tax arrangements. So in that sense, the lighter touch we believe, works both to the benefit of the Government and to the benefit of RBS and its shareholders.

The second aspect of APS is the ability to cancel the policy at any stage, which is now made possible, given we don't expect to claim under it in the base case; and we believe that a series of things around today's announcements brings forward that possibility; in some respects we're thinking of this as a two-step and your free process. Step one, is to move from a heavy touch to a light touch APS today. Step two, will be the cancellation altogether of APS, which if things go according to our plans, we hope to do within the timeframe of our current 5-year strategic plan, of which there are just over four years left.

Associated with APS is the B-share issuance. As you will see, one of the consequences of restructuring APS to a lighter touch outcome is that we are needing to draw down the full amount set aside in February of B-shares as opposed to just the £20 billion that we were previously anticipating. The reason for that is the new APS has less capital relief associated with it and that requires therefore more capital in another form upfront. However, once the rundown of our non-core division is accomplished over the coming years, that permanent capital should improve our capital surplus, bringing forward on its own the ability to exit APS altogether. Obviously that and any other capital surplus we have will be deployed to the benefit of shareholders to minimise dilution, if and when we have that flexibility and surplus.

That is in essence the change in APS which crudely means that shareholders will benefit now directly from any improvements in operating performance and impairment performance at RBS relative to our base case, which previously would have been taken by the Government in terms of reducing the amount of claims under the policy. Similarly, if things get a bit worse, our shareholders are exposed to that, but we still continue to have a large and adequate umbrella over us in the stress case. The one element I should mention is there is additionally some

contingent capital which is necessary because of the higher first loss for the stress case only.

The second aspect of today's announcement relates to the European Union and let me possibly divide that into two components. There has always been - as the European Union's obvious duty as a competition authority makes clear - a desire for us to reduce market share in our core UK market, in particular the one we have the biggest share in, which is our business banking. Always on the table, we put it on the table ourselves, back in July, has been the idea of a divestment in the UK. For working purposes we are describing it as a Williams & Glyn divestment and it represents all the RBS branches outside Scotland i.e. in England and Wales and the NatWest branches in Scotland, plus some other direct business customer contact centres and relationships. That represents roughly 5% of our small and mid corporate business, 2% of our retail business; Bruce will give the financial dimensions later in this call.

While divesting it will create uncertainties for our staff and our customers and an extra set of execution for us to get done, we completely understand and indeed support the competition policy objectives behind this and we believe that we will be able to compete successfully, notwithstanding the divestment over time.

In addition to that, which was always on the table, much more recently has come a hard push from the EU for a range of other disposals which come into the deterrent category for companies taking State aid as opposed to in the reduction of competition, and in fact those disposals net-net make our job more difficult to recover stability and get value for the taxpayer and all shareholders, but nevertheless are a necessary part of reaching agreement with the EU. In that sense we have tried hard to come up with something that allows us the opportunity to preserve shareholder value as much as possible, and as we all know shareholder value in part derives from our capital position and in part from the profitability which flows from our businesses.

The principle item in the second list is our insurance businesses which as everyone knows, in a sense, was always a matter of price rather than principle for me. We took them off the market in January on price grounds. They were part of our core plans, but we will be forced to divest them. However, I believe they can be successfully managed without the

uncertainty damaging them. We have four years with a year additional buffer to make all our disposals and I think that we have the very good prospect of being able to do insurance on an attractive basis for shareholders, thereby creating capital resources with which we will obviously try to deploy to minimise dilution.

At the moment it feels like the best outcome for insurance would be a flotation in the later years of our plan, though of course we will remain open to any superior alternatives. The other two divestitures are Global Merchant Services and within the investment bank, the joint venture with Sempra we have in commodities. These are smaller; we will do them faster. They are good businesses which we would rather not be divesting, but we believe that they are not integral to the future of RBS and therefore represent a compromise that is appropriate for all parties.

There are other details of the EU position which is set out in our press release and I won't cover now.

When we put all of those things together, I believe that this is a major staging point of our recovery. It gives us the tools to do the job. We should now have the resources in both the base case and the stress case to execute our recovery plan successfully to make RBS safe again, to serve our customers and to rebuild our profitability from which shareholder value will derive. We will do our utmost to minimise dilution – in particular, once we get through the next couple of years of maximum uncertainty, if we then have capital surpluses we will target exiting APS early and then behaving in the most shareholder friendly way we can devise at that time; but of course that is for another day.

