



## **UBS Global Financial Services Conference 2010**

**RBS CONFERENCE PRESENTATION**

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### **Presenter**

- **Stephen Hester (RBS Group Chief Executive Officer)**

Unidentified Participant: It's a pleasure to introduce on the stage next to me, Stephen Hester, Group Chief Executive of the Royal Bank of Scotland and Bruce van Saun, the CFO; (inaudible) is probably known to a number of people in the audience from his previous life as well to give an update on their significant restructuring and renewal process being undertaken at Royal Bank. I'll hand it over to Stephen. Thank you.

Stephen Hester: Thank you very much. Good morning everyone and thank you for coming. What I wanted to do this morning and I apologize in advance. The slides are pretty busy and I have no intention of reading every word, but they're hopefully useful for you to take away as much as to follow the thread of what I'm saying. But what we're trying to do is just to remind you of 18 months ago when we had the privilege of being one of the world's bigger train smashers and what did we set out to do to repair the situation? Where are we now 18 months on and more importantly, what visibility can we get you of the building blocks of the plan going forward? What do you need to believe to believe that our plan can be successfully carried off?

And the vision for the bank, and this is not a new slide; we've set it out back last February but I think is an A, attractive one; and B, a doable one; although like all such visions, suffers from certain clichéd words but it's very clear that we're looking to be a universal bank with global scale, characterized by returning more than our costs of capital on a consistent basis, driven by market-leading businesses in large customer-driven markets with an AA category credit risk profile. And that obviously lies behind everything in our plan and everything that we intend to do.

And the way that we are getting the bank to that position or back to that position, depending on your perspective, is through probably the most far-reaching strategic restructuring ever needed to be undertaken by a company, but certainly very far-reaching and complex; but based on some simple principles which have been done on a number of occasions before in financial services and elsewhere. And fundamentally that is about taking all of the good bits of RBS, designating them the core bank, making them better both through investment, cost-cutting, business repositioning; and that will be the driver of value creation of our bank. And then taking all of the pieces of RBS that we are not good at, all that represented excess and inappropriate risk and putting them if you like in a bad bank, in our non-core division and winding them off. Of course that's a process during which we take significant losses, but nevertheless that in itself becomes self-liquidating; and what's left to attach a PE to is the earnings of the core banks as they improve.

And in terms of the timeline of our journey to execute this plan and to achieve the vision that we set out, I would say that 2009 was while only one year in the five-year journey that we believe this thing will take, was clearly the most important year in terms of the year when we were most likely to fail if we were going to fail; and in terms of the most volatile bits of the package that had to be accomplished. Whether that was actually a credible plan itself, setting up the non-core business, starting cost-cutting, starting business improvement, completely replacing the senior management team and recapitalizing the bank in a variety of different ways.

And I would say that having passed successfully through 2009; the really big things that could knock us off course ought to be behind us. So 2010 is very much a focused heads down execution year, not too much excitement but lots of hard work and sweat in rebuilding the foundations on which if you like the eventual house can be revealed.

And in addition to, if you like, our own internal execution, clearly we hope that 2010 continues to be a year of recovery in external markets and in particular where the trajectory of retail and commercial earnings in our bank starts to recover from its nadir

toward the ultimate mix which we expect to have in 2013 of two thirds of our profits coming from stable retail and commercial businesses and one third from investment banking.

And then as you can see, as we go through the timeline of the plan on this page, in addition to our own plans being successfully executed, we start to depend on the next phase of economic recovery to hit our targets and that is to say-- interest rates normalizing which should allow us to drive or to recover some liability margin will be important for us. The plan isn't particularly driven on balance sheet growth, although I hope in the out years we'll get some of that as well and obviously impairments normalizing.

Now where are we? We just last week reported the results of our first quarter and one of the distinguishing characteristics, if you'd like, of our plan is that we have become arguably the most transparent bank in the world in terms of the frequency and quantum of financial disclosure that we give; and on top that disclosure which if you like is backward looking; we have set out a comprehensive series of targets, both at a group level and at every divisional level which we are aspiring to meet at the end of our plan. And the summary of the most important group targets-- some of them relating to return, some of them relating to risks are set out here; the worst point where we ended last year at the end of the first quarter and where we intend to get. And you'll see as you study those, that we are really making very good progress across the board. I would warn you, that the first quarter tends to be seasonally strong; but nevertheless, it does give confidence that we can get where we're going.

