

ROYAL BANK OF SCOTLAND GROUP PLC  
Form 6-K  
August 10, 2012

FORM 6-K

SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

Report of Foreign Private Issuer

Pursuant to Rule 13a-16 or 15d-16 of  
the Securities Exchange Act of 1934

For August 10, 2012

Commission File Number: 001-10306

The Royal Bank of Scotland Group plc

RBS, Gogarburn, PO Box 1000  
Edinburgh EH12 1HQ

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(Address of principal executive offices)

Indicate by check mark whether the registrant files or will file annual reports under cover of Form 20-F or Form 40-F.  
Form 20-F  Form 40-F

Indicate by check mark if the registrant is submitting the Form 6-K in paper as permitted by Regulation S-T Rule 101(b)(1):

Indicate by check mark if the registrant is submitting the Form 6-K in paper as permitted by Regulation S-T Rule 101(b)(7):

Indicate by check mark whether the registrant by furnishing the information contained in this Form is also thereby furnishing the information to the Commission pursuant to Rule 12g3-2(b) under the Securities Exchange Act of 1934.

Yes  No

If "Yes" is marked, indicate below the file number assigned to the registrant in connection with Rule 12g3-2(b): 82-

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This report on Form 6-K shall be deemed incorporated by reference into the company's Registration Statement on Form F-3 (File Nos. 333-162219 and 333-162219-01) and to be a part thereof from the date which it was filed, to the extent not superseded by documents or reports subsequently filed or furnished.



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## Presentation of information

In this document and unless specified otherwise, the term ‘company’ or ‘RBSG’ means The Royal Bank of Scotland Group plc, ‘RBS’, ‘RBS Group’ or the ‘Group’ means the company and its subsidiaries, ‘the Royal Bank’ means The Royal Bank of Scotland plc and ‘NatWest’ means National Westminster Bank Plc.

The company publishes its financial statements in pounds sterling (‘£’ or ‘sterling’). The abbreviations ‘£m’ and ‘£bn’ represent millions and thousands of millions of pounds sterling, respectively, and references to ‘pence’ represent pence in the United Kingdom (‘UK’). Reference to ‘dollars’ or ‘\$’ are to United States of America (‘US’) dollars. The abbreviations ‘\$m’ and ‘\$bn’ represent millions and thousands of millions of dollars, respectively, and references to ‘cents’ represent cents in the US. The abbreviation ‘€’ represents the ‘euro’, the European single currency, and the abbreviations ‘€m’ and ‘€bn’ represent millions and thousands of millions of euros, respectively.

Certain information in this report is presented separately for domestic and foreign activities. Domestic activities primarily consist of the UK domestic transactions of the Group. Foreign activities comprise the Group's transactions conducted through those offices in the UK specifically organised to service international banking transactions and transactions conducted through offices outside the UK.

The geographic analysis in the Business Review, including the average balance sheet and interest rates, changes in net interest income and average interest rates, yields, spreads and margins in this report have been compiled on the basis of location of office - UK and overseas. Management believes that this presentation provides more useful information on the Group's yields, spreads and margins of the Group's activities than would be provided by presentation on the basis of the domestic and foreign activities analysis used elsewhere in this report as it more closely reflects the basis on which the Group is managed. ‘UK’ in this context includes domestic transactions and transactions conducted through the offices in the UK which service international banking transactions.

The results, assets and liabilities of individual business units are classified as trading or non-trading based on their predominant activity. Although this method may result in some non-trading activity being classified as trading, and vice versa, the Group believes that any resulting misclassification is not material.

## International Financial Reporting Standards

As required by the Companies Act 2006 and Article 4 of the European Union IAS Regulation, the consolidated financial statements of the Group are prepared in accordance with International Financial Reporting Standards issued by the International Accounting Standards Board (IASB) and interpretations issued by the IFRS Interpretations Committee of the IASB as adopted by the European Union (together ‘IFRS’). They also comply with IFRS as issued by the IASB.

## RBS Holdings N.V. (formerly ABN AMRO Holding N.V.)

In 2007, RFS Holdings B.V., which was jointly owned by the Group, the Dutch State (successor to Fortis) and Santander (together, the “Consortium Members”) completed the acquisition of ABN AMRO Holding N.V.

On 6 February 2010, the businesses of ABN AMRO Holding N.V. acquired by the Dutch State were legally demerged to a newly established company, ABN AMRO Bank N.V., which on 1 April 2010 was transferred to ABN AMRO Group N.V., itself owned by the Dutch State. Following legal separation, RBS Holdings N.V. (formerly ABN AMRO Holding N.V.) has one operating subsidiary, The Royal Bank of Scotland N.V. (“RBS N.V.”), a fully operational bank within the Group. RBS N.V. is independently rated and regulated by the Dutch Central Bank. Certain assets within RBS N.V. continue to be shared by the Consortium Members.

On 19 April 2011, the Group announced the proposed transfers of a substantial part of the business activities of RBS N.V. to the Royal Bank. Subject to, among other matters, regulatory and other approvals and procedures, it is expected that the transfers will be implemented on a phased basis over a period ending 31 December 2013. A large part of the transfers is expected to have taken place by the end of 2012.

On 17 October 2011, the Group completed the transfer of a substantial part of the UK activities of RBS N.V. to the Royal Bank pursuant to Part VII of the UK Financial Services and Markets Act 2000.

Approximately 98% of the issued share capital of RFS Holdings B.V. is held by the Group.

#### Non-GAAP financial information

The directors manage the Group's performance by class of business, before certain reconciling items, as is presented in the segmental analysis on pages 371 to 375 (the "managed basis"). Discussion of the Group's performance focuses on the managed basis as the Group believes that such measures allow a more meaningful analysis of the Group's financial condition and the results of its operations. These measures are non-GAAP financial measures. A body of generally accepted accounting principles such as IFRS is commonly referred to as 'GAAP'. A non-GAAP financial measure is defined as one that measures historical or future financial performance, financial position or cash flows but which excludes or includes amounts that would not be so adjusted in the most comparable GAAP measure. Reconciliations of these non-GAAP measures are presented throughout this document or in the segmental analysis on pages 371 to 375. These non-GAAP financial measures are not a substitute for GAAP measures. Furthermore, RBS has divided its operations into "Core" and "Non- Core". Certain measures disclosed in this document for Core operations and used by RBS management are non-GAAP financial measures as they represent a combination of all reportable segments with the exception of Non-Core. In addition, RBS has further divided parts of the Core business into "Retail & Commercial" consisting of the UK Retail, UK Corporate, Wealth, International Banking, Ulster Bank and US Retail & Commercial divisions. This is a non-GAAP financial measure. Lastly, the Basel III net stable funding ratio (see page 81) represents a non-GAAP financial measure given it is a metric that is not yet required to be disclosed by a government, governmental authority or self-regulatory organisation.

#### Glossary

A glossary of terms is provided on pages 440 to 447.

## Forward-looking statements

Certain sections in this document contain ‘forward-looking statements’ as that term is defined in the United States Private Securities Litigation Reform Act of 1995, such as statements that include the words ‘expect’, ‘estimate’, ‘project’, ‘anticipate’, ‘believes’, ‘should’, ‘intend’, ‘plan’, ‘could’, ‘probability’, ‘risk’, ‘Value-at-Risk (VaR)’, ‘target’, ‘goal’, ‘objectives’, ‘endeavour’, ‘outlook’, ‘optimistic’, ‘prospects’ and similar expressions or variations on such expressions.

In particular, this document includes forward-looking statements relating, but not limited to: the Group’s restructuring plans, divestments, capitalisation, portfolios, net interest margin, capital ratios, liquidity, risk weighted assets (RWAs), return on equity (ROE), profitability, cost:income ratios, leverage and loan:deposit ratios, funding and risk profile; certain ring-fencing proposals; sustainability targets; the Group’s future financial performance; the level and extent of future impairments and write-downs, including sovereign debt impairments; the protection provided by the Asset Protection Scheme (APS); and the Group’s potential exposures to various types of market risks, such as interest rate risk, foreign exchange rate risk and commodity and equity price risk. These statements are based on current plans, estimates and projections, and are subject to inherent risks, uncertainties and other factors which could cause actual results to differ materially from the future results expressed or implied by such forward-looking statements. For example, certain market risk disclosures are dependent on choices about key model characteristics and assumptions and are subject to various limitations. By their nature, certain of the market risk disclosures are only estimates and, as a result, actual future gains and losses could differ materially from those that have been estimated.

Other factors that could cause actual results to differ materially from those estimated by the forward-looking statements contained in this document include, but are not limited to: the global economic and financial market conditions and other geopolitical risks, and their impact on the financial industry in general and on the Group in particular; the ability to access sufficient sources of liquidity and funding; the recommendations made by the Independent Commission on Banking (ICB) and their potential implications; the ability to implement strategic plans on a timely basis, or at all, including the disposal of certain Non-Core assets and assets and businesses required as part of the State Aid restructuring plan; organisational restructuring, including any adverse consequences of a failure to transfer, or delay in transferring, certain business assets and liabilities from RBS N.V. to RBS; the full nationalisation of the Group or other resolution procedures under the Banking Act 2009; deteriorations in borrower and counterparty credit quality; costs or exposures borne by the Group arising out of the origination or sale of mortgages or mortgage-backed securities in the United States; the extent of future write-downs and impairment charges caused by depressed asset valuations; the value and effectiveness of any credit protection purchased by the Group; unanticipated turbulence in interest rates, yield curves, foreign currency exchange rates, credit spreads, bond prices, commodity prices, equity prices and basis, volatility and correlation risks; changes in the credit ratings of the Group; ineffective management of capital or changes to capital adequacy or liquidity requirements; litigation and regulatory investigations; changes to the valuation of financial instruments recorded at fair value; competition and consolidation in the banking sector; the ability of the Group to attract or retain senior management or other key employees; regulatory or legal changes (including those requiring any restructuring of the Group’s operations) in the United Kingdom, the United States and other countries in which the Group operates or a change in United Kingdom Government policy; changes to regulatory requirements relating to capital and liquidity; changes to the monetary and interest rate policies of central banks and other governmental and regulatory bodies; changes in UK and foreign laws, regulations, accounting standards and taxes, including changes in regulatory capital regulations and liquidity requirements; impairments of goodwill; pension fund shortfalls; general operational risks; HM Treasury exercising influence over the operations of the Group; insurance claims; reputational risk; the ability to access the contingent capital arrangements with HM Treasury; the participation of the Group in the APS and the effect of the APS on the Group’s financial and capital position; the conversion of the B Shares in accordance with their terms; limitations on, or additional requirements imposed on, the Group’s activities as a result of HM Treasury’s investment in the Group; and the success of the Group in managing the risks involved in the foregoing.

The forward-looking statements contained in this document speak only as of the date of this announcement, and the Group does not undertake to update any forward-looking statement to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

The information, statements and opinions contained in this document do not constitute a public offer under any applicable legislation or an offer to sell or solicitation of any offer to buy any securities or financial instruments or any advice or recommendation with respect to such securities or other financial instruments.

#### Explanatory note

##### Divisional reorganisation and Group reporting changes

The company is filing this Form 6-K to restate certain segmental disclosures that were made in the company's annual report on Form 20-F for the year ended 31 December 2011, filed with the Securities and Exchange Commission on 27 March 2012 (the "2011 Form 20-F") to reflect the Group's new organisational structure, the revised allocation of Group Treasury costs, and the revised divisional return on equity ratios, and to combine movements in the fair value of own derivative liabilities, previously incorporated within Markets' operating performance, with changes in the fair value of own debt, in a single measure Own Credit Adjustments.

The Group presented segmental disclosures that reflect the new organisational structure in its interim results for the half year ended 30 June 2012, which were filed with the Securities and Exchange Commission on a separate Form 6-K on 8 August 2012. To facilitate comparison with these interim results, the segmental disclosures in the 2011 Form 20-F have been restated in this Form 6-K.

##### Consolidating financial information

As a result of filing this Form 6-K, the Group has presented a statement of comprehensive income within the consolidating financial information note, for all applicable periods.

##### Share consolidation

Following approval at the Annual General Meeting of the Company held on 30 May 2012, an ordinary share sub-division and one-for-ten consolidation took effect on 6 June 2012. This resulted in the 59,554,319,127 ordinary shares of 25p each, in issue at the record date of 1 June 2012, being sub-divided and consolidated into 5,955,431,912 ordinary shares of £1 each. Consequently, the Group has also restated in this Form 6-K certain disclosures relating to or impacted by numbers of ordinary shares or share prices.

The Group presented disclosures that reflect the changes discussed above in its interim results, which were filed with the Securities and Exchange Commission on a separate Form 6-K on 8 August 2012. To facilitate comparison with these interim results, the disclosures included in the 2011 Form 20-F have been restated in this Form 6-K.

Accordingly, the following pages that correspond to the 2011 Form 20-F have been restated to reflect the amendments identified above.

#### Item 3 - Key information

Pages 8-9 (Business review)

Pages 408-409 (Risk factors)

#### Item 4 - Information on the Company

Pages 4-5 (Business review - Description of business)

Page 6 (Business review - Competition)

Page 102 (Risk and balance sheet management - Divisional analysis of credit risk assets)

Page 104 (Risk and balance sheet management - AQ credit risk assets)

Page 108 (Risk and balance sheet management - Commercial real estate)

Page 110 (Risk and balance sheet management - Commercial real estate - Maturity profile of portfolio)

Page 111



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	(Risk and balance sheet management - Breakdown of portfolio by asset quality (AQ) band – Key points)
Page 121	(Risk and balance sheet management - Credit concentration: Sector and geographical region – Key points)
Page 150	(Risk and balance sheet management - REIL by division)
Pages 162-163	(Risk and balance sheet management - Movement in loan impairment provisions)
Pages 257-258	(Report of the directors)
Pages 386-387	(Additional information - Financial summary)
Page 396	(Supervision)
Page 398	(Major Shareholders)

Item 5 - Operating and Financial Review and Prospects

Page 8	(Business review - Key financials)
Pages 9-11	(Business review - Summary consolidated income statement)
Pages 17-19, 21	(Business review - Non-interest income, Operating expenses and Insurance claims, Impairment losses)
Pages 23-52	(Business review - Divisional performance)
Pages 54-55	(Business review - Commentary on consolidated balance sheet)
Pages 71, 72-74, 76, 78, 81, 89	(Risk and balance sheet management - Liquidity and funding Risk)

Item 6 - Directors, senior management and employees

Page 25	(Business review - Employees)
Page 217	(Corporate governance - Principal activities of the Board during 2011)
Page 215	(Corporate governance - Executive Committee)
Pages 221-222	(Report of the Audit Committee)
Pages 230-232, 238, 240, 241, 243, 245, 249, 250, 251-253	(Directors remuneration report)
Page 255	(Report of Independent Registered Public Accounting Firm)
Page 262	(Directors interests in shares)

Item 7 - Major Shareholders and Related Party Transactions

Page 261 (Report of the directors - Shareholders)

Item 8 - Financial information and Item 18 - Financial statements

Page 4 (Business review - Description of business)  
Page 266 (Consolidated income statement)  
Page 289 (Note 3 - Operating expenses)  
Pages 290-291 (Note 3 - Share-based payments)  
Page 298 (Note 9 - Earnings per ordinary and B share)  
Pages 304-305, 312, 320 (Note 11 - Financial instruments - Valuation)  
Pages 350-352 (Note 27 - Share capital)  
Page 358 (Note 31 - Capital resources)  
Page 366 (Note 32 - Memorandum items - Litigation and investigations)  
Page 370-374 (Note 38 - Segmental analysis)  
Pages 380-381 (Note 43 - Consolidating financial information - statement of comprehensive income)

Item 9 - The Offer and Listing

Page 422 (Shareholder information - Trading market)

Item 10 - Additional Information

Page 424 (Shareholder information - Trading market - Ordinary shares)  
Page 425 (Shareholder information - Dividend history)

Item 11 - Quantitative and Qualitative Disclosure about Market Risk

Page 102 (Risk and balance sheet management - Divisional analysis of credit risk assets)  
Page 103 (Risk and balance sheet management - Credit risk assets by asset quality (AQ) band)  
Page 104 (Risk and balance sheet management - AQ10 credit risk assets by division)  
Page 108 (Risk and balance sheet management - Commercial real estate)  
Page 110 (Risk and balance sheet management - Commercial real estate - Maturity profile of portfolio)  
Page 111 (Risk and balance sheet management - LTVs - Key points)  
Page 121 (Risk and balance sheet management - Credit concentration: Sector and geographical region - Key points)

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Page 150	(Risk and balance sheet management - REIL by division)
Pages 162-163	(Risk and balance sheet management - Movement in loan impairment provisions)
Pages 171, 174	(Risk and balance sheet management - Country risk - key points)
Pages 188-190	(Risk and balance sheet management - Market risk)
Page 191	(Risk and balance sheet management - Trading VaR)
Page 194	(Risk and balance sheet management - Insurance risk)
Pages 205, 207	(Risk and balance sheet management - Asset Protection Scheme)

This Form 6-K includes items 3, 4, 5, 6, 7, 8, 9, 10, 11 and 18 from the 2011 Form 20-F in their entirety and also retains the page numbering in respect of items 3, 4, 5, 6, 7, 8, 9, 10, 11 and 18 for ease of reference.