We are very conscious of our responsibilities to repay the support we've got. We are very conscious that we can only do that if we behave in an unambiguously commercial way in the interests of all shareholders. We are doing that and we intend to continue doing that, albeit with a great sense of responsibility to the communities we serve. Let me stop there and ask Bruce to take you through some of the specifics and then we'll open the Q&A.

**Bruce Van Saun:** Let me direct a few comments towards the appendices in today's announcement. If you turn with me to Appendix 1, I'll start on Schedule 1; here we show some of the moving parts from the original APS

to the revised APS. The capital injection has increased from £19.5 to £25.5 billion and the contingent capital reserve has increased from £6 billion to £8 billion. That contingent capital is triggered when our Core Tier 1 ratio falls below 5% which we find we probably won't need to draw on, certainly not in the base case, and maybe in the stress case. The fee on that contingent capital is 4% per annum.

The insurance cover overall originally was set up at £325 billion; it's been reduced through a process of negotiation. There are some excluded assets so the covered pool is now £282 billion; Stephen indicated in his remarks that number has basically rolled down to about £240 billion as of September 30<sup>th</sup>. The RWA relief that exists under the original APS was about £150 billion; that's now about £140 billion. However, you see the next line, the first loss is £42 billion original, up to £60 billion today. Effectively, this policy is now more of a catastrophe insurance policy, where we wouldn't expect to have to make claims under the policy in our base scenario. The impact on our RWA release is that under the original policy, since it was a lower first loss deduction, there was more benefit the way the securitisation formula works to our capital and that gap increases over time; so there is less overall RWA release under the securitisation scheme but there is still a sum in the base case.

Overall, the fees have been reduced dramatically; it was 6.5 billion out of the original APS. It's now £700 million per annum from 2009 to 2011; it's 500 million thereafter. In addition, under original APS we had a 5.2 billion historical DTA balance at 12/31/08 that we had to give up, plus DTAs incurred on future tax losses in 2009 and 2010, based on projected losses. In the new APS we get to keep those; those form part of our capital base.

Termination rights, under the old APS, were very limited. One of the advantages of the new APS is that we can exit the coverage at any time, provided that we meet the FSA framework. The exit fees now are set; they are 2.5 billion less any fees that we paid on a cumulative basis through the point of exit. Importantly, I guess the bottom line here is that under both the original and now under the current APS that we do satisfy the FSA stress test for the next five years at a 5% Core Tier 1 ratio.

If you look down at the key messages at the bottom of the page, I'd say the key differences of the paradigms are that we are exposed under

revised APS to greater losses from credit risk through the higher first loss deduction; and we also end up with the lower capital benefit under the revised APS compared with our 8% Core Tier 1 target and as I mentioned this gap increases over time based on the way the securitisation formula works, because the capital deductions reduce faster under a low deductible policy.

Offsetting these impacts is the fact that our capital base is bigger due to lower fees, the retention of the deferred tax assets, the greater issuance of the B-shares to HMT and a bigger contingent capital line. Our own modelling suggests that in the base case our expected losses will be less than the first loss provision and we will not make claims under the policy. We would expect to exit the coverage within the 5-year time period of our Strategic Plan; how soon depends on the pace of economic recovery.

If you'll turn to Schedule 2 in Appendix 1, the pro forma capital effect as of June 30<sup>th</sup> indicates that our Core Tier 1 increases from 6.4% to 12.5%; our Tier 1 one increases from 9% to 16% and our total capital increases from 11.7% to 18.2% - these numbers are reflective at June 30<sup>th</sup>. On average we pick up about 6 to 7 percentage points across these ratios.

What we've done is in effect we've over capitalised our start point so we can absorb the flow through of non-core legacy credit costs over the next few Quarters. We remain comfortable with a targeted Core Tier 1 ratio of 8% throughout the 5-year planning horizon and we're confident that we will continue to meet the requirements of the FSA stress tests. We are satisfied that these arrangements give us a solid foundation upon which to exercise our capital plan, our strategic plan.

Let's move on and we will hit the highlights of Appendix 2. In Appendix 2 we identify the approximate scale of the businesses to be divested; please note that we have four years to divest these businesses with a one year buffer and we believe that gives us adequate flexibility to maximise value. The Williams & Glyn business is roughly £20 billion in assets, £18 billion of RWAs and £1 billion in capital. We anticipate that a sales process for this asset will be strong and that there'll be a reasonable level of buyer interest. The Global Merchant Services business is readily separable from our Global Transaction Services business, which will continue to be a top five global player in cash transaction processing.