And just a couple more words on the first quarter results that we published; the pattern is, if you'd like, the emerging pattern and the one that we expected and gave everyone to understand which is to say that our core profits-- the profits of our core bank continue to be good, a bit overly dependent on the investment bank although less so than this time a year ago, but with the retail and commercial businesses beginning to turn. But we are making still losses overall as the costs of winding down our non-core is likely to be elevated for at least the balance of this year, obviously subject to credit markets and credit conditions generally.

However our customer franchises remain very strong. I'm going to come back to this, and indeed growing in a number of areas. And we can say, as we did at the year end, that we are at least on target if not ahead of target in terms of progress against every single one of the strategic targets that we have put out. It doesn't mean to say that we will stay that way, but we are so far.

And again, this slide here gives you a little bit more detail, both in the key trends in the core business and if you'd like the trends on the risk side of the balance sheet side, which is non-core and the framework around the core business all going in broadly the right direction. I'll leave you to read it if you haven't in fact already last week focused on the first quarter.

So let's having, if you like, set the scene of so far so good; let's now move on to the main part of this presentation which is what are the building blocks or to put a different way; what do you need to believe to believe we can pull off the rest of this plan and how does it, if you like, come together in different pieces? And what I will do is go through hopefully reasonably briskly a slide on each of these argumentation points, if you like, but trying to put them together first of all in one go.

As all good businesses, it really starts and arguably finishes on whether we do or don't have leading franchises in large customer-driven markets; which we can further improve from their current position and which will provide attractive, sustainable and

competitively strong returns. We believe we do. That's why above all else, we believe that the plan will succeed and we believe that it's something that we can substantiate and substantiate it in an increasing way as we go through.

Now of course balanced on top of those core business franchises sits, if you'd like, the risk profile and balance sheet; which were the things that brought us down. And again, it's clearly important for us to be able to demonstrate important building blocks for our plan that we are and can remain well-capitalized against the remaining risks in our balance sheet and against regulatory reform which is likely to require more equity; and importantly alongside that, that the funding profile of the bank has returned and you can see the pattern will return to the place we want it to be i.e. AA category; and along with that, the other aspects of risk profile associated with the assets in our non-core division. So important building block; are we already where we need to be in a number of these areas and where we're not where we need to be-- is it credible to believe that we will get where we need to be over the next three years?

If you have then accepted those building blocks of strong inherently valuable franchises, of a package of balance sheet around them that's stable and strong and can be there, then of course we really move on to the P&L as a creation of value in the core business P&L. And we need to look through-- can we achieve on the revenue side what we want to do, given that I've said that we're not expecting a whole lot of balance sheet growth? That's really about margins. And partly that's about margins, if you like, that the economy hands to us; it's partly about margins that we get from improving what we do with customers.

Below the revenue line of course cost line; can we optimize that? Do impairments return to normalized levels and then the management task of executing it; and put all of those things together and that's, if you like, the internal building blocks that you need to believe or not to decide whether you think we're investible in relation to our plan; and I think that we can show you, if you like, much greater clarity of how that hangs together.

Clearly there are also then, some external factors which will impact all banks and which will impact us and I will go through those briefly as well.

So let's just take, and again as I say, I'll skip really fast over these slides because you can review them later. But it is, I believe, a simple fact that our core businesses are each in large stable customer-driven markets. And in each one of our core businesses, at least the primary business lines in which we compete, do have top-tier market positions and those market positions are in the most case either stable or in fact improving. And given, if you like, the restructuring intensity that we've had, the reputational and other issues around the bank; if that is the case at this stage of our recovery, I believe it should give good encouragement that that can be even more the case as we go forward.

And quite interesting is this second slide and we can all obviously have degrees of skepticism about customer surveys; but taking our core U.K. franchise which is our biggest profit center, our U.K. retail bank which is the number-two retail bank in the U.K., our U.K. commercial bank which is the number-one commercial bank in the U.K.; aside from the simple market share data, what this slide shows you is actually in both the RBS and the NatWest brands which are our two used brands in the U.K. market, our customer satisfaction has risen over the last year and is market-leading, again despite all the reputational reasons why you might not have expected that. And I think that's an important thing to have in your mind, if you like, in underlining the ability of these franchises to be strong and once our work on them is complete, deliver the returns that we're anticipating.

So moving from the customer franchises to the balance sheet and funding; the wrap around them and the first issues are capitalization and thanks to the recapitalization of last year we have a core tier-one, an equity tier-one ratio of 10.6% which is at the head of the pack of the U.K. peers that we set out here. That's slightly flattered arguably by the asset protection scheme; while I'd say flattered, the asset protection scheme is real. It provides a credit halo to us that no other bank has and if something were to go wrong in the next couple of years that would be good. However, if things don't go wrong, which is if you like, the precept of our plan-- then we will in due course cancel that and therefore the underlying equity tier one would be middle of the pack, but nevertheless a strong and healthy level which we believe to the extent one can make predictions in the regulation environment, we should be reasonably positioned to absorb regulatory change.