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## Description of business

### Introduction

The Royal Bank of Scotland Group plc is the holding company of a large global banking and financial services group. Headquartered in Edinburgh, the Group operates in the United Kingdom, the United States and internationally through its principal subsidiaries, the Royal Bank and NatWest. Both the Royal Bank and NatWest are major UK clearing banks. In the United States, the Group's subsidiary Citizens is a large commercial banking organisation. Globally, the Group has a diversified customer base and provides a wide range of products and services to personal, commercial and large corporate and institutional customers.

Following the placing and open offers in December 2008 and in April 2009, HM Treasury owned approximately 70.3% of the enlarged ordinary share capital of the company. In December 2009, the company issued a further £25.5 billion of new capital to HM Treasury. This new capital took the form of B shares, which do not generally carry voting rights at general meetings of ordinary shareholders but are convertible into ordinary shares and qualify as Core Tier 1 capital. Following the issuance of the B shares, HM Treasury's holding of ordinary shares of the company remained at 70.3% although its economic interest rose to 84.4%.

At 31 December 2011, HM Treasury's holding in the company's ordinary shares was 66.9% and its economic interest was 82.2%.

The Group had total assets of £1,506.9 billion and owners' equity of £74.8 billion at 31 December 2011. The Group's risk asset ratios at 31 December 2011, were a Total capital ratio of 13.8%, a Core Tier 1 capital ratio of 10.6% and a Tier 1 capital ratio of 13.0%.

### Organisational change

In January 2012, the Group announced changes to its wholesale banking operations in light of a changed market and regulatory environment. The changes saw the reorganisation of the Group's wholesale businesses into 'Markets' and 'International Banking' and the exit and downsizing of selected activities. The changes ensure the wholesale businesses continue to deliver against the Group's strategy.

The changes include an exit from cash equities, corporate brokering, equity capital markets and mergers and acquisitions businesses. Significant reductions in balance sheet, funding requirements and cost base in the remaining wholesale businesses will be implemented.

GBM and GTS divisions have been reorganised as follows:

- The 'Markets' business maintains its focus on fixed income, with strong positions in debt capital raising, securitisation, risk management, foreign exchange and rates. It will serve the corporate and institutional clients of all Group businesses.
- GBM's corporate banking business has been combined with the international businesses of the GTS arm into a new 'International Banking' unit and provides clients with a 'one-stop shop' access to the Group's debt financing, risk management and payments services. This international corporate business will be self-funded through its stable corporate deposit base.
- The domestic small and mid-size corporates previously served within GTS is now managed within RBS's domestic corporate banking businesses in the UK, Ireland (Ulster Bank) and the US (US Retail & Commercial).

Our wholesale business retains its international footprint ensuring that it can serve our customers' needs globally. We believe, that despite current challenges to the sector, wholesale banking services can play a central role in supporting

cross border trade and capital flows, financing requirements and risk management and we remain committed to this business.

#### Organisational structure and business overview

The Group's activities are organised on a divisional basis as follows:

UK Retail offers a comprehensive range of banking products and related financial services to the personal market. It serves customers through a number of channels including: the RBS and NatWest network of branches and ATMs in the United Kingdom, telephony, online and mobile. UK Retail remains committed to delivering 'Helpful and Sustainable' banking and to the commitments set out in its Customer Charter - the results of which are externally assessed and published every six months.

UK Corporate is a leading provider of banking, finance and risk management services to the corporate and SME sector in the United Kingdom. It offers a full range of banking products and related financial services through a nationwide network of relationship managers, and also through telephone and internet channels. The product range includes asset finance through the Lombard brand.

Wealth provides private banking and investment services in the UK through Coutts & Co and Adam & Company, offshore banking through RBS International, NatWest Offshore and Isle of Man Bank, and international private banking through Coutts & Co Ltd.

International Banking serves the world's largest companies with a leading client proposition focused on financing, transaction services and risk management. International Banking serves as the delivery channel for Markets products to corporate clients and serves international subsidiaries of both International Banking and clients from UK Corporate, Ulster Bank and US Retail & Commercial through its international network.

Ulster Bank is a leading retail and commercial bank in Northern Ireland and the Republic of Ireland. It provides a comprehensive range of financial services through both its Retail Banking division, which has a network of branches and operates in the personal and bancassurance sectors, and its Corporate Banking division, which provides services to business customers, corporate customers and institutional markets.

Business review [continued](#)

US Retail & Commercial provides financial services primarily through the Citizens and Charter One brands. US Retail & Commercial is engaged in retail and corporate banking activities through its branch network in 12 states in the United States and through non-branch offices in other states.

The divisions discussed above are collectively referred to as Retail & Commercial.

Markets is a leading origination, sales and trading business across debt finance, fixed income, currencies, investor products and equity derivatives. The division offers a unified service to the Group's corporate and institutional clients. The Markets' sales and research teams build strong ongoing client partnerships, provide market perspective and access, and work with the division's trading and structuring teams to meet the client's objectives across financing, risk management, investment, securitisation and liquidity.

Direct Line Group provides a wide range of general insurance products to consumers through a number of well known brands including; Direct Line, Churchill and Privilege. It also provides insurance services via a number of partner brands. In the commercial sector, its NIG and Direct Line for Business operations provide insurance products for businesses via brokers or direct respectively. Through its international division, Direct Line Group sells general insurance, mainly motor, in Germany and Italy. In addition to insurance services, Direct Line Group continues to provide support and reinsurance to millions of UK motorists through its Green Flag breakdown recovery service and stolen vehicle recovery and telematics business (Tracker). On 15 February 2012, a new corporate brand, Direct Line Group, was announced.

To comply with EC State Aid requirements, the Group has agreed to dispose of Direct Line Group. It continues to be reported as a separate operating segment rather than within the Non-Core division as its business is distinct from the activities of the Non-Core division.

Central Functions comprises Group and corporate functions, such as treasury, funding and finance, risk management, legal, communications and human resources. The Centre manages the Group's capital resources and Group-wide regulatory projects and provides services to the operating divisions.

Non-Core division manages separately assets that the Group intends to run off or dispose of. The division contains a range of businesses and asset portfolios primarily from the legacy GBM businesses, higher risk profile asset portfolios including excess risk concentrations, and other illiquid portfolios. It also includes a number of other portfolios and businesses including regional markets businesses that the Group has concluded are no longer strategic.

Business Services supports the customer-facing businesses and provides operational technology, customer support in telephony, account management, lending and money transmission, global purchasing, property and other services. Business Services drives efficiencies and supports income growth across multiple brands and channels by using a single, scalable platform and common processes wherever possible. It also leverages the Group's purchasing power and is the Group's centre of excellence for managing large-scale and complex change. For reporting purposes, Business Services costs are allocated to the divisions above. It is not deemed a reportable segment.

Business divestments

To comply with EC State Aid requirements the Group agreed a series of restructuring measures to be implemented over a four year period from December 2009. This supplements the measures in the Strategic Plan previously announced by the Group. These include divesting Direct Line Group, 80.01% of GMS (completed in 2010) and substantially all of RBS Sempra Commodities JV business (largely completed in 2010), as well as divesting the RBS branch-based business in England and Wales and the NatWest branches in Scotland, along with the Direct SME customers across the UK.

## Recent developments

### Share consolidation

Following approval at the Group's Annual General Meeting on 30 May 2012, the sub-division and consolidation of the Group's ordinary shares on a one-for-ten basis took effect on 6 June 2012. There was a corresponding change in the Group's share price to reflect this.

The Board believes that the consolidation will result in a more appropriate share price for a company of the Group's size in the UK market. It may also help reduce volatility, thereby enabling a more consistent valuation of the Group.

### Liability management: Exchange offer

On 28 February 2012, The Royal Bank of Scotland plc announced an invitation to offer to exchange certain Canadian Dollar, Australian Dollar, US Dollar, Euro and Swiss Franc denominated subordinated notes for new Canadian Dollar, Australian Dollar, US Dollar, Euro and Swiss Franc denominated subordinated notes, due 2022 and callable 2017. The new notes, other than the Australian Dollar denominated new notes, were issued on 16 March 2012, and the Australian Dollar denominated new notes were issued on 19 March 2012, in each case under the £90,000,000,000 Euro Medium Term Note Programme of The Royal Bank of Scotland plc and The Royal Bank of Scotland Group plc.

Business review [continued](#)

#### National Loan Guarantee Scheme

On 20 March 2012, RBS agreed to participate in the National Loan Guarantee Scheme (the Scheme), pursuant to which The Commissioners of Her Majesty's Treasury (HM Treasury) have agreed to unconditionally and irrevocably guarantee the due payment of all sums due and payable by RBS under any senior unsecured notes issued by RBS in accordance with the terms of the Scheme in respect of which HM Treasury issues a Guarantee Certificate (as defined in a deed of guarantee dated 20 March 2012 (the "Deed of Guarantee")). The Guarantor's obligations in that respect, are contained in the Deed of Guarantee, the form of which is available at [www.dmo.gov.uk](http://www.dmo.gov.uk).

#### 2012 Budget

In the Budget statement on 21 March 2012, the Chancellor of the Exchequer announced a further reduction of 1% in the rate of corporation tax such that the rate will fall by 2% from 26% to 24% in April 2012, to 23% in April 2013 and to 22% in April 2014. It was also announced in the Budget statement that the full rate of the bank levy will increase to 0.105 per cent. from 1 January 2013.

#### Competition

The Group faces strong competition in all the markets it serves. Banks' balance sheets have strengthened whilst loan demand has been subdued as many customers have sought to delever and the UK economy has remained weak. Competition for retail deposits remains intense as institutions continue to target strong and diverse funding platforms for their balance sheets.

Competition for corporate and institutional customers in the UK is from UK banks and from large foreign financial institutions who are also active and offer combined investment and commercial banking capabilities. In asset finance, the Group competes with banks and specialist asset finance providers, both captive and non-captive. In European and Asian corporate and institutional banking markets the Group competes with the large domestic banks active in these markets and with the major international banks.

In the small business banking market, the Group competes with other UK clearing banks, specialist finance providers and building societies.

In the personal banking segment, the Group competes with UK clearing banks and building societies, major retailers and life assurance companies. In the mortgage market, the Group competes with UK clearing banks and building societies. The ambitions of non-traditional players in the UK market remain strong, with new entrants active and potentially seeking to build their platforms by acquiring businesses made available through restructuring of incumbents. The Group distributes life assurance products to banking customers in competition with independent advisors and life assurance companies.

In the UK credit card market large retailers and specialist card issuers are active in addition to the UK banks. In addition to physical distribution channels, providers compete through direct marketing activity and the internet.

In Wealth Management, The Royal Bank of Scotland International competes with other UK and international banks to offer offshore banking services. Coutts and Adam & Company compete as private banks with UK clearing and private banks, and with international private banks. Competition in wealth management remains strong as banks maintain their focus on competing for affluent and high net worth customers.

Direct Line Group competes in personal lines insurance and, to a more limited extent, in commercial insurance. There is strong competition from a range of insurance companies which now operate telephone and internet direct sales businesses. Competition in the UK motor market remains intense, and price comparison internet sites now play a major role in the marketplace. These sites are now extending their scope to home insurance and other lines. Direct



Line Group also competes with local insurance companies in the direct motor insurance markets in Italy and Germany.

In Ireland, Ulster Bank competes in retail and commercial banking with the major Irish banks and building societies, and with other UK and international banks and building societies active in the market. The challenging conditions in the Irish economy persist and many of the domestic Irish banks have required State support and are engaged in significant restructuring actions.

In the United States, Citizens competes in the New England, Mid-Atlantic and Mid-West retail and mid-corporate banking markets with local and regional banks and other financial institutions. The Group also competes in the US in large corporate lending and specialised finance markets, and in fixed-income trading and sales. Competition is principally with the large US commercial and investment banks and international banks active in the US. The economic recovery in the US is proving weaker than expected and loan demand is weak in Citizens' markets.

## Risk factors

Set out below is a summary of certain risks which could adversely affect the Group; it should be read in conjunction with the Risk and balance sheet management section of the Business review (pages 58 to 207). This summary should not be regarded as a complete and comprehensive statement of all potential risks and uncertainties. A fuller description of these and other risk factors is included on pages 405 to 418.

- The Group's businesses, earnings and financial condition have been and will continue to be affected by geopolitical conditions, the global economy, the instability in the global financial markets and increased competition. Together with a perceived increased risk of default on the sovereign debt of certain European countries and unprecedented stresses on the financial system within the eurozone, these factors have resulted in significant changes in market conditions including interest rates, foreign exchange rates, credit spreads, and other market factors and consequent changes in asset valuations.
- The Group's ability to meet its obligations' including its funding commitments, depends on the Group's ability to access sources of liquidity and funding. The inability to access liquidity and funding due to market conditions or otherwise could adversely affect the Group's financial condition. Furthermore, the Group's borrowing costs and its access to the debt capital markets and other sources of liquidity depend significantly on its and the UK Government's credit ratings.
- The Independent Commission on Banking has published its final report on competition and possible structural reforms in the UK banking industry. The Government has indicated that it supports and intends to implement the recommendations substantially as proposed which could have a material adverse effect on the Group.
- The Group's ability to implement its Strategic Plan depends on the success of its efforts to refocus on its core strengths and its balance sheet reduction programme. As part of the Group's Strategic Plan and implementation of the State Aid restructuring plan agreed with the European Commission and HM Treasury, the Group is undertaking an extensive restructuring which may adversely affect the Group's business, results of operations and financial condition and give rise to increased operational risk and may impair the Group's ability to raise new Tier 1 capital due to restrictions on its ability to make discretionary dividend or coupon payments on certain securities.
- The occurrence of a delay in the implementation of (or any failure to implement) the approved proposed transfers of a substantial part of the business activities of RBS N.V. to the Royal Bank may have a material adverse effect on the Group.
- The Group or any of its UK bank subsidiaries may face the risk of full nationalisation or other resolution procedures and various actions could be taken by or on behalf of the UK Government, including actions in relation to any securities issued, new or existing contractual arrangements and transfers of part or all of the Group's businesses.
- The actual or perceived failure or worsening credit of the Group's counterparties or borrowers and depressed asset valuations resulting from poor market conditions have adversely affected and could continue to adversely affect the Group.
- The value of certain financial instruments recorded at fair value is determined using financial models incorporating assumptions, judgements and estimates that may change over time or may ultimately not turn out to be accurate.
  - The Group's insurance businesses are subject to inherent risks involving claims on insured events.
- The Group's business performance, financial condition and capital and liquidity ratios could be adversely affected if its capital is not managed effectively or as a result of changes to capital adequacy and liquidity requirements,

including those arising out of Basel III implementation (globally or by European or UK authorities), or if the Group is unable to issue Contingent B Shares to HM Treasury under certain circumstances.

- The Group could fail to attract or retain senior management, which may include members of the Group Board, or other key employees, and it may suffer if it does not maintain good employee relations.
- Any significant developments in regulatory or tax legislation could have an effect on how the Group conducts its business and on its results of operations and financial condition, and the recoverability of certain deferred tax assets recognised by the Group is subject to uncertainty.
- The Group is subject to substantial regulation and oversight, and any significant regulatory or legal developments could have an adverse effect on how the Group conducts its business and on its results of operations and financial condition. In addition, the Group is, and may be, subject to litigation and regulatory investigations that may impact its business, results of operations and financial condition.
  - Operational and reputational risks are inherent in the Group's operations.
- The Group may be required to make contributions to its pension schemes and government compensation schemes, either of which may have an adverse impact on the Group's results of operations, cash flow and financial condition.
- As a result of the UK Government's majority shareholding in the Group it can, and in the future may decide to, exercise a significant degree of influence over the Group including on dividend policy, modifying or cancelling contracts or limiting the Group's operations. The offer or sale by the UK Government of all or a portion of its shareholding in the company could affect the market price of the equity shares and other securities and acquisitions of ordinary shares by the UK Government (including through conversions of other securities or further purchases of shares) may result in the delisting of the Group from the Official List.