The GMS business has £552 million in revenue and £276 million in pre-tax

profit. We expect strong buyer interest in the business; however, we will explore various possibilities, including JVs where we retain an equity stake. We expect that any strategic transaction will be accretive to our capital base.

The insurance business is a discrete segment within our core business activities and as such it is also readily separable from the Group. Our expectation is that we will be deliberate in evaluating alternatives for this business. It may be that an IPO and a spin-off in a couple of years' time is a sensible strategy. The business dimensions are £4.4 billion in '08 revenues, £584 million in operating profit and about £4 billion of capital of which about £1 billion is goodwill.

The RBS commodities JV with Sempra, had '08 revenue of £765 million, operating profit after minority interests of £209 million and RWAs of about £11 billion. This is a relatively new business for GBM which provided an opportunity for GBM to expand its product activities to commodities. The way to look at this is that the divestiture is just an opportunity cost for us, while the GBM core franchise remains strong and intact.

The total divestitures aggregate to roughly £1.1 billion in operating profit for 2008 with RWAs of about £30 billion at June 30<sup>th</sup>. There may be some dilution to earnings depending on ultimate exit strategies and how we deploy capital, but clearly our capital will benefit and overall we expect the impact to be manageable. With that let me turn it back to Stephen.

**Stephen Hester:** We are, of course, painfully aware that with this announcement there are some issues around dilution in terms of additional B-shares and in terms of business sales and that we have a very strong starting capital base in exchange for that. In addition to the expected losses to absorb, we've tried to make a conservative provision for other things that might hit us, such as current account charge settlements, such as significant risk weighted assets increased through procyclicality and some other issues associated with the integration of ABN and the change from Basel I to Basel II, that that will imply in our RWA calculation. However, notwithstanding all of that, we do hope and believe that capital surpluses will arise over our planning horizon, as I said before, both to apply to early exit from APS and then to devising other ways to make that benefit available to shareholders.

However, we have to get there first; we need the stability from which the rest of our plan will flow and as I said, that is the really important bit about today's announcement. We have the tools to do the job; we're going to get on and do it. Thank you very much for listening and we're now happy to take questions with of course the caveat that you'll get a second bite of the cherry on Friday.

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

**Robin Down:** A quick question on the disposal programme; I appreciate you might be limited in terms of what you can actually say at this point. I can see what you're saying about the insurance business – you might IPO that - but I was just wondering what restrictions there might be on disposing of the businesses because the press will certainly speculate a lot that you would be heavily restricted in terms of who you could sell the businesses to i.e. you couldn't sell them to any existing UK banking player. I was just wondering whether that was actually case, whether you have been told by the Government or the EU that there are certain parties that you couldn't dispose of these businesses to?

**Stephen Hester:** Obviously most of our disposals have got nothing whatsoever to do with increasing competition, in fact they will reduce competition and so the restrictions don't apply to most of them. With respect to Williams & Glyn, that's the only place where there is a restriction on buyer identity and I believe that is a common restriction to companies in a similar position with the EU, and common for example for Lloyds as well and that is to say that there is a pro forma market share cap of 14% on the combination of Williams & Glyn plus whoever the buyer is, which has the effect of removing the biggest people already in the market.

**Robin Down:** On the Williams & Glyn business, have you got any ball park indications of revenues, costs and profits, or is it too early?

**Stephen Hester:** I think we are nervous about giving them because this thing doesn't exist today and has got to be carved out. I think what I could say is that today it is little more than breakeven, reflecting where our SME and

retail business is and so in that sense, there is no dilution today, there is actually earnings enhancement from selling it although clearly during our plan period we would expect to return to good profitability in that as in other businesses.

**Operator:** The next question comes from Ian Gordon from BNP Paribas; please go ahead.

**Ian Gordon:** I've just got three areas; the first one is probably straightforward. On B-shares, can you just reconfirm the policy in terms of coupon payment or perhaps coupon non-payment?