And of very great significance and I'll spend another slide on this as well; one of the important pledges that we made to the outside world at the time of recovering RBS, given that one of the key things about RBS's recovery was the unwieldy balance sheet and the exposure to short-term wholesale funding; was that we would return to what I've always described as the gold standard of banking-- balance sheet which is a one to one lender deposit ratio order of magnitude.

And you can see that we have already in 18 months made considerable progress going from 155% to 131%. But our core businesses are already at one to one. And so all you need to believe to believe we can get to what I would call the gold standard is that we run down non-core and that our deposits keep pace with their existing relationship with loans in the core businesses we already have.

Let's spend another moment on that. Our non-core division is running down. It's running down to schedule; very slightly ahead of schedule. It does of course contain our biggest risk concentration, so it's doing so with some considerable P&L pain; albeit again, arguably less than the P&L pain that we had budgeted for at this juncture because markets have turned a little bit more favorable. And for those of you who follow us, on our website in our presentations, there is very great, granular disclosure as to what's in there and exactly what assumptions we've made behind this runoff and you'll see an addition to getting rid of risk concentrations where we are on track; it's a key element in returning our funding profile to the AA category since in effect the funds that are generated by running these assets down, go to repay a combination of short-term debt and the remaining amount of government-guaranteed debt that we and most other banks used during crisis; therefore, leaving us without if you like, any significant refinancing cliff which some other banks face in coming years.

So again, progress largely ahead of schedule on balance sheet and funding, clear what we have to do in order to get to where we want to be on balance sheet and funding; and so far the trends would suggest that that's believable. Although of course, the world can still dish out surprises to us.

So now, if you like, moving into the P&L and where we need to get; and really two components of P&L. As I said, a lot of this is about margin which I'll talk about in another moment, but right across RBS's core businesses, the pattern is almost identical in each one and that is to say that RBS spent too much of its time in the last 15 years acquiring companies and not enough of its time in making its existing businesses best in class; which given their market positions, is an achievable aim or at least a direction we can go a long way towards.

And so we are going to do a massive amount of work; we are, which is underway to improve and capitalize on the franchises we have. Some of that is on the cost side I'll come to. A lot of it is on the revenue side. Basic investment, some of which benefits costs, benefits customer service, benefits the information we have increasing marketing

volumes, aiming at better cross sales and many, many things of the same nature. And again, we set those out in more detail, but these are important in terms of the detail of our execution to improve the quality of our earnings and in particular to improve their quantity in a market where we don't expect the economy to be giving us big balance sheet growth.

And as I said, net interest margin is of course one of our most important revenue lines and broadly what we hope will be the case, what is needed to meet our plan is that the current margins that we get on the asset side are broadly sustainable because they've already been increased significantly to where they were before. Obviously it's working through the whole book.

The liability margins; that has been substantially squeezed by low interest rates, by increased liquidity requirements, by increased cost of term funding and that squeeze is continuing as hedges roll off; that those liability margins are given some relief as interest rates move up and can rebuild, allowing the total margin to rebuild. The total margin is already gently rebuilding, but to get where we need it to do, either we need more liability margin or if the world should go into some sort of Japanese long-term low-interest rate environment, we're going to need to come back to asset margins and do something else to them which may create an elongation of the time period. But that if you like is a default not just for us, but for the whole banking industry, if interest rates should not normalize.

So moving down from revenues to costs; what do you need to believe on costs? Broadly, we are asking you believe that we can cut enough in terms of cost efficiencies out of our business to number one, remove the costs that currently support the non-core businesses that are disappearing or being sold; number two, make enough of a dent in our other costs to absorb inflation and the reinvestment in our business that I mentioned two slides previously, leaving core business costs approximately flat in absolute terms; if we can do those things, then the cost income ratio and other ambitions work as we go through and our cost levels should be appropriate, if not good, in every one of the businesses that we operate in. And so far, all we can say is, if you like, the cost-reduction component of that is in fact gently ahead of schedule and we continue to identify additional things in the coming years that can help bolster that position.