Business review [continued](#)

## Key financials

	2011	2010	2009
for the year ended 31 December	£m	£m	£m
Total income	28,937	31,868	33,026
Operating loss before tax	(766)	(399)	(2,647)
Loss attributable to ordinary and B shareholders	(1,997)	(1,125)	(3,607)
Cost:income ratio	62%	57%	52%
Basic loss per ordinary and B share from continuing operations (pence) (1)	(18.5p)	(4.5p)	(63.1p)

at 31 December	2011	2010	2009
	£m	£m	£m
Funded balance sheet (2)	977,249	1,026,499	1,255,032
Total assets	1,506,867	1,453,576	1,696,486
Loans and advances to customers	515,606	555,260	728,393
Deposits	611,759	609,483	756,346
Owners' equity	74,819	75,132	77,736
Risk asset ratios			
- Core Tier 1	10.6%	10.7%	11.0%
- Tier 1	13.0%	12.9%	14.1%
- Total	13.8%	14.0%	16.1%

## Notes:

(1) Adjusted for the sub-division and one-for-ten consolidation of ordinary shares, which took effect in June 2012.

(2) Funded balance sheet represents total assets less derivatives.

## Overview of results

The results of RFS Holdings B.V., the entity that acquired ABN AMRO, are fully consolidated in the Group's financial statements. The interests of the State of the Netherlands and Santander in RFS Holdings are included in non-controlling interests. Legal separation of ABN AMRO Bank N.V. took place on 1 April 2010. As a result, RBS presents the interests of the Consortium Members in ABN AMRO as discontinued operations.

Summary consolidated income statement  
for the year ended 31 December 2011

	2011	2010	2009
	£m	£m	£m
Net interest income	12,679	14,209	13,388
Fees and commissions receivable	6,384	8,193	8,738
Fees and commissions payable	(1,460)	(2,211)	(2,790)
Other non-interest income	7,078	6,549	8,424
Insurance net premium income	4,256	5,128	5,266
Non-interest income	16,258	17,659	19,638
Total income	28,937	31,868	33,026
Operating expenses	(18,026)	(18,228)	(17,417)
Profit before insurance net claims and impairment losses	10,911	13,640	15,609
Insurance net claims	(2,968)	(4,783)	(4,357)
Impairment losses	(8,709)	(9,256)	(13,899)
Operating loss before tax	(766)	(399)	(2,647)
Tax (charge)/credit	(1,250)	(634)	429
Loss from continuing operations	(2,016)	(1,033)	(2,218)
Profit/(loss) from discontinued operations, net of tax	47	(633)	(105)
Loss for the year	(1,969)	(1,666)	(2,323)
Non-controlling interests	(28)	665	(349)
Other owners' dividends	—	(124)	(935)
Loss attributable to ordinary and B shareholders	(1,997)	(1,125)	(3,607)
Basic loss per ordinary and B share from continuing operations (1)	(18.5p)	(4.5p)	(63.1p)

Note:

(1) Adjusted for the sub-division and one-for-ten consolidation of ordinary shares, which took effect in June 2012.

Results summary

2011 compared with 2010

Operating profit

Group operating loss before tax for the year was £766 million compared with £399 million in 2010. Group operating profit on a managed basis was £1,824 million compared with £1,845 million in 2010. Adjusting for the impact of the disposal of GMS in 2010, which recorded an operating profit of £207 million, Group operating profit on a managed basis was up 11%. The improvement was driven by a strong Retail & Commercial (R&C) operating performance and the return to profit of Direct Line Group. Ulster Bank and Markets faced more difficult conditions, leaving total Core operating profit on a managed basis at £6,045 million. Non-Core operating loss in 2011 was 26% lower compared with 2010, despite the acceleration of disposals in the second half of the year.

Total income

Total income fell by 9% to £28,937 million, primarily reflecting lower net interest income, lower trading income in Markets and Non-Core and a fall in insurance net premium income.

Net interest income

Group net interest income fell 11% to £12,679 million largely driven by the run-off of balances and exit of higher margin and higher risk segments in Non-Core. Group NIM was 14 basis points lower, reflecting the cost of carrying a higher liquidity portfolio and by the impact of non-performing assets in the Non-Core division. However, R&C NIM

was up 6 basis points, with strengthening asset margins in the first half of the year offsetting the impact of a competitive deposit market.

Non-interest income

Non-interest income decreased to £16,258 million from £17,659 million in 2010. This included movements in the fair value of the Asset Protection Scheme resulting in a £906 million charge (2010 - £1,550 million), gain on redemption of own debt of £255 million (2010 - £553 million) and a gain in own credit adjustments of £1,914 million (2010 - £242 million gain). Excluding these items, non-interest income was down 19% primarily reflecting a reduction in income from trading activities and lower net fees and commissions.

Business review [continued](#)

Operating expenses

Operating expenses decreased to £18,026 million (2010 - £18,228 million). Operating expenses on a managed basis fell to £15,478 million from £16,710 million in 2010.

This decrease was primarily driven by cost savings achieved as a result of the cost reduction programme and Non-Core run-off, largely reflecting the disposal of RBS Sempra and specific country exits. Staff costs fell 9%, driven by lower Markets and International Banking variable compensation as a result of its decrease in revenues, and in Non-Core, given the impact of a 32% reduction in headcount and continued business disposals and country exits.

The Group cost:income ratio was 62% in 2011 compared with 57% in 2010.

Net insurance claims

Bancassurance and general insurance claims, after reinsurance, reduced by 38% to £2,968 million.

General insurance claims were £1,730 million lower, mainly due to the non-repeat of bodily injury reserve strengthening in 2010, de-risking of the motor book, more benign weather in 2011 and claims in Non-Core decreasing as legacy policies ran-off.

Impairment losses

Impairment losses were £8,709 million compared with £9,256 million in 2010, with Core loan impairments falling by £260 million and Non-Core by £1,557 million, despite continuing challenges in Ulster Bank and corporate real estate portfolios, partially offset by an impairment of £1,099 million and interest rate hedge adjustments on impaired available-for-sale Greek government bonds of £169 million.

Risk elements in lending represented 8.6% of gross loans and advances to customers excluding reverse repos at 31 December 2011 (2010 - 7.3%).

Provision coverage of risk elements in lending was 49% (2010 - 47%).

Tax

The tax charge was £1,250 million in 2011, compared with £634 million in 2010. The high tax charge in the year reflects profits in high tax regimes (principally US) and losses in low tax regimes (principally Ireland), losses in overseas subsidiaries for which a deferred tax asset has not been recognised (principally Ireland and the Netherlands) and the effect of the two reductions of 1% in the rate of UK corporation tax enacted in March 2011 and July 2011 on the net deferred tax balance.

Earnings

Basic loss per ordinary and B share from continuing operations increased from a loss of 4.5p to a loss of 18.5p.

Business review [continued](#)

Results summary continued  
2010 compared with 2009

Operating loss

Operating loss before tax for the year was £399 million compared with a loss of £2,647 million in 2009. The improvement in performance is primarily driven by stronger Core Retail & Commercial operating profits offsetting more normal results from Markets, coupled with lower impairments in the Non-Core division.

After tax, non-controlling interests and preference share and other dividends, the loss attributable to ordinary and B shareholders was £1,125 million, compared with an attributable loss of £3,607 million in 2009.

Total income

Total income decreased 4% to £31,868 million in 2010 reflecting the return to more normal levels in Markets compared with the favourable market conditions seen in 2009. This was offset by good growth in Core Retail & Commercial and the improvement in Non-Core.

Net interest income

Net interest income increased by 6% to £14,209 million, reflecting improvements in net interest margin which more than offset lower interest-earning assets and interest-bearing liabilities. Group net interest margin increased from 1.83% to 2.06% largely reflecting expanding asset margins in UK Retail and UK Corporate divisions as well as in US Retail & Commercial. The run-off of low-yielding Non-Core assets also contributed to this increase. The Group net interest margin was also affected by increased funding costs.

Non-interest income

Non-interest income decreased to £17,659 million from £19,638 million in 2009. This included movements in the fair value of the Asset Protection Scheme - credit default swap resulting in a £1,550 million charge and gain on redemption of own debt of £553 million (2009 - £3,790 million). Excluding these items, non-interest income was up 18% primarily reflecting an increase in income from trading activities.

Operating expenses

Operating expenses increased to £18,228 million (2009 - £17,417 million). The main driver of this 5% increase was the impact of a £2,148 million gains on pension curtailment in 2009. This was partially offset by gains on the recognition of benefits from the Group-wide efficiency programme. The programme continues to deliver material savings which have been funding investments to strengthen our Core franchises. Annualised savings are now just ahead of the £2.5 billion target for 2011 and are forecast to exceed £3 billion by 2013. Integration and restructuring costs were £1,032 million compared with £1,286 million in 2009. Write-down of goodwill and other intangible assets was £10 million compared with £363 million in 2009. Premises and equipment costs fell by 7% in the year largely driven by efficiency cost savings, significant one-off property impairments recognised in 2009 and country exits following Non-Core disposals.

Net insurance claims

Bancassurance and general insurance claims, after reinsurance, increased by 10% to £4,783 million.

Impairment losses

Impairment losses were £9,256 million compared with £13,899 million in 2009, with Core impairments falling by £898 million and Non-Core by £3,745 million. The decrease reflects an overall improvement in the economic environment. Impairments fell in all businesses, except Ulster Bank, which has faced an economic environment that remains challenging.



Risk elements in lending and potential problem loans represented 7.4% of gross loans and advances to customers excluding reverse repos at 31 December 2010 (2009 - 5.5%).

Provision coverage of risk elements in lending and potential problem loans was 46% (2009 - 45%).

Tax

The Group recorded a tax charge of £634 million in 2010, compared with a tax credit of £429 million in 2009.

Earnings

Basic loss per ordinary and B share from continuing operations improved from a loss of 63.1p to a loss of 4.5p.

Business review [continued](#)

## Analysis of results

## Net interest income

	2011	2010	2009
	£m	£m	£m
Interest receivable	21,410	22,776	33,836
Interest payable	(8,731)	(8,567)	(17,332)
Net interest income	12,679	14,209	16,504
	%		
Gross yield on interest-earning assets of the banking business (1)	3.24	3.30	3.76
Cost of interest-bearing liabilities of the banking business	(1.68)	(1.47)	(2.18)
Interest spread of the banking business (2)	1.56	1.83	1.58
Benefit from interest-free funds	0.36	0.23	0.25
Net interest margin of the banking business (3)	1.92	2.06	1.83
	%	%	%
Yields, spreads and margins of the banking business			
Gross yield (1)			
- Group	3.24	3.30	3.76
- UK	3.56	3.42	3.35
- Overseas	2.77	3.15	4.09
Interest spread (2)			
- Group	1.56	1.83	1.58
- UK	1.81	2.01	1.50
- Overseas	1.22	1.59	1.67
Net interest margin (3)			
- Group	1.92	2.06	1.83
- UK	2.07	2.22	1.81
- Overseas	1.70	1.84	1.85
The Royal Bank of Scotland plc base rate (average)	0.50	0.50	0.64
London inter-bank three month offered rates (average)			
- Sterling	0.87	0.70	1.21
- Eurodollar	0.33	0.34	0.69
- Euro	1.36	0.75	1.21

## Notes:

- (1) Gross yield is the interest earned on average interest-earning assets of the banking book.
- (2) Interest spread is the difference between the gross yield and the interest rate paid on average interest-bearing liabilities of the banking business.
- (3) Net interest margin is net interest income of the banking business as a percentage of average interest-earning assets of the banking business.
- (4) The analysis into UK and overseas has been compiled on the basis of location of office.
- (5) Interest receivable and interest payable on trading assets and liabilities are included in income from trading activities.

## Average balance sheet and related interest

		2011			2010		
		Average Balance £m	Interest £m	Rate %	Average balance £m	Interest £m	Rate %
<b>Assets</b>							
Loans and advances to banks	- UK	31,994	293	0.92	22,714	222	0.98
	- Overseas	41,840	404	0.97	30,148	369	1.22
Loans and advances to customers	- UK	294,301	12,105	4.11	310,712	11,989	3.86
	- Overseas	171,979	5,864	3.41	195,858	6,900	3.52
Debt securities	- UK	62,231	1,449	2.33	66,765	1,459	2.19
	- Overseas	58,773	1,295	2.20	63,334	1,837	2.90
Interest-earning assets	- UK	388,526	13,847	3.56	400,191	13,670	3.42
	- Overseas	272,592	7,563	2.77	289,340	9,106	3.15
Total interest-earning assets	- banking business	661,118	21,410	3.24	689,531	22,776	3.30
	- trading business	278,975			276,330		
Interest-earning assets		940,093			965,861		
Non-interest-earning assets (5)		595,062			706,343		
Total assets		1,535,155			1,672,204		
Percentage of assets applicable to overseas operations		40.2%			44.0%		
<b>Liabilities</b>							
Deposits by banks	- UK	17,224	242	1.41	21,816	334	1.53
	- Overseas	47,371	740	1.56	59,799	999	1.67
Customer accounts: demand deposits	- UK	112,522	664	0.59	120,796	621	0.51
	- Overseas	43,177	483	1.12	39,127	607	1.55
Customer accounts: savings deposits	- UK	76,719	1,177	1.53	68,142	935	1.37
	- Overseas	25,257	130	0.51	25,587	213	0.83
Customer accounts: other time deposits	- UK	39,672	481	1.21	39,934	431	1.08
	- Overseas	33,971	594	1.75	43,996	914	2.08
Debt securities in issue	- UK	108,406	2,606	2.40	111,277	2,212	1.99
	- Overseas	42,769	765	1.79	72,175	1,065	1.48
Subordinated liabilities	- UK	16,874	470	2.79	19,442	398	2.05
	- Overseas	5,677	270	4.76	8,714	19	0.22
Internal funding of trading business	- UK	(40,242)	149	(0.37)	(41,451)	(140)	0.34
	- Overseas	(8,783)	(40)	0.46	(6,864)	(41)	0.60
Interest-bearing liabilities	- UK	331,175	5,789	1.75	339,956	4,791	1.41
	- Overseas	189,439	2,942	1.55	242,534	3,776	1.56
Total interest-bearing liabilities	- banking business	520,614	8,731	1.68	582,490	8,567	1.47
	- trading business (5)	307,564			293,993		
Interest-bearing liabilities		828,178			876,483		

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Non-interest-bearing liabilities:

Demand deposits	- UK	46,495	46,692
	- Overseas	19,909	23,994
Other liabilities (5)		565,534	648,129
Owners' equity		75,039	76,906
Total liabilities and owners' equity		1,535,155	1,672,204
Percentage of liabilities applicable to overseas operations		37.1%	41.7%

For notes relating to this table refer to page 12.

Business review [continued](#)

## Average balance sheet and related interest continued

		2009		
		Average balance £m	Interest £m	Rate %
<b>Assets</b>				
Loans and advances to banks	- UK	21,616	310	1.43
	- Overseas	32,367	613	1.89
Loans and advances to customers	- UK	333,230	11,940	3.58
	- Overseas	376,382	16,339	4.34
Debt securities	- UK	52,470	1,414	2.69
	- Overseas	84,822	3,220	3.80
Interest-earning assets	- UK	407,316	13,664	3.35
	- Overseas	493,571	20,172	4.09
Total interest-earning assets	- banking business	900,887	33,836	3.76
	- trading business (5)	291,092		
Interest-earning assets		1,191,979		
Non-interest-earning assets		831,501		
Total assets		2,023,480		
Percentage of assets applicable to overseas operations		47.4%		
<b>Liabilities</b>				
Deposits by banks	- UK	24,837	679	2.73
	- Overseas	104,396	2,362	2.26
Customer accounts: demand deposits	- UK	110,294	569	0.52
	- Overseas	82,177	1,330	1.62
Customer accounts: savings deposits	- UK	54,270	780	1.44
	- Overseas	83,388	2,114	2.54
Customer accounts: other time deposits	- UK	68,625	932	1.36
	- Overseas	71,315	2,255	3.16
Debt securities in issue	- UK	116,536	2,830	2.43
	- Overseas	117,428	2,500	2.13
Subordinated liabilities	- UK	26,053	834	3.20
	- Overseas	12,468	656	5.26
Internal funding of trading business	- UK	(60,284)	(317)	0.53
	- Overseas	(14,845)	(192)	1.29
Interest-bearing liabilities	- UK	340,331	6,307	1.85
	- Overseas	456,327	11,025	2.42
Total interest-bearing liabilities	- banking business	796,658	17,332	2.18
	- trading business (5)	331,380		
Interest-bearing liabilities		1,128,038		
Non-interest-bearing liabilities:				
Demand deposits	- UK	38,220		
	- Overseas	27,149		
Other liabilities (5)		772,770		
Owners' equity		57,303		

Total liabilities and owners' equity	2,023,480
Percentage of liabilities applicable to overseas operations	45.8%

For notes relating to this table refer to page 12.