**Stephen Hester:** There is no payment for two years on the B-shares; thereafter the payment is entirely in the gift of the Board, just as ordinary dividends are. However, there is a formula that would suggest that if we make payments under it, we would pay 7%, or the formula that was previously there in relation to if we had resumed other ordinary dividends. However, the enhanced dividend – the 7% or the formula – falls away when our share price hits 65p. In a perfect world our share price will hit 65p within two years and we will never pay dividends on them but we will see whether the world is that perfect or not.

**Ian Gordon:** The second point, you mentioned in your opening remarks in relation to Sempra and the other non-UK businesses that the disposal timetable might be quicker. Just to clarify, my understanding is that you do have the full 4-year timeline, so you're under no pressure to carry out a fire sale. To broaden that question, I appreciate it's hard to see certainty in anything nowadays – do you think there is any material scope for the disposal requirements to be renegotiated over the course of four years, especially if you exit APS early and especially if your overall level of State support seems to have reduced materially?

**Stephen Hester:** I believe there is no prospect of lightening the load on disposals; in the eyes of the EU - not inaccurately - we are the biggest recipient of State aid and must pay the price for that. However, we do, as you mentioned, technically have five years, four years under our own steam and one more year if we should fail to do it under our own steam and so I think that there is more than a reasonable prospect with that amount of flexibility that we can get proper value for shareholders from these disposals. I wish we didn't have to get rid of the earnings, or have the

extra uncertainty and execution risk on top of the heavy diet, but we do and so we'll get on with it.

**Ian Gordon:** Finally can you just make a few comments around the science around establishing the 60 billion ceiling for the first loss? Is it fair to say that this is based on a reasonable assessment of the likely outcome in a base case view or...?

**Stephen Hester:** No, I think it's fair to say that it was a horse trade.

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

**Mike Trippitt:** I have just two questions; on your outlook in terms of credit impairments, the front and centre you're saying now that you believe they may be plateauing. I just wondered if you could talk a little bit more about that because that is a slightly more positive outlook than you've had in the past. Secondly, on the B-shares, I appreciate that 25 billion was the amount originally announced in February, but given the change in the whole terms here, I just wondered again if you could explain why 25 billion is the right figure and how you've arrived at the 25 billion, given the change of terms of gaps overall.

**Stephen Hester:** Obviously we will be able to answer more detailed questions on provisions on Friday when you can see our NPLs and our actual charge in the Third Quarter and so on. I'm afraid I can't give you as full an answer we will be able to give you on Friday, but what you will see on Friday, both from our actual results and from our outlook discussion, is that at the moment we are not seeing the rate of provisions in the first half as a whole being exceeded. While we remain cautious in terms of predicting when they will start materially coming down, we are at least optimistic enough to talk about a plateau. If the current progress in the world economy - and in particular things like real estate markets - continues, I would have thought that it's on watch for a positive upgrade, but probably not for some months.

With respect to the B-share issuance, as I mentioned what we have needed to do is to take cautious account of the reduction in Core Tier 1 ratio this year. The expected reduction next year from operating losses and RWA cyclicalities and other things that are likely to hit our capital base,

which I enumerated a couple; quite simply the difference between the 19.5 billion that we were originally expecting to draw and the 25.5 - although that was always provided for - is on its own accounted for by the lighter capital relief from the restructured APS, so it gets us back to the same place that we would otherwise have been in. However, as I also mentioned, once non-core is run down, that permanent capital then gives us a bigger surplus than we would have had under the previous APS, which in turn brings forward the ability to exit APS earlier and any other shareholder friendly measures such as dividend resumption et cetera that may flow thereafter.

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

**Manus Costello:** I have a couple of questions please; firstly, in the statement you keep open the prospect that you may issue additional equity in place of the B-shares. I wondered if you could give us an idea of timing of when you make a decision on that and what the considerations are for you in terms of whether to issue equity versus the B-shares. Secondly I wondered if you could go through in a bit more detail exactly how the capital implications as per Appendix 1, part 2 of the way you're treating things now. It seems that you're deducting the whole of the contingent capital fee upfront and it also looks like the whole of the reduction, the potential exit fee is being deducted as well. I wondered if you could just explain that in more detail.

**Stephen Hester:** There are some complexities around the accounting for the insurance policy, but let me ask Bruce to do those in a second. In answer to your first question, of course we have absolutely no desire to turn to the Government for the equity that we need. We would be keen to start the process of reversing Government ownership in RBS and I think the Government would be keen for that and therefore our plan is to assess the reaction to our revised APS and EU terms to assess the reaction to our Third Quarter results, to assess stock market conditions generally in determining whether there is an opportunity to raise any of the £25.5 billion, or substitute some of it for some privately raised capital. I would think in the coming handful of weeks we will make that assessment. Aside from our natural desire to reduce the Government interest in RBS, obviously the other driving factor is price and dilution and those are the

things that we'll be weighing up of course together with UKFI in whose gift the decision also lies.