And then if you like the final piece of the P&L, the impairment line; and again what does one have to believe to get to our future projections? Then I guess it's really some sort of normalization of the world. Now we are a little bit on the conservative side. We set out for our portfolio the long-term impairment charges across the last decade or so; we are actually not assuming that things get back quite to where they were over that long-term average; in part because our balance sheet was growing fast then so some of these percentages are a bit flattered by balance sheet growth. But nevertheless, we are assuming that impairments get down towards that territory and of course that's a bet on world recovery; albeit remember these are 2013 targets and the direction is positive; in fact ahead of schedule at this early stage of 2010.

So those are the internal pieces of the puzzle over and above, if you like, management capability to execute those plans. Let's just spend a couple of minutes on the external pieces. And as I've mentioned, economic recovery for all banks including for us, is a piece of this. Clearly we have a global business but our biggest economies are the U.K. and the U.S. and economic recovery we are assuming is modest and slow but nevertheless happens. We're assuming that real estate markets are stable to positive from here on with some bumps, no doubt; and that interest rates while staying low probably this year, begin their normalization path next year. I think all of these are broadly consensus economic forecasts. I don't have a better crystal ball than any of you might have on this issue. But these are things that are important to our interest margins and to our impairment levels. And as I say, what we're not assuming is a storming recovery. If

there was a storming recovery it may give us some balance sheet growth we were not relying on, it may help impairments go down faster and help margins normalize; but of course the inverse could also be true as we know.

And in terms of the markets in which we operate, I guess put simply, banking needs to be seen increasingly as like most other mature, capital-intensive businesses; becoming yet more capital-intensive of course by both the market and regulatory demands for holding more capital. And that is to say that the industry, in reaction to these trends, has consolidated; probably has gotten more consolidation in some markets to go; the majority of players in these markets have similar costs of capital, similar costs of doing business, similar return objectives and therefore while competition is strong and intense in the vast majority of the places we operate, it is today rational competition in pursuit of exceeding one's cost of capital with similar costs of capital as opposed to the period of distortion, in particular over, if you like, the securitization years when irrational competition was funded irrationally by securitization markets and could devastate margins, thereby forcing either subnormal profitability or excess leverage which of course the second route was the way that the world went.

And so the risks, if you like, to the competitive structure, being an enabler of rational returns to cover the cost of capital would be if you got a return to irrationally priced access to securitized funding, which you can have your own point of view on; whether you think that will or won't happen.

Now of course, also out there externally is an endless raft of regulatory/governmental discussion around change and actual change affecting our industry as well as the economies around it; and clearly it would be problematic to be certain at this stage as to exactly where that comes out and so I simply say I think any investors in the banking industry must accept some level of health warning that while I think that in the end the outcomes are likely to be okay, they're likely to strike a balance both in time and amount between allowing economic recovery and making banks safer, but not destroying the thing on the way through. There is the risk of tail outcomes, particularly through the political processes that are engaged and one must keep an eye on them.

Now obviously the changes that we know most about are the changes associated with the Basel process in the first instance hitting in the next year on investment banking trading books and then a little further out on definitions of capital and other issues in the Basel consultation. These are by and large rational responses in rational areas, but the speed of implementation and the totality of calibration has still got some extreme ends within it and the ability to get global agreement is probably very close to zero. And so I think will it be a sort of slightly jerky process as we go through-- the world goes through -- regulates and trying to calibrate exactly where they're going to come out on these issues.

The promise is by the end of this year we'll know. I'm dubious as to whether it will be that clear cut. But this year is certainly a very important year in calibrating the, if you like, consequences of change and therefore the pace that banks can accommodate, consistent with allowing economies to grow.

Clearly over and above, if you like, what you might call the technocratic improvements of making banks safer and more liquid; there are then the whole series of structural debates; some of which is political and of which is, if you like, industrially thoughtful whether those are the Volcker reforms, whether those are debates around Glass Steagall; then of course resolution regimes and so on. And again, I think we can all see that A, these are live issues that are being grappled with; B, there are some very important elements in here around too big to fail, which I think drive you down resolution regime-- resolution implementation of different, if you like, legislative regimes around the world; and then there are things that are more politically appealing but less obviously answering

the problem to do with splitting investment banks and deposit-taking institutions and so on.

But these are things where they can be tail events, even though if you like, my central view is that in this area we will end up concentrating on resolution-regime type stuff, rather than size and shape for its own sake.

Now of course, in the case of RBS, there are one or two other, if you like, governmental aspects that not every bank has, not least that we are majority-owned by the U.K. government and of course without their support would not be standing here with the prospect-- with the fact of investor value today and the prospect of more of it tomorrow. And that means obviously absolutely essential to what we intend to do is to behave in a way that justifies that support; that means serving our customers well; that means making the bank safe again for ourselves, our customers, our shareholders and for the financial system; and recreating shareholder value for everyone, but on a scale that allows the U.K. government to sell its shares at a profit, thereby helping to close the budget deficit of the U.K. and allowing the full cycle of the support to have been achieved with I hope at RBS that can never go back to those vulnerabilities again.