## Analysis of change in net interest income - volume and rate analysis

Volume and rate variances have been calculated based on movements in average balances over the period and changes in interest rates on average interest-earning assets and average interest-bearing liabilities. Changes due to a combination of volume and rate are allocated pro rata to volume and rate movements.

	2011 over 2010		
	Increase/(decrease) due to		
	changes in:		
	Average	Average	Net
	volume	rate	change
	£m	£m	£m
Interest-earning assets			
Loans and advances to banks			
UK	86	(15)	71
Overseas	124	(89)	35
Loans and advances to customers			
UK	(652)	768	116
Overseas	(820)	(216)	(1,036)
Debt securities			
UK	(102)	92	(10)
Overseas	(125)	(417)	(542)
Total interest receivable of the banking business			
UK	(668)	845	177
Overseas	(821)	(722)	(1,543)
	(1,489)	123	(1,366)
Interest-bearing liabilities			
Deposits by banks			
UK	66	26	92
Overseas	197	62	259
Customer accounts: demand deposits			
UK	45	(88)	(43)
Overseas	(58)	182	124
Customer accounts: savings deposits			
UK	(125)	(117)	(242)
Overseas	3	80	83
Customer accounts: other time deposits			
UK	3	(53)	(50)
Overseas	189	131	320
Debt securities in issue			
UK	58	(452)	(394)
Overseas	494	(194)	300
Subordinated liabilities			
UK	58	(130)	(72)
Overseas	9	(260)	(251)
Internal funding of trading business			
UK	(4)	(285)	(289)
Overseas	10	(11)	(1)
Total interest payable of the banking business			
UK	101	(1,099)	(998)

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Overseas	844	(10)	834
	945	(1,109)	(164)
Movement in net interest income			
UK	(567)	(254)	(821)
Overseas	23	(732)	(709)
	(544)	(986)	(1,530)



Business review [continued](#)

## Analysis of change in net interest income - volume and rate analysis continued

	2010 over 2009		
	Increase/(decrease) due to changes in:		
	Average volume	Average rate	Net change
	£m	£m	£m
Interest-earning assets			
Loans and advances to banks			
UK	15	(103)	(88)
Overseas	(40)	(204)	(244)
Loans and advances to customers			
UK	(836)	885	49
Overseas	(6,776)	(2,663)	(9,439)
Debt securities			
UK	342	(297)	45
Overseas	(716)	(667)	(1,383)
Total interest receivable of the banking business			
UK	(479)	485	6
Overseas	(7,532)	(3,534)	(11,066)
	(8,011)	(3,049)	(11,060)
Interest-bearing liabilities			
Deposits by banks			
UK	75	270	345
Overseas	845	518	1,363
Customer accounts: demand deposits			
UK	(54)	2	(52)
Overseas	670	53	723
Customer accounts: savings deposits			
UK	(192)	37	(155)
Overseas	965	936	1,901
Customer accounts: other time deposits			
UK	336	165	501
Overseas	708	633	1,341
Debt securities in issue			
UK	123	495	618
Overseas	799	636	1,435
Subordinated liabilities			
UK	180	256	436
Overseas	152	485	637
Internal funding of trading business			
UK	(83)	(94)	(177)
Overseas	(75)	(76)	(151)
Total interest payable of the banking business			
UK	385	1,131	1,516
Overseas	4,064	3,185	7,249
	4,449	4,316	8,765

Movement in net interest income

UK	(94)	1,616	1,522
Overseas	(3,468)	(349)	(3,817)
	(3,562)	1,267	(2,295)

## Non-interest income

	2011	2010	2009
	£m	£m	£m
Fees and commissions receivable	6,384	8,193	8,738
Fees and commissions payable	(1,460)	(2,211)	(2,790)
Income from trading activities			
- managed basis	3,314	6,074	3,909
- Asset Protection Scheme	(906)	(1,550)	—
- own credit adjustments	293	(7)	(148)
	2,701	4,517	3,761
Gain on redemption of own debt	255	553	3,790
Other operating income (excluding insurance net premium income)			
- managed basis	2,525	1,059	690
- strategic disposals	(24)	171	132
- own credit adjustments	1,621	249	51
	4,122	1,479	873
Insurance net premium income	4,256	5,128	5,266
Total non-interest income	16,258	17,659	19,638

## 2011 compared with 2010

Non-interest income decreased by £1,401 million in 2011 principally driven by lower trading income in Markets and Non-Core and a fall in insurance net premium income, partially offset by a higher gain on movements in own credit adjustments.

Volatile market conditions led to a reduction in Markets trading income, driven by the deterioration in global credit markets as sovereign difficulties in the eurozone grew.

Non-Core trading losses increased by £704 million, reflecting costs incurred as part of the division's focus on reducing capital trading assets, with activity including the restructuring of monoline exposures, which mitigated both significant immediate and future regulatory uplifts in risk-weighted assets.

A gain in own credit adjustments of £1,914 million was recorded as a result of Group credit spreads widening, partially offset by the 2011 charges. This compares with a smaller gain of £242 million in 2010.

Insurance net premium income fell by 17% largely driven by Direct Line Group's exit from certain business segments, along with reduced volumes driven by the de-risking of the motor book. Insurance net premium income in Non-Core also decreased as legacy policies ran-off.

2010 results included £482 million of income recorded for GMS prior to its disposal in November 2010.

## 2010 compared with 2009

Net fees and commissions increased by £34 million to £5,982 million primarily due to improved performance in Markets (£173 million), driven by higher portfolio management and origination income, and UK Corporate (£123 million), principally reflecting strong refinancing levels and increased operating lease activity. This increase was partially offset by reduced fees in UK Retail (£160 million) and Ulster Bank (£73 million) principally reflecting the restructuring of current account overdraft fees.

Income from trading activities, excluding fair value movements in the Asset Protection Scheme, rose substantially during the year by £2,306 million to £6,067 million. Trading revenues in Markets were lower than 2009, which saw

unusually buoyant market conditions as rapidly falling interest rates generated significant revenue opportunities. This was more than offset by the improvement in Non-Core trading losses from £5,122 million for 2009 to £16 million for 2010 as underlying asset prices recovered and monoline spreads tightened. The unwinding of some banking book hedges also helped reduce trading losses.

The Asset Protection Scheme is accounted for as a credit derivative, and movements in the fair value of the contract are recorded as income from trading activities. The charge of £1,550 million in 2010 reflects improving credit spreads on the portfolio of covered assets.

A gain of £553 million was booked associated with the liability management exercise undertaken in May 2010, through which the Group strengthened its Core Tier 1 capital base by repurchasing existing Tier 1 securities and exchanging selected existing Upper Tier 2 securities for new senior debt securities. A similar series of exchange and tender offers concluded in April 2009 resulted in a gain of £3,790 million.

Other operating income increased by £606 million to £1,479 million. This improvement principally reflected a profit on sale of securities of £496 million compared with £162 million in 2009, higher profits from associated entities and an increased credit of £249 million compared with £51 million in 2009 relating to movements in own credit adjustments. These were partially offset by losses in the fair value of securities and investment properties.

Insurance net premium income fell by £138 million to £5,128 million principally reflecting lower general insurance premiums, driven by a managed reduction in the risk of the UK motor book, largely offset by price increases.

Business review *continued*

## Operating expenses and insurance claims

	2011	2010	2009
	£m	£m	£m
Staff costs			
- excluding gains on pensions curtailment	8,678	9,671	9,993
- gains on pensions curtailment	—	—	(2,148)
Premises and equipment	8,678	9,671	7,845
Other administrative expenses	2,451	2,402	2,594
- managed basis	2,722	2,963	3,163
- Payment Protection Insurance costs	850	—	—
- integration and restructuring costs	1,059	1,032	1,286
- bank levy	300	—	—
	4,931	3,995	4,449
Administrative expenses	16,060	16,068	14,888
Depreciation and amortisation	1,875	2,150	2,166
Write-down of goodwill and other intangible assets	91	10	363
Operating expenses	18,026	18,228	17,417
General insurance	2,968	4,698	4,223
Bancassurance	—	85	134
Insurance net claims	2,968	4,783	4,357
Staff costs as a percentage of total income	30%	30%	30%

## 2011 compared with 2010

Group operating expenses fell by 1% in 2011, driven by cost savings achieved as a result of the cost reduction programme and Non-Core run-off, largely reflecting the disposal of RBS Sempra and specific country exits, partially offset by Payment Protection Insurance costs.

Staff costs fell 10%, driven by lower Markets and International Banking discretionary compensation as a result of its decrease in revenues, and in Non-Core, given the impact of a 32% reduction in headcount and continued business disposals and country exits.

In May 2011, following the decision of the British Bankers' Association not to appeal the judgement of the judicial review, the Group recorded a provision of £850 million in respect of the costs of Payment Protection Insurance redress.

General insurance claims were £1,730 million lower, mainly due to the non-repeat of bodily injury reserve strengthening in 2010, de-risking of the motor book, more benign weather in 2011 and claims in Non-Core decreasing as legacy policies ran-off.

The Group's cost reduction programme delivered cost savings with an underlying run rate of over £3 billion by the end of 2011.

Business review [continued](#)Operating expenses and insurance claims continued  
2010 compared with 2009

The main driver of a 7% decrease in operating expenses, excluding gains on pensions curtailment of £2,148 million, is the recognition of benefits from the Group-wide efficiency programme. The programme continues to deliver material savings which have been funding investments to strengthen our Core franchises. Annualised savings are now just ahead of the £2.5 billion target for 2011 and are forecast to exceed £3 billion by 2013.

Staff costs, excluding pension schemes curtailment gains, fell by £322 million to £9,671 million, driven by savings in Markets, UK Retail, International Banking and Non-Core partially offset by higher costs in Group Centre.

Premises and equipment costs fell by 7% in the year to £2,402 million largely driven by efficiency cost savings, significant one-off property impairments recognised in 2009 and country exits following Non-Core disposals.

Other administrative expenses fell by £454 million to £3,995 million principally reflecting continued savings from the Group's efficiency programme.

Insurance net claims increased 10% to £4,783 million.

## Integration costs

	2011	2010	2009
	£m	£m	£m
Staff costs	38	210	365
Premises and equipment	6	3	78
Other administrative expenses	51	143	398
Depreciation and amortisation	11	20	18
	106	376	859

## Note:

(1) Integration costs for 2011 above exclude £2 million charge included within net interest income and a loss of £3 million within other operating income in respect of integration activities.

## 2011 compared with 2010

Integration costs were £106 million compared with £376 million in 2010. Integration costs decreased primarily due to a reduction of RBS N.V. (formerly ABN AMRO) integration activity during the year.

## 2010 compared with 2009

Integration costs were £376 million compared with £859 million in 2009. The fall in integration costs primarily relates to RBS N.V., as they migrate onto RBS systems.

Accruals in relation to integration costs are set out below.

	At 1 January 2011 £m	Charge to income statement £m	Utilised during the year £m	At 31 December 2011 £m
Staff costs - redundancy	—	8	(8)	—
Staff costs - other	—	30	(30)	—
Premises and equipment	24	6	(19)	11

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Other administrative expenses	—	51	(48)	3
Depreciation and amortisation	—	11	(11)	—
	24	106	(116)	14

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Business review *continued*

## Restructuring costs

	2011	2010	2009
	£m	£m	£m
Staff costs	356	353	328
Premises and equipment	156	117	48
Other administrative expenses	276	104	51
	788	574	427

## 2011 compared with 2010

Restructuring costs were £788 million compared with £574 million in 2010. The increase is due to the number of Group restructuring projects increasing during the year.

## 2010 compared with 2009

Restructuring costs were £574 million compared with £427 million in 2009. The increase is a result of the number of restructuring projects being undertaken.

Accruals in relation to restructuring costs are set out below.

	At 1 January 2011	Currency translation adjustments	Charge to income statement	Utilised during the year	At 31 December 2011
	£m	£m	£m	£m	£m
Staff costs - redundancy	201	—	274	(349)	126
Staff costs - other	17	(1)	82	(58)	40
Premises and equipment	117	—	156	(107)	166
Other administrative expenses	46	(2)	276	(210)	110
	381	(3)	788	(724)	442

## Divestment costs

	2011	2010	2009
	£m	£m	£m
Staff costs	95	51	—
Premises and equipment	11	6	—
Other administrative expenses	59	25	—
	165	82	—

## 2011 compared with 2010

Divestment costs of £165 million compared to £82 million in 2010 related to the European Commission mandated divestments.

## 2010 compared with 2009

Divestment costs of £82 million in the year relate to the European Commission mandated divestments.

Accruals in relation to divestment costs are set out below.

At	Charge	Utilised	At
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	1		31	
	January to income	during	December	
	2011 statement	the year	2011	
	£m	£m	£m	
Staff costs - redundancy	22	36	(13)	45
Staff costs - other	8	59	(66)	1
Premises and equipment	—	11	(11)	—
Other administrative expenses	2	59	(40)	21
	32	165	(130)	67

Business review [continued](#)

## Impairment losses

	2011	2010	2009
	£m	£m	£m
New impairment losses	9,236	9,667	14,224
Less: recoveries of amounts previously written-off	(527)	(411)	(325)
Charge to income statement	8,709	9,256	13,899
Comprising:			
Loan impairment losses	7,241	9,144	13,090
Securities			
- managed basis	200	112	809
- sovereign debt impairment	1,099	—	—
- interest rate hedge adjustments on impaired available-for-sale sovereign debt	169	—	—
	1,468	112	809
Charge to income statement	8,709	9,256	13,899

## 2011 compared with 2010

Impairment losses decreased by 6% compared with 2010, driven largely by a £1,569 million reduction in Non-Core loan impairments, despite continuing challenges in Ulster Bank and corporate real estate portfolios. This was partially offset by impairments taken on the Group's available-for-sale bond portfolio, as a result of the decline in the value of Greek sovereign bonds.

Retail & Commercial impairment losses fell by £227 million, driven by improving credit metrics in UK Retail and US Retail & Commercial partially offset by increases in Ulster Bank, largely reflecting a deterioration in credit metrics on the mortgage portfolio, and a single name provision in International Banking.

Total Core and Non-Core Ulster Bank impairment losses decreased by 4%, as the £223 million increase in Core Ulster Bank losses was more than offset by a decrease in losses recognised in Non-Core.

The Group holds Greek government bonds with a notional amount of £1.45 billion. As a result of Greece's continuing fiscal difficulties, the Group recorded impairment charges on these bonds totalling £1,099 million during the year. These charges were recorded to write the bonds down to their market price as at 31 December 2011 (c.21% of notional).

## 2010 compared with 2009

Impairment losses were £9,256 million, compared with £13,899 million in 2009. The 33% decrease reflects an overall improvement in the economic environments in which the Group operates.

Impairments fell in all Core businesses, except Ulster Bank Group, which faced an economic environment that remains challenging, with rising default levels across both personal and corporate portfolios.

Impairments for Ulster Bank Group (Core and Non-Core) increased to £3,843 million compared with £1,927 million in 2009.

A significant proportion of the reduction in Core impairments relates to lower specific and latent provisions in UK Retail, UK Corporate, International Banking, US Retail & Commercial and Markets.

Non-Core impairments fell by 41% in 2010 reflecting the gradual improvement in the economic environment through 2010 and lower specific provisions, alongside a non-repeat of the large single name losses seen in 2009.

Business review [continued](#)

Tax	2011	2010	2009
	£m	£m	£m
Tax (charge)/credit	(1,250)	(634)	429
	%	%	%
UK corporation tax rate	26.5	28.0	28.0
Effective tax rate	nm	nm	16.2

nm = not meaningful

The actual tax (charge)/credit differs from the expected tax credit computed by applying the standard rate of UK corporation tax as follows:

	2011	2010	2009
	£m	£m	£m
Expected tax credit	203	112	741
Sovereign debt impairment where no deferred tax asset recognised	(275)	—	—
Other losses in year where no deferred tax asset recognised	(530)	(450)	(780)
Foreign profits taxed at other rates	(417)	(517)	(276)
UK tax rate change - deferred tax impact	(110)	(82)	—
Unrecognised timing differences	(20)	11	274
Non-deductible goodwill impairment	(24)	(3)	(102)
Items not allowed for tax			
- losses on strategic disposals and write-downs	(72)	(311)	(152)
- UK Bank levy	(80)	—	—
- employee share schemes	(113)	(32)	(29)
- other disallowable items	(271)	(296)	(327)
Non-taxable items			
- gain on sale of Global Merchant Services	12	221	—
- gain on redemption of own debt	—	11	693
- other non-taxable items	245	341	410
Taxable foreign exchange movements	4	4	1
Losses brought forward and utilised	2	2	94
Adjustments in respect of prior years	196	355	(118)
Actual tax (charge)/credit	(1,250)	(634)	429

## 2011 compared with 2010

The high tax charge in 2011 reflects profits in high tax regimes (principally US) and losses in low tax regimes (principally Ireland), losses in overseas subsidiaries for which a deferred tax asset has not been recognised (principally Ireland and the Netherlands) and the effect of two reductions of 1% in the rate of UK corporation tax enacted in March 2011 and July 2011 on the net deferred tax balance.