**Manus Costello:** There's nothing in terms of the EU decisions which could change based on equity issuance?

**Stephen Hester:** I think it's important to say that although clearly I'm not privy to exactly how the EU arrives at their solutions, it was far from obvious that the EU solution was in any way mathematically linked to the arrangements that we have with the Government. Under any version of the arrangements we had with the Government, we would have been the biggest recipient of State aid and I think in a sense it ended up being quite binary of that position, as opposed to the precise amount of State aid. Let me ask Bruce to take you through the capital schedule which, as you quite rightly mentioned, has been a bit complicated by having to account for the insurance contract as a derivative, but Bruce will explain that.

**Bruce Van Saun:** If you look at the Schedule 2 in Appendix 1 and you see the CDS value being a deduct of 2.5, effectively under our base case we don't have any payments coming in under the insurance contract and we would have our fees as outflows and we would expect to terminate it over the next five years. What we have to reflect is a Day 1 profit - it is really a cost - is the amount of that termination fee; that comes out similarly with the contingent capital fee. Under the base case we don't expect to have to draw any contingent capital, but we are paying a 4% fee on £8 billion, which is £320 per year, times 5 is £1.6 billion; so we're also deducting that from capital as well.

**Stephen Hester:** Just to be clear, the reason for that is that when we first talked about APS in February we were thinking of it in what I'll call banking book terms; in other words as an insurance policy that protected assets, but didn't change the accounting treatment. The Government has subsequently required a form of contract that means technically the insurance contract is accounted for as a derivative and therefore PVs expected cash flows, which was not the case in the original design of APS. You get to the same place eventually, but it does reduce the capital relief upfront.

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

**Robert Law:** Can I just explore the commentary made about the first loss piece change and the fee change being broadly awash. The original fee was roughly £16.5 billion if you aggregate up the paper B-share fee plus the tax write-offs or the tax give up. If you terminate the APS now within five years, I think that gives you a total fee of something like £2.9 billion. Is your base case essentially that the credit impairments you're likely to make now will be essentially some £13 billion higher than the original first loss piece?

**Stephen Hester:** No, Robert, what I said was that I expected us to be beneficiaries of this result. I expected that the base case losses would be less than the benefit to us of the fee change. Clearly how much less than depends on whether we've plateaued, or whether the plateau starts sloping downwards earlier than we thought et cetera, but in that sense there should be no worries from your community that somehow the movement in expected loss and all these other things signal that there's something worse under the covers than you were previously thinking.

**Robert Law:** Is your base case that you would have triggered the first loss piece under the original scheme?

**Stephen Hester:** Yes, we were always ... and in fact I think I said earlier in the year that we did expect to be well into that in our base case, probably roughly to the tune of the DTA values, but I'm very hesitant to get precise about this because we're speculating about the unknowable throughout this in terms of future impairments. What I would say is that impairments over the last six months of this year have been quite closely in line with our expectations, which on the one hand is a good thing - they are not getting worse than our expectations - but on the other hand are not yet getting better even though we think that the downside variability is getting better.

**Operator:** The next question comes from Sandy Chen from Panmure Gordon; please go ahead.

**Sandy Chen:** Just two quick questions; one on the deferred tax asset. Obviously it's quite good that you're not having to give that up, but I just wanted to make sure that my thinking on the maths might be correct, which is that if you've got about £5 billion of deferred tax asset existing and the Treasury in its statement was saying that they expected roughly

£9 to £11 billion of deferred tax assets over a 5-year period. Working that backwards or forwards, would that imply roughly about £16-18 billion of operating losses before tax over the next two or three years?

**Stephen Hester:** As you will recall, we were the ones that put out the £9-£11 forecast earlier in the year and it is unengineerable in the sense that you don't know where our losses within our group are going to occur and therefore I don't think you can reach any inference. We are not trying to signal worse impairment expectations than are currently out in the market, but we have consistently signalled the expectation of being loss making overall next year; profitable in core and unprofitable in non-core.