And so very central to what we do is all of that, and on the basis of trust and confidence in our ability to do that, what I can also say to you is that to date the U.K. government through its agency UKFI, which holds our shares, if you like, as a buffer agency between politicians and ourselves, has behaved exactly as they said they would do, namely as an engaged institutional shareholder in pursuit of institutional shareholder type goals of shareholder value creation and on not one occasion in the last year has any significant operational strategic decision been imposed, altered or otherwise tampered with by the government. We are running ourselves as we would without a government shareholding but in pursuit of goals that clearly the government wants us to do in order to get them out of a hole or preferably at a profit. That isn't the same as saying that we have no political risk. The political debates that swirl around us have minor amounts, sometimes more than minor amounts of de-stabilization on our people and other things. And of course with a U.K. election on, it's not impossible that some changes could occur post that, although as we speak, none of the parties that would lead any U.K. coalition appear to have a defined policy that is differential as it relates to us. But of course we will watch that space.

We have along the way, made some commitments, in particular to lending in the U.K. It's important to say two things; number one, we would have done this anyway because a part of what we want to do is support our customers and if credit-worthy customers want to borrow from us we have the money to lend it to them. The problem in the U.K. is exactly the same as the problem here and everywhere else, which is at this stage a recovery, most people want to save more and not borrow more and therefore demand for credit is relatively weak. But nevertheless we are prepared and happy to do our bit should there be demand, but not are under an obligation to lend either off market or to people who we don't think will pay us back.

And then finally, as we know, there are some risks in the political process which probably affect all banks, although we may have some vulnerabilities that others don't at this stage.

And this is just if you like, a little bit more information because the other, if you like, complexity associated with a government shareholding is understanding its structure and that is to say that structurally just over half of it is held in B shares which are of themselves identical to A shares except they don't vote, but they can be converted into A shares and vote if the government want to. So you should think of it all as A shares for your purposes with the one twist that alongside the B shares, the U.K. government holds

a dividend right which gives them a super-charged dividend on the B shares if we pay any dividends to anyone else and that right drops away once our share price hits 65 pence, which it hasn't done yet although it's going generally in the right direction with some ups and downs.

And so if you like, that twist in the capital structure will impact our own views of the timing of resumption of dividends and the interplay between our share price and dividends and the B share and the A shares.

It is-- we obviously don't control what the government do with their shares, I think though it is pretty commonly accepted by the government and all others that their desire is to sell their shares as fast as is consistent with making a profit and not de-stabilizing the market. So I'm sure it will be in a number of tranches well spread apart so that the overhang doesn't behave mischievously. But beyond that, obviously the timing is up to them as we go through.

So in conclusion, I think we have set out where we want to go, how we're going to get there, how much progress we have made so far, and going through both the customer franchises, the balance sheet and funding and the different items on the P&L; the sorts of things-- the sorts of building blocks that will go towards achieving our story or not, and clearly it's entirely up to you to have your point of view on whether you think we can do that. At the moment, we feel like we can do that, but of course this is not without risks. We still are likely to make losses this year overall, even though our core businesses will be in profit, there still are vulnerabilities in our balance sheet. There still are political vulnerabilities quarter by quarter. We're working through those and I believe so far executing well against that and again I won't read down this slide, but it's my assertion to you this morning that if indeed you believe that RBS has or will have these characteristics within the time period of this plan, we are not only investible, but highly attractive as an investment.

Thank you very much for listening.

Unidentified Participant: Thank you, Stephen. We've actually probably got one time for one question-- also there is a breakout session if people want to continue that debate going forward. Let me throw it out and see if there are any burning questions from the floor.

Unidentified Audience Member: I was wondering how you keep people motivated to work on or for non-core assets?

Stephen Hester: As I said before, actually this is not a very novel strategic plan. Non-core banks have been done plenty of times before. I've done them before. Other people have done them before. And so it's pretty well-rehearsed. In fact, it's interesting that people actually often quite enjoy it; it gives them restructuring skills that are in quite high demand. You clearly have very different incentives to the normal business incentives and in some cases, people then move to other businesses and other cases. Obviously they move on. But it's a well-trodden path and I think working fine.

Unidentified Participant: (Inaudible) we shall close then. Let's continue in the breakout session. Thanks, Stephen and Bruce. Thank you.