## 2010 compared with 2009

The high tax charge in 2010 reflects profits in high tax regimes and losses in low tax regimes, together with £450 million relating to losses in overseas subsidiaries for which a deferred tax asset has not been recognised, and £311 million mainly in respect of losses on disposal of businesses for which no tax relief is available. This was offset in part by the non-taxable gain arising on the disposal of 80.01% of the GMS business.



Business review [continued](#)

## Divisional performance

	2011	2010	2009
	£m	£m	£m
Operating profit/(loss) by division			
UK Retail	2,021	1,348	375
UK Corporate	1,924	1,893	1,392
Wealth	248	283	373
International Banking	755	1,311	1,118
Ulster Bank	(984)	(683)	(385)
US Retail & Commercial	537	349	(52)
Retail & Commercial	4,501	4,501	2,821
Markets	899	2,724	4,991
Direct Line Group	454	(295)	58
Central items	191	630	456
Core	6,045	7,560	8,326
Non-Core	(4,221)	(5,715)	(14,461)
Managed basis	1,824	1,845	(6,135)
Reconciling items			
Own credit adjustments	1,914	242	(97)
Asset Protection Scheme	(906)	(1,550)	—
Payment Protection Insurance costs	(850)	—	—
Sovereign debt impairment	(1,099)	—	—
Amortisation of purchased intangible assets	(222)	(369)	(272)
Integration and restructuring costs	(1,064)	(1,032)	(1,286)
Gain on redemption of own debt	255	553	3,790
Strategic disposals	(104)	171	132
Gains on pension curtailment	—	—	2,148
Bank levy	(300)	—	—
Write-down of goodwill and other intangible assets	(11)	(10)	(363)
Bonus tax	(27)	(99)	(208)
Interest rate hedge adjustments on impaired available-for-sale sovereign debt	(169)	—	—
RFS Holdings minority interest	(7)	(150)	(356)
Group operating loss before tax	(766)	(399)	(2,647)

	2011	2010	2009
Impairment losses/(recoveries) by division	£m	£m	£m
UK Retail	788	1,160	1,679
UK Corporate	793	767	936
Wealth	25	18	33
International Banking	168	86	418
Ulster Bank	1,384	1,161	649
US Retail & Commercial	326	519	705
Retail & Commercial	3,484	3,711	4,420
Markets	38	65	250
Direct Line Group	—	—	8
Central items	(2)	4	—
Core	3,520	3,780	4,678
Non-Core	3,919	5,476	9,221
Managed basis	7,439	9,256	13,899
Reconciling items			
Sovereign debt impairment	1,099	—	—
Interest rate hedge adjustments on impaired available-for-sale sovereign debt	169	—	—
RFS Holdings minority interest	2	—	—
Group impairment losses	8,709	9,256	13,899
	2011	2010	2009
Net interest margin by division	%	%	%
UK Retail	3.95	3.89	3.74
UK Corporate	3.06	2.89	2.53
Wealth	3.23	3.26	4.07
International Banking	1.73	1.92	1.86
Ulster Bank	1.87	2.03	1.83
US Retail & Commercial	3.06	2.82	2.34
Retail & Commercial	2.97	2.91	2.62
Non-Core	0.63	1.02	0.74
Group net interest margin	1.92	2.06	1.76
	2011	2010	2009
Risk-weighted assets by division	£bn	£bn	£bn
UK Retail	48.4	48.8	51.3
UK Corporate	79.3	84.2	92.5
Wealth	12.9	12.5	11.2
International Banking	43.2	51.7	67.7
Ulster Bank	36.3	31.6	29.9
US Retail & Commercial	59.3	57.4	60.1
Retail & Commercial	279.4	286.2	312.7
Markets	120.3	110.3	72.4
Other	12.0	18.0	9.4
Core	411.7	414.5	394.5
Non-Core	93.3	153.7	171.3
Group before benefit of Asset Protection Scheme	505.0	568.2	565.8
Benefit of Asset Protection Scheme	(69.1)	(105.6)	(127.6)

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Group before RFS Holdings minority interest	435.9	462.6	438.2
RFS Holdings minority interest	3.1	2.9	102.8
Group	439.0	465.5	541.0



Business review [continued](#)

## Divisional performance continued

## Employee numbers at 31 December

(full time equivalents in continuing operations rounded to the nearest hundred)

	2011	2010	2009
UK Retail	27,700	28,200	30,000
UK Corporate	13,600	13,200	12,400
Wealth	5,700	5,200	4,600
International Banking	5,400	5,300	6,800
Ulster Bank	4,200	4,200	4,500
US Retail & Commercial	15,400	15,900	15,700
Retail & Commercial	72,000	72,000	74,000
Markets	13,900	15,700	14,300
Direct Line Group	14,900	14,500	13,900
Central items	6,200	4,700	4,200
Core	107,000	106,900	106,400
Non-Core	4,700	6,900	15,100
	111,700	113,800	121,500
Business Services	34,000	34,400	38,600
Integration and restructuring	1,100	300	500
RFS Holdings minority interest	—	—	300
Group	146,800	148,500	160,900

## UK Retail

	2011	2010	2009
	£m	£m	£m
Net interest income	4,302	4,054	3,598
Net fees and commissions	1,066	1,100	1,244
Other non-interest income	140	322	391
Non-interest income	1,206	1,422	1,635
Total income	5,508	5,476	5,233
Direct expenses			
- staff	(839)	(889)	(968)
- other	(437)	(480)	(458)
Indirect expenses	(1,423)	(1,514)	(1,619)
	(2,699)	(2,883)	(3,045)
Profit before insurance net claims and impairment losses	2,809	2,593	2,188
Insurance net claims	—	(85)	(134)
Impairment losses	(788)	(1,160)	(1,679)
Operating profit	2,021	1,348	375
Analysis of income by product			
Personal advances	1,089	993	1,192
Personal deposits	961	1,102	1,349
Mortgages	2,277	1,984	1,214
Cards	950	962	869
Other, including bancassurance	231	435	609
Total income	5,508	5,476	5,233
Analysis of impairments by sector			
Mortgages	182	177	124
Personal	437	682	1,023
Cards	169	301	532
Total impairment losses	788	1,160	1,679
Loan impairment charge as % of gross customer loans and advances (excluding reverse repurchase agreements) by sector			
Mortgages	0.2%	0.2%	0.1%
Personal	4.3%	5.8%	7.5%
Cards	3.0%	4.9%	8.6%
Total	0.7%	1.1%	1.6%
Performance ratios			
Return on equity (1)	24.5%	16.3%	4.8%
Net interest margin	3.95%	3.89%	3.74%
Cost:income ratio	49%	53%	58%
Adjusted cost:income ratio (2)	49%	53%	60%
	£bn	£bn	£bn
Capital and balance sheet			
Loans and advances to customers (gross) (3)			
- mortgages	95.0	90.6	83.2

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- personal	10.1	11.7	13.6
- cards	5.7	6.1	6.2
	110.8	108.4	103.0
Customer deposits (excluding bancassurance) (3)	101.9	96.1	87.2
Assets under management (excluding deposits)	5.5	5.7	5.3
Risk elements in lending (3)	4.6	4.6	5.7
Loan:deposit ratio (excluding repos)	106%	110%	115%
Risk-weighted assets	48.4	48.8	51.3

Notes:

- (1) Divisional return on equity is based on divisional operating profit after tax divided by average notional equity (based on 10% of the monthly average of divisional RWAs, adjusted for capital deductions).
- (2) Adjusted cost:income ratio is based on total income after netting insurance claims, and operating expenses.
- (3) Includes disposal groups: loans and advances to customers - £7.3 billion; customer deposits - £8.8 billion; risk elements in lending - £0.5 billion.

Business review [continued](#)

UK Retail continued

In 2010, UK Retail set out an aspiration to become the UK's most helpful bank and launched the Customer Charter. In 2011, we made good progress on our Customer Charter commitments and the roll-out of innovation that actually helps customers. In December 2011, UK Retail refined its staff incentive scheme to further strengthen the role of customer service and to help build long lasting customer relationships.

Progress against the Customer Charter commitments is independently assessed and has shown encouraging results. By the end of 2011, we achieved the goal of serving 80% of our customers in less than 5 minutes in our busiest branches. Branch opening hours have also been extended and standardised, which means that our branches are now open for an additional 5,000 hours per week at times our customers have told us suit them.

Innovation has supported the delivery of Helpful Banking by focusing on solutions that make it easier for customers to bank with RBS and NatWest. An important example has been giving customers access to 24 hour emergency cash from NatWest and RBS ATMs when their cards are lost or stolen. We also updated our market-leading iPhone application and by the end of the year 1 million customers had downloaded the application. With successful apps also launched for iPad, Android and Blackberry, RBS is now the leading mobile bank in the UK.

2011 compared with 2010

UK Retail delivered strong full year results, as operating profit increased by £673 million to £2,021 million, despite continued uncertainty in the economic climate and the low interest rate environment. Impairments fell by £372 million, with further improvements in the unsecured book and continued careful mortgage underwriting. Return on equity improved to 24.5%.

The division continued to focus on growing secured lending while at the same time building customer deposits, thereby reducing the Group's reliance on wholesale funding. Loans and advances to customers grew 2%, with a change in mix from unsecured to secured as the Group actively sought to improve its risk profile. Mortgage balances grew by 5%, while unsecured lending contracted by 11%.

- Mortgage growth reflected continued strong new business levels. Gross mortgage lending market share of 10% continues above our stock position of 8%.
- Customer deposits grew 6%, outperforming the market total deposit growth of 3%. Savings balances grew by £6 billion, or 9%, with 1.5 million accounts opened, demonstrating the strength of our customer franchise and our strategy to further develop primary banking relationships.

Net interest income increased by 6% to £4,302 million, driven by strong balance sheet growth. Net interest margin decreased 6 basis points with recovering asset margins more than offset by more competitive savings rates and lower long term swap rate returns adversely impacting liability margins.

Non-interest income declined 15% to £1,206 million, primarily driven by lower investment and protection income as a result of the dissolution of the bancassurance joint venture. In addition, a number of changes have been made to support delivery of Helpful Banking, such as 'Act Now' text alerts, which have decreased fee income.

Overall expenses decreased by 6%, with the adjusted cost:income ratio improving from 53% to 49%. Cost reductions were driven by a clear management focus on process re-engineering and operational efficiency together with benefits from the dissolution of the bancassurance joint venture, partly offset by higher inflation rates in utility and mail costs.

Impairment losses decreased 32% to £788 million reflecting the impact of a strengthened risk appetite, and a more stable economic environment.

Risk-weighted assets were broadly stable, with volume growth in lower risk secured mortgages partly offset by a decrease in the unsecured portfolio.

2010 compared with 2009

Operating profit recovered strongly from the low levels recorded in 2008 and 2009 to £1,348 million and impairments fell by £519 million as the economic environment continued to recover.

The division has continued to focus in 2010 on growing secured lending while at the same time building customer deposits, thereby reducing the Group's reliance on wholesale funding. Loans and advances to customers grew 5%, with a change in mix from unsecured to secured as the Group actively sought to improve its risk profile. Mortgage balances increased by 9% while unsecured lending contracted by 10%.

- Mortgage growth was due to good retention of existing customers and new business, the majority of which comes from the existing customer base. Gross mortgage lending market share remained broadly in line with 2009 at 12%, with the Group on track to meet its Government target on net mortgage lending.
- Customer deposits grew 10% on 2009, reflecting the strength of the UK Retail customer franchise, which outperformed the market in an increasingly competitive environment. Savings balances grew by £8 billion or 13% with 1.8 million accounts opened, outperforming the market total deposit growth of 3%. Personal current account balances increased by 3% on 2009.

Net interest income increased significantly by 13% to £4,054 million, driven by strong balance sheet growth and repricing. Net interest margin improved by 15 basis points to 3.89%, with widening asset margins partially offset by contracting liability margins in the face of a competitive deposit market.

Non-interest income declined 13% to £1,422 million, principally reflecting the restructuring of current account overdraft fees in the final quarter of 2009.

Expenses decreased by 5%, with the cost:income ratio (net of insurance claims) improving from 60% to 53%.

- Direct staff costs declined by 8%, largely driven by a clear management focus on process re-engineering enabling a 7% reduction in headcount.
- RBS continues to progress towards a more convenient, lower cost operating model, with over 4.8 million active users of online banking and a record share of new sales achieved through direct channels. More than 7.8 million accounts have switched to paperless statements and 276 branches now utilise automated cash deposit machines.

Impairment losses decreased 31% to £1,160 million primarily reflecting the recovery in the economic environment.

- The mortgage impairment charge was £177 million (2009 - £124 million) on a total book of £91 billion. Mortgage arrears rates marginally increased in 2010 but remain below the industry average, as reported by the Council of Mortgage Lenders. Repossessions showed only a small increase on 2009, as the Group continues to support customers facing financial difficulties.
- The unsecured lending impairment charge was £983 million (2009 - £1,555 million) on a total book of £18 billion.

Risk-weighted assets decreased by 5% to £48.8 billion, with lower unsecured lending, improving portfolio credit metrics and small procyclicality benefits more than offsetting growth in mortgages.

Business review [continued](#)

## UK Corporate

	2011	2010	2009
	£m	£m	£m
Net interest income	3,092	3,000	2,633
Net fees and commissions	1,375	1,353	1,230
Other non-interest income	396	443	499
Non-interest income	1,771	1,796	1,729
Total income	4,863	4,796	4,362
Direct expenses			
- staff	(922)	(912)	(882)
- other	(390)	(411)	(311)
Indirect expenses	(834)	(813)	(841)
	(2,146)	(2,136)	(2,034)
Profit before impairment losses	2,717	2,660	2,328
Impairment losses	(793)	(767)	(936)
Operating profit	1,924	1,893	1,392
Analysis of income by business			
Corporate and commercial lending	2,643	2,571	2,100
Asset and invoice finance	660	616	500
Corporate deposits	694	738	984
Other	866	871	778
Total income	4,863	4,796	4,362
Analysis of impairments by sector			
Banks and financial institutions	20	20	15
Hotels and restaurants	59	52	98
Housebuilding and construction	103	131	106
Manufacturing	34	1	51
Other	171	133	159
Private sector education, health, social work, recreational and community services	113	30	59
Property	170	245	259
Wholesale and retail trade, repairs	85	91	76
Asset and invoice finance	38	64	113
Total impairment losses	793	767	936
Loan impairment charge as % of gross customer loans and advances (excluding reverse repurchase agreements) by sector			
Banks and financial institutions	0.3%	0.3%	0.2%
Hotels and restaurants	1.0%	0.8%	1.5%
Housebuilding and construction	2.6%	2.9%	2.5%
Manufacturing	0.7%	-	0.9%
Other	0.5%	0.4%	0.5%
Private sector education, health, social work, recreational and community services	1.3%	0.3%	0.9%
Property	0.6%	0.8%	0.8%
Wholesale and retail trade, repairs	1.0%	0.9%	0.7%
Asset and invoice finance	0.4%	0.6%	1.3%

Total	0.7%	0.7%	0.8%
Performance ratios			
Return on equity (1)	15.2%	13.6%	10.4%
Net interest margin	3.06%	2.89%	2.53%
Cost:income ratio	44%	45%	47%

Note:

(1) Divisional return on equity is based on divisional operating profit after tax, divided by average notional equity (based on 10% of the monthly average of divisional RWAs, adjusted for capital deductions).