**Sandy Chen:** Understood; the second question that I had was just in terms of the ban on cash based compensation - at least for the 2009 performance; would that imply that there might a shift to share-based compensation and if there is, what's your estimate in terms of the scale and the timing of that?

**Stephen Hester:** We are required, as part of the FSA's new rules on compensation, to introduce a substantial element of stock-based compensation in replacement of cash-based compensation and so we will be doing that. It is way too premature to have any idea as to quantum. We have to see how we do this year and what the market as a whole is, but there will indeed be increased share issuance in that way. Obviously in normal times we would expect to neutralise stock issuance to employees in the market. Probably this year and next we wouldn't do that because the FSA will force us to increase capital ratios and indeed other banks, but in normal times we would expect that to be neutralised.

**Operator:** The next question comes from Laurent Rossouw from JP Morgan; please go ahead.

**Laurent Rossouw:** I have a question on the insurance business and I was wondering why the IPO was planned in the later years of the strategic plan when you've said that it is a discrete entity that can readily be separated.

**Stephen Hester:** Simply we believe that the profits and the quality of those profits will be materially better, as you will see in more detail when we talk about our Third Quarter results on Friday, the profits of this business are (a) being hit by lower investment income due to the recession and (b) by

some significant short term problems around bodily injury claims. Over and above those two deteriorations we have the belief that we can improve the profitability, manage the business better and reduce its costs.

Since we are in the business of maximising shareholder value, we would like to realise it off the best profit base possible and unlike some of our other businesses, because this business can't be sold to an in-market competitor, there isn't anyone that could buy it in market, the uncertainty of waiting in terms of staff, uncertainty of the jobs and customer uncertainty is not a particular penalty, whereas it is for other businesses. Putting all that together means we want to be profit maximisers on this business and we think we can by waiting, but that is not to rule out earlier solutions, but we demonstrated pretty comprehensively in January of this year that selling today was not a profit maximising outlook.

**Operator:** Next question comes from Jonathan Pierce from Credit Suisse; please go ahead.

**Jonathan Pierce:** I've got a few actually: the first is on why, with a 12.5% equity Tier 1 starting base, there is the need to have a billion of contingent capital on a 5% equity Tier 1 breach. You talked a little bit about the APS assets although I'm still surprised that you think you could exceed a £40 billion first loss piece even on the stressed scenario. It might be interesting just to hear your thoughts a little bit further on of what it is that worries you in particular within the APS pool, but I'm also interested in what you're assumptions are around some of the other potential hits to equity Tier 1, in particular the current account settlements that you mentioned and also RWA procyclicality.

**Stephen Hester:** Just answering some of those different questions. The 12.5% is pro forma for June and we'll give a September update on Friday. The £8 billion contingency is really a straightforward mathematical function of the higher first loss, because obviously in the stressed case we blow through the first loss and into the insurance policy and therefore there are in effect £20 billion more of losses - between £40bn and £60bn - to be absorbed. Some of that is absorbed from the lower fees and some of it needs to be absorbed by contingent capital and in fact contingent capital allows us to absorb losses from wherever they arise rather than if they just arise in the pool and in that sense it's quite efficient; it is a simple

mathematical consequence of a higher first loss piece.

The stress case itself that the FSA has run is broadly comparable in its impact to that that they ran in February. We can argue whether it should be or not because the chances of that happening, I believe, have clearly receded, but nevertheless they were in charge of the pen and that was how they wrote the case. It's dimensions involve not only high impairments from a lapse back into recession in all our major economies, big further falls in real estate markets and so on, but also significant weakening of operating performance which is assumed to happen were that environment to take place; and other things hitting us like RWA procyclicality that would accelerate again and then, as you mentioned, things like current account settlements and so on and so forth.

I have to say that our version of the stress case is not as pessimistic as the FSA's, but the FSA's is what we have to pass and so there comes a point where it's out of our hands to argue. With respect to the things that we're guarding against, you will appreciate that the current account settlement, while being a significant number, would be a highly prejudicial number to talk about and so I'm sorry I can't, other than to say to you that we will not be hardest hit in our industry if and when it happens, but I think it would be prudent to have some regard for that on the horizon and perhaps the not many years from now horizon.

Additionally, as I mentioned, we have procyclicality of RWAs and again we'll talk more on Friday, but the other specific item we have next year is that ABN Amro is currently consolidated under Basel I with some amendments and during the course of next year when its finally split into RBS, that moves to Basel II and that will have an increase in RWAs. I can't give you a good number for it because there's currently an extended discussion about what it could be, but that's another thing that we're guarding against.

**Jonathan Pierce:** That ABN Amro hit is separate to any changes at the end of next year for market risk requirements?

**Stephen Hester:** That's another thing that is also on our horizon, in our view. Obviously this is going to be difficult for all of us thinking about banks. The regulatory climate is of course exceptionally uncertain and none of us quite know what rules we'll be facing or what calibration of those rules – a

lot will become clearer in the next 15 months or so. There can be no assurance that we've got our guess work right, but we've tried to be somewhat conservative in the face of those uncertainties in the knowledge that to come back to the well another time would be pretty disastrous, whereas returning surplus capital at the end of the period is pretty easy to do. We've tried to responsibly take that balance as we look forward and it's really for that reason that we have not done a further liability management exercise this time.

The amount of true capital gain that was available to us was marginal and getting rid of Tier 1 capital in exchange for Tier 2, even though the Tier 2 might fit an FSA stress test, we thought was not the right thing to do ahead of regulatory change, that we believe will still have a valuable role for Tier 1 capital.

**Jonathan Pierce:** On the APS risk related asset relief, what percentage of that do you think comes back per year? How has the scheme now been structured with regard to what happens at the point of refinance?

**Stephen Hester:** Obviously the point of refinance, when we exit APS, any then extent capital relief disappears; that will depend how full the first loss bucket has got and will depend what procyclicality impact has been on the insured assets, so I can't give you either of those numbers, but those are the two things that you have to model, and there may be no fee impact if the cumulative fees by that stage have got to 2.5 billion, although it might be a minor one.

**Jonathan Pierce:** Final question; the tangible equity impacts of the CDS and the contingent capital fees, are those the same as the regulatory Tier 1? Do you upfront them in the tangible equity as well?

**Stephen Hester:** No.

**Jonathan Pierce:** They'll come through as and when...?

**Stephen Hester:** That is our understanding - although forgive me if the accountants do a late u-turn on us, because obviously in the year-end they have to really close in on these things, some of which have been happening quickly.

**Operator:** Once again, if you would like to ask a question, please press the \* key followed by the digit 1 on your telephone keypad. Next question comes from James Alexander from M&G; please go ahead.

**James Alexander:** A question about the B-shares; can you guarantee that they are going to be issued before year-end, and if they are issued before year-end what is a long term exit strategy on those B-shares? Will they be around for 10 years, 20 years? I'm still a bit unclear about how to treat them in relation to the ordinary shares.

**Stephen Hester:** It is our objective that they are issued by the year-end; however that objective is in the hands of our shareholders who will vote in a EGM that will convene early in December, the Government not having any votes in that; but we would be in a very bad shape with respect to our capital ratios were that not to be approved. With respect to the exit from the B-shares, you should really think of the B-shares in a sense as two components. There is a dividend right which falls away when our share price hits 65p; so the quicker that happens, the quicker any negative impact from the B-shares disappears.

Aside from that, you should think of them as ordinary shares, save that the Government has agreed not to vote more than 75% in total in order for our listing to be undisturbed and so therefore the ultimate exit from the B-shares, aside from the dividend right issue, is simply that our share price and investor demand is at a level where the Government can sell down. Of course, if we were to have surplus capital and to feel that the right use of it was buy back of securities, one of the options would be to buy back B-share securities, but we would obviously want to fully consult on whether that was an appropriate option or whether something to all shareholders was more appropriate in that eventuality, which isn't today's business. I think that's the best way to think about it.

As a consequence of all of that, I would be very disappointed if the B-shares were around for even a fraction of the timescale that you lay out, but of course that depends a little bit on our share price.

**James Alexander:** So they'd be disappearing because of conversion, or because of being ... I'm not sure what...

**Stephen Hester:** The only feature about them that is important is the enhanced dividend right; that disappears when our share price hits 65p. The only other feature of them is they don't have votes until they convert and therefore their conversion and turning into votes is dependent on the Government selling down the rest of its stake in order to stay below 75% of the vote.

**James Alexander:** They rank pari passu only in a windup; they actually rank ahead of ordinary shares, don't they ... and if there are ongoing losses for three years...

**Stephen Hester:** They rank ahead of ordinary shares for dividends, but not in any other circumstance; so losses are equally apportioned. I think you should think of them as if they were ordinary shares, save only for the dividend right which you should think of as time limited, according to what your view of our share price is.