	2011 £bn	2010 £bn	2009 £bn
Capital and balance sheet			
Total third party assets	114.2	117.0	116.7
Loans and advances to customers (gross) (1)			
- banks and financial institutions	5.8	6.2	6.3
- hotels and restaurants	6.1	6.8	6.7
- housebuilding and construction	3.9	4.5	4.3
- manufacturing	4.7	5.4	6.0
- other	34.2	32.6	31.0
- private sector education, health, social work, recreational and community services	8.7	9.0	6.5
- property	28.2	29.5	33.0
- wholesale and retail trade, repairs	8.7	9.9	10.4
- asset and invoice finance	10.4	9.9	8.8
	110.7	113.8	113.0
Customer deposits (1)	126.3	124.5	110.8
Risk elements in lending (1)	5.0	4.0	2.3
Loan:deposit ratio (excluding repos)	86%	90%	101%
Risk-weighted assets	79.3	84.2	92.5

## Note:

(1) Includes disposal groups: loans and advances to customers - £12.2 billion; customer deposits - £21.8 billion; risk elements in lending - £1.0 billion.

In 2011, UK Corporate focused on supporting its customers through challenging economic times. As a result of over 5,000 hours of customer research, UK Corporate launched the 'Ahead for Business' promise to its small and medium-sized enterprise (SME) customers.

To deliver on this, the division launched a number of initiatives to improve the service it offers to customers. For example, the 'Working with You' initiative, has seen over 4,600 visits to customer businesses since its launch in Q2 2011. Additionally, following the launch of the relationship manager accreditation programme, also in Q2 2011, almost all relationship managers have gained full accreditation in the initial phase.

UK Corporate continued to support new and existing businesses during 2011:

- launching its best ever fixed rate loan product for SMEs;
- reacting quickly after the August riots to give affected businesses access to special interest rate and fee free lending products;
- answering over 4,000 calls on the Start-up Hotline, offering free advice and a complementary business plan review service; and
- supporting more debt capital and loan market deals for larger corporates than any other bank.

The division also took measures to reduce the risk retained in the business allowing for quicker and more consistent decisions by simplifying the credit underwriting process and improving automated decision making.

## 2011 compared with 2010

Operating profit increased 2% to £1,924 million, as higher income was only partially offset by higher impairments and an increase in expenses. Net interest income remained broadly flat. Net interest margin improved 17 basis points with benefits from re-pricing the lending portfolio and the revision to income deferral assumptions in Q1 2011 partially

offset by increased funding costs together with continued pressure on deposit margins. A 1% increase in deposit balances supported an improvement in the loan:deposit ratio to 86%.

Non-interest income decreased by 1% as a result of lower Markets cross-sales and fee income, partially offset by increased Invoice Finance and Lombard income.

Excluding the £29 million OFT penalty in 2010, total costs increased by 2%, largely reflecting increased investment in the business and higher costs of managing the non-performing book.

Impairments of £793 million were 3% higher due to increased specific impairments and collectively assessed provisions, partially offset by lower latent loss provisions.

2010 compared with 2009

Operating profit grew by £501 million, 36%, compared with 2009, driven by strong income growth and significantly lower impairments, partially offset by higher costs.

UK Corporate performed strongly in the deposit market, with customer deposit balance growth of £14 billion contributing to a 11 percentage point improvement in the loan:deposit ratio in 2010. While customer lending increased only marginally (with gross lending largely offset by customer deleveraging) net interest income rose by £367 million, 14%, and net interest margin rose by 36 basis points driven primarily by the good progress made on loan repricing.

Non-interest income increased 4% reflecting strong refinancing levels and increased operating lease activity, partially offset by lower sales of financial market products.

Total costs increased 5% (£102 million) or 4% excluding the OFT penalty in 2010.

Impairments were 18% lower, primarily as a result of higher charges taken during the first half of 2009 to reflect potential losses in the portfolio not yet specifically identified.

Return on equity increased from 10.4% to 13.6%, reflecting higher operating profit and lower RWAs as a result of improved risk metrics.

Business review *continued*

## Wealth

	2011	2010	2009
	£m	£m	£m
Net interest income	645	588	616
Net fees and commissions	375	376	363
Other non-interest income	84	71	83
Non-interest income	459	447	446
Total income	1,104	1,035	1,062
Direct expenses			
- staff	(413)	(382)	(357)
- other	(195)	(142)	(144)
Indirect expenses	(223)	(210)	(155)
	(831)	(734)	(656)
Profit before impairment losses	273	301	406
Impairment losses	(25)	(18)	(33)
Operating profit	248	283	373
Analysis of income			
Private banking	902	836	869
Investments	202	199	193
Total income	1,104	1,035	1,062
Performance ratios			
Return on equity (1)	13.1%	15.9%	24.8%
Net interest margin	3.23%	3.26%	4.07%
Cost:income ratio	75%	71%	62%
	£bn	£bn	£bn
Capital and balance sheet			
Loans and advances to customers (gross)			
- mortgages	8.3	7.8	6.5
- personal	6.9	6.7	4.9
- other	1.7	1.6	2.3
	16.9	16.1	13.7
Customer deposits (2)	38.2	37.1	35.7
Assets under management (excluding deposits) (2)	30.9	33.9	32.5
Risk elements in lending	0.2	0.2	0.2
Loan:deposit ratio (excluding repos) (2)	44%	43%	38%
Risk-weighted assets	12.9	12.5	11.2

## Notes:

(1) Divisional return on equity is based on divisional operating profit after tax divided by average notional equity (based on 10% of the monthly average of divisional RWAs, adjusted for capital deductions).

(2) 2010 and 2009 comparatives have been revised to reflect the current reporting methodology.



2011 has been a significant year for the Coutts businesses from a strategic perspective. In Q1 2011, a new divisional strategy was defined with the execution of early changes already making an impact.

Key strategic changes in 2011 included:

- A refreshed Coutts brand bringing Coutts UK and RBS Coutts under one single contemporary brand.
- A refocus on territories where the businesses have the opportunity for greatest scale or growth such as UK, Asia, Middle East, and Eastern Europe.
- Further development of client propositions as well as the portfolio of products and services for key international markets.
- Strategic investment in technology leading to the development of a single global technology platform for the Wealth division. The platform was successfully deployed in Adam & Company in 2011 with Coutts UK to follow in 2012.
- Strengthening the connectivity between Wealth and other Group divisions including referrals in international jurisdictions and improved connectivity with UK Corporate.
- Continued activity to ensure the division responds to new or expected regulatory changes with proactive solution design and preparation.
- Injection of new management into key roles from both internal and external sources including key segment heads, marketing, products & services, and international executive leadership.

Following the establishment of a single global brand in Q4 2011, focus turned to the reorganisation of key global functions such as marketing and product & services, as well as some local management structures. These reorganisations have realigned the division to maximise execution of the divisional strategy. The execution plan for the strategy will continue into 2012 and position Wealth strongly against its peers.

2011 compared with 2010

Operating profit decreased by 12% on 2010 to £248 million, driven by increases in expenses (13%) and impairments (39%) partially offset by a 7% growth in income.

Income increased by £69 million with a 24 basis points improvement in lending margins, strong treasury income and increases in lending and deposit volumes. Non-interest income rose 3%, with investment income growing 2% despite turbulent market conditions.

Expenses increased by £97 million, largely driven by adverse foreign exchange movements and headcount growth to service the increased revenue base. Additional strategic investment in technology enhancement, rebranding and programmes to support regulatory change also contributed to the increase.

Client assets and liabilities managed by the division decreased by 1%. Customer deposits grew 3% in a competitive environment and lending volumes grew 5%. Assets under management declined 9%, with fund outflows contributing 3% of the decrease and market conditions making up the balance.

2010 compared with 2009

2010 operating profit fell by 24% driven by lower net interest income and higher expenses, partly offset by a 45% decline in impairments in the year.

Income declined by 3% primarily due to lower net interest income. Strong lending and investment income was offset by the impact of a competitive deposit market.

Expenses grew by 12% to £734 million. Direct expenses were up 5%, £23 million reflecting additional strategic investment. Indirect expenses increased by £55 million reflecting a change in allocation of Business Services costs.

Assets under management grew by 4% largely through improving market conditions.

Business review [continued](#)

## International Banking

	2011	2010	2009
	£m	£m	£m
Net interest income from banking activities	1,199	1,353	1,665
Funding costs of rental assets	(42)	(37)	(49)
Net-interest income	1,157	1,316	1,616
Non-interest income	1,398	1,961	1,940
Total income	2,555	3,277	3,556
Direct expenses			
- staff	(706)	(871)	(934)
- other	(226)	(274)	(317)
Indirect expenses	(700)	(735)	(769)
	(1,632)	(1,880)	(2,020)
Profit before impairment losses	923	1,397	1,536
Impairment losses	(168)	(86)	(418)
Operating profit	755	1,311	1,118
Of which:			
Ongoing businesses	773	1,348	1,136
Run-off businesses	(18)	(37)	(18)
Analysis of income by product			
Cash management	940	1,368	1,298
Trade finance	275	243	246
Portfolio	1,265	1,578	1,886
Ongoing businesses	2,480	3,189	3,430
Run-off businesses	75	88	126
Total income	2,555	3,277	3,556
Analysis of impairments by sector			
Manufacturing and infrastructure	254	(17)	89
Property and construction	17	102	50
Transport and storage	11	—	2
Telecommunications, media and technology	—	7	—
Banks and other financial institutions	(42)	49	174
Other	(72)	(55)	103
	168	86	418
Performance ratios (ongoing businesses)			
Return on equity (1)	11.5%	15.4%	11.5%
Net interest margin	1.73%	1.92%	1.86%
Cost:income ratio	62%	55%	55%
	£bn	£bn	£bn
Capital and balance sheet			
Total third party assets (excluding derivatives mark-to-market)	69.9	77.9	75.3
Loans and advances	60.3	66.0	66.9

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Customer deposits (excluding repos)	45.1	43.7	38.1
Risk elements in lending	1.6	1.5	1.0
Loan:deposit ratio (excluding repos)	126%	142%	171%
Risk-weighted assets	43.2	51.7	67.7
	£m	£m	£m
Run-off businesses (2)			
Total income	75	88	126
Direct expenses	(93)	(125)	(144)
Operating loss	(18)	(37)	(18)

Notes:

(1) Divisional return on equity is based on divisional operating profit after tax divided by average notional equity (based on 10% of the monthly average of divisional RWAs, adjusted for capital deductions).

(2) Run-off businesses consist of the exited corporate finance businesses.



International Banking serves companies with a leading client proposition focused on financing, transaction services and risk management. The International Banking structure and governance were complete by the end of June 2012. Management is focused on leveraging the International network and the Transaction Services offering to ensure relevance and intimacy with the division's client base.

During the year, International Banking invested in improving existing products and services and also in developing new ones. To help corporate treasurers manage their global positions, the division launched a global Liquidity Solutions Portal, giving its customers a view of their operational and investment balances and rates all in one place, improving transparency, and enabling them to execute and redeem investments effectively.

2011 compared with 2010

Operating profit was down 42%, partly reflecting the sale of Global Merchant Services (GMS) which completed on 30 November 2010. Adjusting for the disposal, operating profit decreased 32%, driven by an impairment provision on a single name in 2011.

Excluding GMS income of £451 million, income was 10% lower despite the success of deposit-gathering initiatives, as deposits increased £2 billion in a competitive environment.

Excluding GMS expenses of £244 million, expenses decreased by £4 million, reflecting business improvement initiatives and investment in technology and support infrastructure.

Impairment losses increased to £168 million compared with £86 million in 2010 reflecting a single name impairment.

For the eleven months in 2010 before completion of the disposal, GMS generated income of £451 million, total expenses of £244 million and an operating profit of £207 million.

2010 compared with 2009

Operating profit increased 17%, driven by lower costs and impairment losses (which has more than compensated for the loss of Global Merchant Services (GMS) income). Adjusting for the disposal operating profit increased 28%.

For the eleven months before disposal, International Banking booked income of £451 million (2009 - £505 million) and total expenses of £244 million (2009 - £249 million) for GMS, generating an operating profit of £207 million (2009 - 256 million).

Income was down 8%, or 7% excluding GMS, reflecting lower deposit volumes in Cash Management business, a decline in the Trade Finance business.

Expenses decreased 7% to £1,880 million, as increased investment in front office and support infrastructure was offset by tight management of business costs.

Third party assets increased by £2.6 billion, or £1.5 billion excluding GMS, as Yen clearing activities were brought in-house and loans and advances increased.

Business review [continued](#)

## Ulster Bank

	2011	2010	2009
	£m	£m	£m
Net interest income	736	839	763
Net fees and commissions	142	156	228
Other non-interest income	69	58	26
Non-interest income	211	214	254
Total income	947	1,053	1,017
Direct expenses			
- staff	(221)	(237)	(325)
- other	(67)	(74)	(86)
Indirect expenses	(259)	(264)	(342)
	(547)	(575)	(753)
Profit before impairment losses	400	478	264
Impairment losses	(1,384)	(1,161)	(649)
Operating loss	(984)	(683)	(385)
Analysis of income by business			
Corporate	435	521	580
Retail	428	465	412
Other	84	67	25
Total income	947	1,053	1,017
Analysis of impairments by sector			
Mortgages	570	294	74
Corporate			
- property	324	375	306
- other corporate	434	444	203
Other lending	56	48	66
Total impairment losses	1,384	1,161	649
Loan impairment charge as % of gross customer loans and advances (excluding reverse repurchase agreements) by sector			
Mortgages	2.8%	1.4%	0.5%
Corporate			
- property	6.8%	6.9%	3.0%
- other corporate	5.6%	4.9%	1.8%
Other lending	3.5%	3.7%	2.7%
Total	4.1%	3.1%	1.6%
Performance ratios			
Return on equity (1)	(22.8%)	(16.8%)	(12.7%)
Net interest margin	1.87%	2.03%	1.83%
Cost:income ratio	58%	55%	74%

## Note:

(1) Divisional return on equity is based on divisional operating loss after tax divided by average notional equity (based on 10% of the monthly average of divisional RWAs, adjusted for capital deductions).



	2011 £bn	2010 £bn	2009 £bn
Capital and balance sheet			
Loans and advances to customers (gross)			
- mortgages	20.0	21.2	16.2
- corporate			
- property	4.8	5.4	10.1
- other corporate	7.7	9.0	11.0
- other lending	1.6	1.3	2.4
	34.1	36.9	39.7
Customer deposits	21.8	23.1	21.9
Risk elements in lending			
- mortgages	2.2	1.5	0.6
- corporate			
- property	1.3	0.7	0.7
- other corporate	1.8	1.2	0.8
- other lending	0.2	0.2	0.2
Total risk elements in lending	5.5	3.6	2.3
Loan:deposit ratio (excluding repos)	143%	152%	177%
Risk-weighted assets	36.3	31.6	29.9
Spot exchange rate - €/£	1.196	1.160	1.126

2011 was another difficult year for the business due to the continued challenging economic environment. This was reflected in the financial performance, with ongoing pressure on income and a further increase in impairment losses.

Ulster Bank continues to make progress on its customer commitments and deposit gathering strategy, while cost management and targeting growth in areas that leverage competitive advantage, remain priorities. In 2011, customer numbers increased by 2%, representing a strong performance in current and savings accounts, driven by the enhanced customer service highlighted by our 'Help for what matters' programme.

Following a review of the cost base and operating model, 950 proposed job losses were announced in January 2012, the majority of which are expected by the end of 2012. This decision is a necessary part of the changes required to build a stronger sustainable business for the future.

#### 2011 compared with 2010

Operating profit before impairment losses decreased by £78 million in 2011 with lower income partially mitigated by cost savings. Impairment losses of £1,384 million increased by 19% from 2010 resulting in an operating loss of £984 million, 44% higher than 2010.

Income fell by 10% driven by a contracting performing loan book coupled with higher funding costs. Loans and advances to customers decreased by 8% during 2011.

Expenses fell by 5% reflecting tight management of the cost base across the business.

Impairment losses increased by 19% largely reflecting the deterioration in credit metrics on the mortgage portfolio driven by a combination of higher debt flow and further fall in asset prices.

Despite intense competition, retail and small business deposit balances have grown strongly throughout 2011, driven by the benefits of a focused deposit gathering strategy. However, total customer deposit balances fell by 6% terms largely driven by the outflow of wholesale customer balances due to rating downgrades.

Risk-weighted assets increased by 15% in 2011 reflecting the deterioration in credit risk metrics.

Business review [continued](#)

Ulster Bank continued

2010 compared with 2009

Overall performance deteriorated in 2010, largely as a result of an increase in impairment losses of £512 million. Operating profit before impairment increased to £478 million, up 81%, driven by the culmination of a bank-wide cost saving programme during 2010.

Net interest income increased by 10%, as tightening deposit margins due to intensive market competition and movements in foreign exchange rates were offset by actions to increase asset margins.

Non-interest income was 16% lower, basis reflecting a non-recurring gain in 2009.

Loans to customers fell by 7%. On 1 July 2010 the division transferred a portfolio of development property assets to the Non-Core division, partially offset by a simultaneous transfer of a portfolio of retail mortgage assets to the core business.