**Operator:** Next question comes from Stephen Hayne from Morgan Stanley; please go ahead.

**Stephen Hayne:** Two quick questions: number one on the FSA stress test, I'm just interested to know whether the input assumptions that the FSA ran were the same this time versus what they ran when they originally set up the FSA – that's question number one. Question number two, and perhaps this is a better question for Friday with your results, but I'm wondering if you can give some guidance on given the tax situation has now changed, what assumptions we should use for, for tax for this year and next? Thank you.

**Stephen Hester:** Because we're doing DTAs we'll have a normal tax rate because in a sense we capitalise the difference. On the stress assumptions, while there were detailed changes, the overall impact of the stress test was very similar to that of February.

**Operator:** The next question comes from Mike Trippitt from Oriel Securities; please go ahead.

**Mike Trippitt:** In the original GAPS scheme we were making a deduction from capital for the unused first loss; does that still apply in terms of modelling capital going forward?

**Bruce Van Saun:** Yes; you can see how we've done the analysis in Appendix 1 one, Schedule 2 and so we've done that calculation there – 11.2 - capital requirement and the coverage benefit of 4% and then we have the securitisation deduction there. The securitisation deduction is the lesser of 4% of the risk weighted assets or half of the unused first loss deduction.

**Stephen Hayne:** Therefore as we use it up, the capital relief changes.

**Operator:** The next question comes from Leigh Goodwin from Citigroup; please go ahead.

**Leigh Goodwin:** Following up some of the earlier ones, I wonder if you could just tell us on the stress test, just going back to that, you said that in the event of a stress test you would bust through the first loss. Was there a scenario in which you were actually making money out of this scheme as it was originally configured, in other words would the losses actually go through the fee as well?

**Bruce Van Saun:** Only in the stress scenario.

**Stephen Hayne:** I would in the stress scenario the losses become somewhat comparable to the fee, depending how many years we pay the fee. Obviously in the stress scenario we pay the fee for more years than in the unstressed scenario, because we expect to get rid of it otherwise; so we don't go deeply into it, even in the stress, even in our stress scenario, although obviously you can invent any stress scenario you like and come up with any number that you like.

**Leigh Goodwin:** If we're talking about the FSA stress scenario, would that apply that you'd still essentially be more or less NPV neutral perhaps at best?

**Stephen Hester:** I think in the FSA's overall view we would be NPV positive in cash terms.

**Leigh Goodwin:** A question on the B-shares: is there any chance that these could be repaid before they convert? In other words at maybe 50p rather

than we have to wait until we'd get up to 65p, or whatever they convert and then there's an eventual placement?

**Stephen Hester:** There is no specific clause that allows us to repay them. There's no option clause in it, otherwise it couldn't count as core Tier 1 capital and so anything would be a process of negotiation with the Government. I am sure that the Government would be highly receptive to ways of closing its budget deficit early, provided that they thought that there was value for taxpayers, but as they say very carefully about quality of treatment and so on and so forth before determining what the right thing to do was.

**Leigh Goodwin:** Just one other thing; assuming the scheme goes ahead now and it gets voted on and in place, you'll reinstate all your 2009 numbers, will you, as if the scheme was in place from the 1<sup>st</sup> January, which is how we've been thinking about it? So we'll have a restatement for example the first half?

**Stephen Hester:** I haven't thought that far, to tell you the truth.

**Leigh Goodwin:** Well that's just a modelling question; and finally I just wondered why this time there is a 4% prime fee on the contingent shares when that didn't seem to be a feature of the original option that you had with the B-shares? It seems a little bit mean, frankly...

**Stephen Hester:** It's an EU requirement.

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

**Stephen Hester:** Again, thank you very much for listening; we obviously look forward with great delight to repeating this exercise on a different topic of our actual business on Friday and I would simply end by reiterating this is a really important building block in our plan for recovery. I'm really pleased that we have got past this; we are bruised in the exercise, but intact. We have the tools to do the job, both for security, for customers and to rebuild shareholder value. We will work as hard as we possibly can to overcome the dilution issues and minimise them, but the most important thing is that we have some strength and security to execute the plan and get to a position where we can start repaying people's trust and confidence. We are very appreciative of the support that we have from

our Government and we plan to justify that and do so to the benefit of everyone. Thank you again for listening.

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