Despite intense competition, customer deposit balances increased by 5% over the year with strong growth across all deposit categories, driven by a focus on improving the bank's funding profile.

Expenses were 24% lower. The strong year-on-year performance in expenses was primarily driven by an increased focus on active management of the cost base, and the benefits derived from the business restructuring and cost-saving programme which commenced in 2009.

Impairment losses increased by £512 million to £1,161 million reflecting the deteriorating economic environment in Ireland and rising default levels across both personal and corporate portfolios. Lower asset values, particularly in property-related lending together with pressure on borrowers with a dependence on consumer spending have resulted in higher corporate loan losses, while higher unemployment, lower incomes and increased taxation have driven mortgage impairment increases.

Risk-weighted assets have increased due to deteriorating credit risk metrics.

Customer numbers increased by 3% during 2010, with a strong performance in current and savings accounts switchers.

## US Retail &amp; Commercial

	2011	2010	2009	2011	2010	2009
	US\$m	US\$m	US\$m	£m	£m	£m
Net interest income	3,048	2,940	2,755	1,900	1,902	1,758
Net fees and commissions	1,350	1,328	1,335	841	859	853
Other non-interest income	473	464	368	296	301	235
Non-interest income	1,823	1,792	1,703	1,137	1,160	1,088
Total income	4,871	4,732	4,458	3,037	3,062	2,846
Direct expenses						
- staff	(1,344)	(1,238)	(1,239)	(838)	(801)	(792)
- other	(893)	(897)	(941)	(557)	(580)	(600)
Indirect expenses	(1,250)	(1,255)	(1,255)	(779)	(813)	(801)
	(3,487)	(3,390)	(3,435)	(2,174)	(2,194)	(2,193)
Profit before impairment losses	1,384	1,342	1,023	863	868	653
Impairment losses	(524)	(802)	(1,104)	(326)	(519)	(705)
Operating profit/(loss)	860	540	(81)	537	349	(52)
Average exchange rate - US\$/£				1.604	1.546	1.566
Analysis of income by product						
Mortgages and home equity	744	786	781	463	509	499
Personal lending and cards	709	761	707	442	492	451
Retail deposits	1,487	1,465	1,518	927	948	969
Commercial lending	936	901	855	584	583	546
Commercial deposits	667	627	631	416	406	403
Other	328	192	(34)	205	124	(22)
Total income	4,871	4,732	4,458	3,037	3,062	2,846
Analysis of impairments by sector						
Residential mortgages	44	85	114	28	55	73
Home equity	165	164	261	103	106	167
Corporate and commercial	88	354	518	55	228	331
Other consumer	101	146	211	61	96	134
Securities	126	53	—	79	34	—
Total impairment losses	524	802	1,104	326	519	705
Loan impairment charge as % of gross customer loans and advances (excluding reverse repurchase agreements) by sector						
Residential mortgages	0.5%	0.9%	1.1%	0.5%	0.9%	1.1%
Home equity	0.7%	0.7%	1.0%	0.7%	0.7%	1.1%
Corporate and commercial	0.2%	1.1%	1.6%	0.2%	1.1%	1.7%
Other consumer	0.8%	1.4%	1.7%	0.8%	1.4%	1.8%
Total	0.5%	1.0%	1.4%	0.5%	1.0%	1.4%
Performance ratios						
Return on equity (1)	6.3%	3.7%	(0.6%)	6.3%	3.7%	(0.6%)
Net interest margin	3.06%	2.82%	2.34%	3.06%	2.82%	2.34%

Cost:income ratio	72%	72%	77%	72%	72%	77%
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Note:

(1) Divisional return on equity is based on divisional operating profit/(loss) after tax divided by average notional equity (based on 10% of the monthly average of divisional RWAs, adjusted for capital deductions).

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Business review [continued](#)

## US Retail &amp; Commercial continued

	2011	2010	2009	2011	2010	2009
	US\$bn	US\$bn	US\$bn	£bn	£bn	£bn
Capital and balance sheet						
Total third party assets	117.3	112.4	124.2	75.8	72.4	76.5
Loans and advances to customers (gross)						
- residential mortgages	9.4	9.4	10.6	6.1	6.1	6.5
- home equity	23.1	23.6	25.0	14.9	15.2	15.4
- corporate and commercial	35.3	31.7	31.6	22.9	20.5	19.5
- other consumer	12.0	10.7	12.2	7.7	6.9	7.5
	79.8	75.4	79.4	51.6	48.7	48.9
Customer deposits (excluding repos)	92.8	92.1	98.0	60.0	59.3	60.4
Risk elements in lending						
- retail	1.0	0.7	0.6	0.6	0.4	0.4
- commercial	0.6	0.7	0.4	0.4	0.5	0.2
Total risk elements in lending	1.6	1.4	1.0	1.0	0.9	0.6
Loan:deposit ratio (excluding repos)	85%	81%	80%	85%	81%	80%
Risk-weighted assets	91.8	89.1	97.5	59.3	57.4	60.1
Spot exchange rate - US\$/£				1.548	1.552	1.622

Sterling weakened relative to the US dollar during the fourth quarter, with the average exchange rate decreasing by 2% compared with Q3 2011.

US R&C continued to focus on its back-to-basics strategy, with good progress made in developing the division's customer franchise during 2011. The bank continued to re-energise the franchise through new branding, product development and competitive pricing.

To strengthen retail alignment and improve efficiencies, US R&C formed a consolidated Consumer Banking division by combining management of the retail banking franchise with the consumer lending division during H2 2011. This continued focus on alignment is expected to further contribute to the improved penetration of loan products to deposit households, which has already increased in ten consecutive quarters. The penetration of on-line banking customers, a key indicator of customer retention, also continued to improve during 2011.

To enhance the customer experience, in Q4 2011, Consumer Banking introduced four core Customer Commitments, built around feedback received from customers in Massachusetts. In Q1 2012, the Commitments will be rolled out to Citizens Financial Group's (CFG's) entire branch footprint.

Significant organisational changes and investment in Commercial Banking, including unification under the RBS Citizens brand, has been important in positioning the business for growth. The enhanced sales training programme for managers and sales colleagues in this business has begun to deliver results with both higher credit balances and increased client satisfaction. External researchers TNS awarded Citizens the second highest score in relationship manager satisfaction among its competitors for 2011.

Risk management was also an important focus for 2011 and in Q4 2011, CFG's Board of directors approved a new formal risk appetite statement aimed at ensuring sustained predictable earnings and further strengthening the control environment.



2011 compared with 2010

Operating profit increased to £537 million (\$860 million) from £349 million (\$540 million), an increase of £188 million (\$320 million), or 54%. Excluding a credit of £73 million (\$113 million) related to changes to the defined benefit plan in Q2 2010, operating profit increased by £261 million (\$433 million), or 95%, substantially driven by lower impairments and improved income.

The macroeconomic operating environment remained challenging, with low rates, high unemployment, a soft housing market, sluggish consumer activity and the continuing impact of legislative changes including the Durbin Amendment in the Dodd-Frank Act which became effective on 1 October 2011.

The Durbin Amendment lowers the allowable interchange on debit transactions to \$0.23-\$0.24 per transaction. The current annualised impact of the Durbin Amendment is estimated at £94 million (\$150 million).

Net interest income was down £2 million. In US dollar terms, net interest income increased by \$108 million, 4%. Net interest margin improved by 24 basis points to 3.06% reflecting changes in deposit mix, continued discipline around deposit pricing and the positive impact from the balance sheet restructuring programme carried out during Q3 2010 combined with strong commercial loan growth, partially offset by run-off of consumer loans.

Non-interest income was down £23 million, 2%. In US dollar terms, non-interest income increased by \$31 million, 2%. The increase is primarily driven by higher account and transaction fees, partially offset by the impact of legislative changes on debit card and deposit fees.

Excluding the defined benefit plan credit of £73 million (\$113 million) in Q2 2010, total expenses were down £93 million, 4% (\$16 million in US dollar terms) due to a number of factors including lower Federal Deposit Insurance Corporation (FDIC) deposit insurance levies, and lower litigation and marketing costs, partially offset by higher regulatory costs.

Impairment losses declined by £193 million (\$278 million), or 37%, largely reflecting an improved credit environment slightly offset by higher impairments related to securities. Loan impairments as a percent of loans and advances improved to 0.5% from 1.0%.

Customer deposits were up 1% with particularly strong growth achieved in checking balances. Consumer checking balances grew by 6%, while small business checking balances grew by 5% over the year.

2010 compared with 2009

Operating profit of £349 million (\$540 million) represented a marked improvement from an operating loss of £52 million (\$81 million) with income up 8% and impairment losses down 26%.

Net interest income was up 8%, despite a smaller balance sheet, with net interest margin improving by 48 basis points to 2.82%.

Non-interest income was up 7% reflecting higher mortgage banking and debit card income, commercial banking fees and higher gains on securities realisations. This was partially offset by lower deposit fees which were impacted by Regulation E legislative changes in 2010. In addition, gains of £213 million (\$330 million) were recognised on the sale of available-for-sale securities as part of the balance sheet restructuring exercise, but these were almost wholly offset by losses crystallised on the termination of swaps hedging fixed-rate funding.

Total expenses were up £1 million (\$45 million), reflecting a £73 million (\$113 million) credit related to changes to the defined benefit pension plan, and lower Federal Deposit Insurance Corporation (FDIC) deposit insurance levies,

partially offset by the impact of changing rates on the valuation of mortgage servicing rights and litigation costs.

Impairment losses declined 26%, following significant loan reserve building in 2009 and a gradual improvement in the underlying credit environment, offset by higher impairments related to securities. Loan impairments as a percentage of loans and advances decreased from 1.4% to 1.0%.

Business review [continued](#)

## Markets

	2011	2010	2009
	£m	£m	£m
Net interest income	67	581	1,095
Net fees and commissions receivable	371	520	347
Income from trading activities	4,601	5,234	7,669
Other operating income	(624)	(102)	(321)
Non-interest income	4,348	5,652	7,695
Total income	4,415	6,233	8,790
Direct expenses			
- staff	(1,963)	(2,082)	(2,197)
- other	(746)	(663)	(560)
Indirect expenses	(769)	(699)	(792)
	(3,478)	(3,444)	(3,549)
Profit before impairment losses	937	2,789	5,241
Impairment losses	(38)	(65)	(250)
Operating profit	899	2,724	4,991
Of which:			
Ongoing businesses	943	2,743	4,764
Run-off businesses	(44)	(19)	227
Analysis of income by product			
Rates	1,474	2,312	4,111
Currencies	1,060	1,047	1,220
Asset backed products (ABP)	1,254	1,479	1,534
Credit markets	616	1,350	1,612
Investor products and equity derivatives	593	672	862
Total income continuing businesses	4,997	6,860	9,339
Inter-divisional revenue share	(767)	(883)	(987)
Run-off businesses	185	256	438
Total income	4,415	6,233	8,790
Memo - Fixed income and currencies			
Rates/currencies/ABP/credit markets	4,402	6,191	8,477
Less primary credit markets	(688)	(863)	(1,069)
Total fixed income and currencies	3,714	5,328	7,408
Performance ratios (ongoing businesses)			
Return on equity (1)	6.1%	19.1%	44.1%
Cost:income ratio	79%	55%	40%
Compensation ratio (2)	44%	33%	25%

## Notes:

(1) Divisional return on equity is based on divisional operating profit after tax divided by average notional equity (based on 10% of the monthly average of divisional RWAs, adjusted for capital deductions).

(2) Compensation ratio is based on staff costs as a percentage of total income.



	2011 £bn	2010 £bn	2009 £bn
Capital and balance sheet			
Loans and advances	61.2	68.6	73.1
Reverse repos	100.4	94.7	73.3
Securities	108.1	115.8	102.1
Cash and eligible bills	28.1	38.8	74.0
Other	14.8	20.1	27.5
Total third party assets (excluding derivatives mark-to-market)	312.6	338.0	350.0
Net derivative assets (after netting)	37.0	37.4	68.0
Risk-weighted assets	120.3	110.3	72.4
Run-off businesses (£m)			
Total income	185	256	438
Direct expenses	(229)	(275)	(211)
Operating (loss)/profit	(44)	(19)	(227)
Balance sheet - run-off businesses (£bn)			
Total third party assets (excluding derivatives mark-to-market)	1.3	2.4	2.3

During Q4 2011, the market environment continued to weaken. Market volatility remained elevated and liquidity depressed as markets reacted to developments in the European sovereign debt crisis. Deal flow was weak reflecting investor pessimism about the outlook for the world economy. Throughout the year, Markets continued to deliver core products and innovative solutions to clients, while also focusing on management of its cost base and on tight control of its risk positions.

On 12 January 2012 the Group announced changes to its wholesale banking operations in light of a changed market and regulatory environment. The changes saw the reorganisation of RBS's wholesale businesses into 'Markets' and 'International Banking' and the exit and downsizing of selected activities. The changes will ensure the wholesale businesses continue to deliver against the Group's strategy.

#### 2011 compared with 2010

Operating profit fell by 67%, from £2,724 million for 2010 to £899 million for 2011, driven by a 29% decrease in revenue. The year was characterised by volatile and deteriorating credit markets, especially during the second half of the year when the European sovereign debt crisis drove a sharp widening in credit spreads.

Due to this deterioration in the markets both the Rates and Credit businesses suffered significantly, and income from trading activities, which is after funding costs both internal and external, fell from £5,234 million in 2010, to £4,601 million in 2011. The heightened volatility increased risk aversion amongst clients and limited opportunities for revenue generation in the secondary markets.

Total costs increased by 1% due increased investment costs in 2011, which included a programme to meet new regulatory requirements. The compensation ratio in Markets was 44%, driven by fixed salary costs and prior year deferred awards.

Variable compensation accrued in the first half of the year were reduced in the second half of the year, leaving the former GBM 2011 variable compensation awards 58% lower than 2010.

Third party assets fell from £338.0 billion in 2010 to £312.6 billion in 2011 as a result of lower levels of activity and careful management of balance sheet exposures.

A 9% increase in risk-weighted assets reflected the impact of significant regulatory changes, with a £21 billion uplift as a result of CRD III, largely offset by the impact of the division's focus on risk management.

2010 compared with 2009

A fall in operating profit, of 45% year on year reflects sharply reduced revenue partially offset by lower costs and a significant improvement in impairments.

Total income was £2,557 million lower in 2010 driven by increased risk aversion in the market during Q3 and Q4 2010, combined with the non-repeat of favourable market conditions seen in the first half of 2009.

- Higher revenue across the Rates and Currencies businesses during 2009 was driven by rapidly falling interest rates and wide bid-offer spreads generating exceptional revenue opportunities, which have not been repeated in 2010.
- The Credit Markets business weakened by 16%, reflecting lower levels of activity in debt capital markets.

Expenses fell by 3% to £3,444 million. This was largely driven by a decrease in staff costs, including on-going benefits from cost synergies.

The low level of impairments in 2010 reflected a small number of specific cases partially offset by an improved picture on latent loss provisions. This contrasted with 2009, which witnessed a significantly higher level of specific impairments.



Business review *continued*

## Direct Line Group

	2011	2010	2009
	£m	£m	£m
Earned premiums	4,221	4,459	4,519
Reinsurers' share	(252)	(148)	(165)
Net premium income	3,969	4,311	4,354
Fees and commissions	(400)	(410)	(367)
Instalment income	138	159	171
Investment income	265	277	305
Other income	100	179	151
Total income	4,072	4,516	4,614
Direct expenses			
- staff expenses	(288)	(287)	(304)
- other expenses	(333)	(325)	(368)
Indirect expenses	(225)	(267)	(270)
	(846)	(879)	(942)
Impairment losses	-	-	(8)
Net claims	(2,772)	(3,932)	(3,606)
Operating profit/(loss)	454	(295)	58
Analysis of income by product			
Personal lines motor excluding broker			
- own brands	1,874	1,962	1,814
- partnerships	228	373	360
Personal lines home excluding broker			
- own brands	490	488	442
- partnerships	378	408	389
Personal lines rescue and other excluding broker			
- own brands	185	197	191
- partnerships	132	168	220
Commercial	365	341	305
International	346	333	288
Other (1)	74	246	605
Total income	4,072	4,516	4,614
In-force policies (000s)			
Personal lines motor excluding broker			
- own brands	3,787	4,162	4,762
- partnerships	320	645	844
Personal lines home excluding broker			
- own brands	1,811	1,797	1,774
- partnerships	2,497	2,530	2,566
Personal lines rescue and other excluding broker			
- own brands	1,844	1,966	2,262
- partnerships	7,307	7,497	6,688
Commercial	422	352	346
International	1,387	1,082	944

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Other (1)	1	644	1,049
Total in-force policies (2)	19,376	20,675	21,235

For notes relating to this table refer to page 44.

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	2011 £m	2010 £m	2009 £m
Gross written premium			
Personal lines motor excluding broker			
- own brand	1,584	1,647	1,738
- partnerships	137	257	311
Personal lines home excluding broker			
- own brand	474	478	462
- partnerships	549	556	560
Personal lines rescue and other excluding broker			
- own brand	174	178	176
- partnerships	174	159	141
Commercial	435	397	395
International	570	425	354
Other (1)	1	201	343
Total gross written premium	4,098	4,298	4,480
Performance ratios			
Return on regulatory capital (3)	11.3%	(7.9%)	1.7%
Return on tangible equity (4)	10.3%	(6.8%)	1.4%
Loss ratio (5)	70%	91%	83%
Commission ratio (6)	10%	10%	8%
Expense ratio (7)	20%	20%	21%
Combined operating ratio (8)	100%	121%	112%
Balance sheet			
Total insurance reserves (£m) (9)	7,284	7,643	7,139

## Notes:

- (1) 'Other' predominately consists of the personal lines broker business.
- (2) Total in-force policies include travel and creditor policies sold through RBS Group. These comprise travel policies included in bank accounts e.g. Royalties Gold Account, and creditor policies sold with bank products including mortgage, loan and card payment protection.
- (3) Return on regulatory capital required is based on annualised operating profit/(loss) after tax divided by average notional regulatory equity.
- (4) Return on tangible equity is based on annualised operating profit/(loss) after tax divided by average tangible equity.
- (5) Loss ratio is based on net claims divided by net premium income.
- (6) Commission ratio is based on fees and commissions divided by gross written premium income.
- (7) Expense ratio is based on expenses divided by gross written premium.
- (8) Combined operating ratio is the sum of the loss, commission and expense ratios.
- (9) Consists of general and life insurance liabilities, unearned premium reserves and liability adequacy reserve.

Business review [continued](#)

Direct Line Group continued

Direct Line Group continues to make good progress ahead of its divestment from the Group. Operating profit of £454 million for 2011 shows a return to full year profitability and represents close to a £750 million turnaround from 2010. These results demonstrate the success of the first phase of management's transformation plan - to return to profit in 2011. The full year combined operating ratio improved to 100% (2010 - 121%) with a full year return on equity of 10.3% compared with a negative return of 6.8% in 2010.

The second phase of the Direct Line Group transformation plan, to build competitive advantage, is underway and tangible benefits are already being delivered. All new Churchill, Direct Line and Privilege motor claims, as well as all new Churchill home claims, are now being processed through a new claims management system. Within motor, the rollout of a new rating engine and new pricing tools ensured more accurate and tailored pricing with the aim of generating greater value from Direct Line Group's multi-brand, multi-distribution strategy.

As part of the plan to build competitive advantage, the rationalisation of occupied sites continues, with 15 site exits by the end of 2011. The consolidation of the four UK general insurance underwriting entities within the Direct Line Group was successfully completed in December 2011. All UK general insurance business is now written through one underwriter with the aim of improving operational and capital efficiency.

Marking a significant new partnership, Direct Line Group signed a five-year contract with Sainsbury's Finance in 2011 to provide underwriting, sales, service and claims management for its car insurance customers. Following the successful launch and development of the car insurance partnership, a further contract was signed early in 2012 to provide home insurance for Sainsbury's customers. Building on Direct Line Group's established successful relationship with Nationwide Building Society, a deal was concluded to extend its provision of home insurance until the end of 2015. Direct Line Group is also concluding terms with RBS Group's UK Retail bank on the details of a five-year agreement for the continued provision of general insurance products post separation. The term would commence from the point of initial divestment.

While overall gross written premium fell by 5% in 2011, it increased by 10% in Commercial, which includes NIG, the commercial broker business, and Direct Line for Business, the direct SME insurer. A new brand identity was unveiled for NIG and work continued to improve its product offering and service to brokers. Direct Line for Business continued to develop well.

Direct Line Group's international division showed strong growth in gross written premiums primarily in Italy, assisted by the first full year of its sales agreements with FGA Capital, a joint venture between Fiat and Credit Agricole. The German business also showed good growth following improvements in the second half of 2011 to its direct and partnership business, including strengthening its relationship with Renault.

Ahead of the planned divestment in the second half of 2012, Direct Line Group has begun separating its activities and operations from RBS Group. Its corporate functions have been strengthened, arm's length agreements are under discussion with the Group where appropriate, a new corporate brand, Direct Line Group was announced on 15 February 2012 and a new risk and control framework has been implemented, in readiness for standalone status.

Overall, Direct Line Group has powerful brands, improved earnings, a robust balance sheet and is executing the second phase of its transformation plan to rebuild competitive advantage.

2011 compared with 2010

Operating profit rose by £749 million in 2011, principally due to the non repeat of the bodily injury reserve strengthening in 2010, derisking of the motor book, exit of certain business segments and more benign weather in 2011.

Gross written premium fell £200 million, 5%, as the business continued to drive improved profitability through reduced volumes in unattractive segments. This was partially offset by growth in Commercial and International.

Total income fell £444 million, 10%, following the exit of personal lines broker, a decline in premiums reflecting reduced motor volumes and higher reinsurance costs to reduce the risk profile of the book. Investment income fell £12 million, 4%, reflecting decreased yields on the portfolio in 2011, partially offset by higher realised gains.

Total direct expenses rose by £9 million principally driven by project activity to support the transformation plan.

Net claims fell £1,160 million, 30%, due to the non recurrence of bodily injury reserve strengthening in 2010, actions taken to de-risk the book, the exit of certain business segments and more benign weather in 2011.

At the end of 2011, Direct Line Group 's investment portfolios comprised primarily cash, gilts and investment grade bonds. Within the UK portfolio, £8.9 billion, and the International portfolio, £827 million, there was no exposure to sovereign debt issued by Portugal, Ireland, Italy, Greece or Spain.

Total in-force policies fell 6% in the year due to planned de-risking of the motor book and the exiting of certain other segments and partnerships, including personal lines broker.

2010 compared with 2009

Direct Line Group has embarked on a significant programme of investment designed to achieve a substantial lift in operational and financial performance, ahead of the planned divestment of the business, with a current target date of 2012. This programme encompasses the enhancement of pricing capability, transformation of claims operations and expense reduction, together with a range of other improvements across the business, including a greater focus on capital management.

2010 as a whole was a disappointing profit year, impacted by significant reserve strengthening for bodily injury claims and severe weather, resulting in a loss of £295 million.

Income was down 2% (£98 million) against 2009, driven by a managed reduction in the risk of the UK motor book, largely offset by significant price increases:

- This de-risking was achieved by a combination of rating action to reduce the mix of higher-risk drivers, and the partial or total exit of higher risk business lines (significantly scaling back the fleet and taxi business and the exit of personal lines business sold through insurance brokers). As a result in-force motor policies fell 14% compared with 2009.
- Even with the significant reduction in the risk mix of the book, average motor premiums were up 7% in the year, due to significant price increases. The prices of like-for-like policies have increased by 35-40% over the last year. These increases were in addition to the significant increases achieved in 2009.

Initiatives to grow ancillary income were also implemented during the year resulting in revenues of £46 million in 2010 (£25 million in 2009). Away from UK motor, overall home gross written premiums grew by 1%. This included the exit from less profitable business in line with overall strategy. Our underlying own brands business continues to

grow successfully, with gross written premiums increasing 4%.

The International business continued to invest in growth in 2010 with gross written premiums of £425 million up 20% on 2009. The Italian business successfully grew to a market share approaching 30% of the direct insurer market. The German business grew 7% and is well positioned to take advantage of the emerging shift to direct/internet distribution in that market.

Several programmes to further improve the overall efficiency of the business took effect during the year, including a reduction of six sites and operational process improvements, which will continue to improve efficiency.

Total in-force policies declined by 3%, driven by a fall of 14% in motor policies. This was partly offset by higher travel policies, up 64% with new business from a partnership with Nationwide Building Society commencing in Q4 2010. The personal lines broker segment overall declined by 43%, in line with business strategy.

Total income declined by £98 million, with lower motor premium income, driven by rating action. Increased fees and commissions reflected profit sharing arrangements with UK Retail in relation to insurance distribution to bank customers. Investment income was £28 million lower, reflecting the impact of low interest rates on returns on the investment portfolio as well as lower gains realised on the sale of investments.

Net claims were £326 million higher than in 2009, driven by increases to bodily injury reserves relating to prior years, including allowance for higher claims costs in respect of Periodic Payment Orders due to an increased settlement rate of such claims. Although bodily injury frequency has stabilised, severity has continued to deteriorate. Claims were also impacted by the adverse weather experienced in the first and fourth quarters.

Expenses were down 7%, driven by lower industry levies and marketing costs.

Business review [continued](#)

## Central items

	2011	2010	2009
	£m	£m	£m
Central items not allocated	191	630	456

Funding and operating costs have been allocated to operating divisions, based on direct service usage, requirement for market funding and other appropriate drivers where services span more than one division.

Residual unallocated items relate to volatile corporate items that do not naturally reside within a division.

## 2011 compared with 2010

Central items not allocated represented a credit of £191 million in 2011, a decline of £439 million compared with 2010. 2010 benefited from c.£300 million of accounting gains on hybrid securities, c.£150 million of which was amortised during 2011. A VAT recovery of £176 million in 2010 compared with £85 million recovered in 2011.

## 2010 compared with 2009

Central items not allocated including available-for-sale (AFS) gains of £237 million and one-off VAT recovery in 2010 of £170 million, amounted to a net credit of £630 million, an increase of £174 million on 2009.

The Group's credit spreads have fluctuated over the course of the year, but ended the year slightly wider, resulting in an overall annual decrease in the carrying value of own debt.

## Non-Core

	2011	2010	2009
	£m	£m	£m
Net interest income	858	1,756	1,603
Funding costs of rental assets	(210)	(283)	(256)
Net interest income	648	1,473	1,347
Net fees and commissions	(38)	471	510
Loss from trading activities	(721)	(31)	(5,161)
Insurance net premium income	286	702	784
Other operating income			
- rental income	953	1,035	946
- other (1)	60	(896)	(700)
Non-interest income/(loss)	540	1,281	(3,621)
Total income/(loss)	1,188	2,754	(2,274)
Direct expenses			
- staff	(375)	(731)	(851)
- operating lease depreciation	(347)	(452)	(402)
- other	(256)	(573)	(573)
Indirect expenses	(317)	(500)	(552)
	(1,295)	(2,256)	(2,378)
Profit before insurance net claims and impairment losses	(107)	498	(4,652)
Insurance net claims	(195)	(737)	(588)
Impairment losses	(3,919)	(5,476)	(9,221)
Operating loss	(4,221)	(5,715)	(14,461)
Analysis of income/(loss) by business			
Banking and portfolios	1,465	1,463	(148)
International businesses	411	778	1,296
Markets	(688)	513	(3,422)
Total income/(loss)	1,188	2,754	(2,274)
Loss from trading activities			
Monoline exposures	(670)	(5)	(2,387)
Credit derivative product companies	(85)	(139)	(947)
Asset-backed products (2)	29	235	(288)
Other credit exotics	(175)	77	(558)
Equities	(11)	(17)	(47)
Banking book hedges	(1)	(82)	(1,613)
Other (3)	192	(100)	679
	(721)	(31)	(5,161)
Impairment losses			
Banking and portfolios	3,833	5,328	8,350
International businesses	82	200	499
Markets	4	(52)	372
Total impairment losses	3,919	5,476	9,221



Loan impairment charge as % of gross customer loans and advances (excluding reverse repurchase agreements) (4)

Banking and portfolios	4.9%	5.0%	5.8%
International businesses	3.7%	4.4%	4.1%
Markets	(3.0%)	0.2%	7.5%
Total	4.8%	4.9%	5.7%

Notes:

- (1) Includes losses on disposals of £127 million for 2011 (2010 - £504 million).
- (2) Asset-backed products include super asset backed structures and other asset-backed products.
- (3) Includes profits in RBS Sempra Commodities JV of £4 million for 2011 (2010 - £372 million).
- (4) Includes disposal groups.

Business review [continued](#)

## Non-Core continued

	2011	2010	2009
Performance ratios			
Net interest margin	0.63%	1.02%	0.74%
Cost:income ratio	109%	82%	(105%)
Adjusted cost:income ratio	130%	112%	(83%)
	£bn	£bn	£bn
Capital and balance sheet			
Total third party assets (excluding derivatives) (1)	93.7	137.9	201.0
Total third party assets (including derivatives) (1)	104.7	153.9	220.9
Loans and advances to customers (gross) (2)	79.4	108.4	149.5
Customer deposits (2)	3.5	6.7	12.6
Risk elements in lending (2)	24.0	23.4	22.9
Risk-weighted assets (1)	93.3	153.7	171.3
Gross customer loans and advances			
Banking and portfolios	77.3	104.9	138.3
International businesses	2.0	3.5	9.4
Markets	0.1	-	1.8
	79.4	108.4	149.5
Risk-weighted assets			
Banking and portfolios	64.8	83.5	92.5
International businesses	4.1	5.6	11.5
Markets	24.4	64.6	67.3
	93.3	153.7	171.3
Third party assets (excluding derivatives)			
Banking and portfolios	81.3	113.9	153.2
International businesses	2.9	4.4	10.9
Markets	9.5	19.6	36.9
	93.7	137.9	201.0

	31 December 2010	Disposals/ Drawings/ Run-off restructuring roll overs Impairments				FX	31 December 2011
	£bn	£bn	£bn	£bn	£bn	£bn	£bn
Third party assets (excluding derivatives)	42.6	(5.6)	(2.4)	0.7	(3.4)	(0.4)	31.5
Commercial real estate	59.8	(8.5)	(11.3)	2.5	(0.1)	(0.2)	42.2
Corporate	3.7	(1.6)	-	0.1	(0.1)	-	2.1
SME	9.0	(1.1)	(1.4)	-	(0.3)	(0.1)	6.1
Retail	2.5	(0.6)	-	-	-	-	1.9
Other	13.6	(2.9)	(1.8)	1.0	-	(0.1)	9.8
Markets	131.2	(20.3)	(16.9)	4.3	(3.9)	(0.8)	93.6
Total (excluding derivatives)	6.7	(1.3)	(5.0)	-	-	(0.3)	0.1

Markets - RBS Sempra  
Commodities JV

Total (3)	137.9	(21.6)	(21.9)	4.3	(3.9)	(1.1)	93.7
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Notes:

(1) Includes RBS Sempra Commodities JV (2011 third party assets, excluding derivatives (TPAs) £0.1 billion, RWAs £1.6 billion; 2010 TPAs £6.7 billion, RWAs £4.3 billion).

(2) Excluding disposal groups.

(3) Disposals of £0.2 billion have been signed as at 31 December 2011 (2010 - £12 billion).

	2011	2010	2009
	£m	£m	£m
Impairment losses by donating division and sector			
UK Retail			
Mortgages	5	5	6
Personal	(27)	8	47
Total UK Retail	(22)	13	53
UK Corporate			
Manufacturing and infrastructure	76	26	87
Property and construction	224	437	651
Transport	52	3	10
Financial institutions	5	69	102
Lombard	75	129	95
Other	96	166	732
Total UK Corporate	528	830	1,677
Ulster Bank			
Mortgages	-	42	42
Commercial real estate			
- investment	609	630	286
- development	1,552	1,759	733
Other corporate	173	251	217
Other EMEA	15	52	106
Total Ulster Bank	2,349	2,734	1,384
US Retail & Commercial			
Auto and consumer	58	82	136
Cards	(9)	23	130
SBO/home equity	201	277	452
Residential mortgages	16	4	54
Commercial real estate	40	185	224
Commercial and other	(3)	17	83
Total US Retail & Commercial	303	588	1,079
International Banking			
Manufacturing and infrastructure	57	(290)	1,404
Property and construction	752	1,296	1,413
Transport	(3)	33	178
Telecoms, media and technology	68	9	545
Financial institutions	(98)	196	620
Other	(19)	14	616
Total International Banking	757	1,258	4,776
Other			
Wealth	1	51	251
Central items	3	2	1
Total Other	4	53	252
Total impairment losses	3,919	5,476	9,221



Business review [continued](#)

## Non-Core continued

Gross loans and advances to customers (excluding reverse repurchase agreements) by donating division and sector	2011 £bn	2010 £bn	2009 £bn
UK Retail			
Mortgages	1.4	1.6	1.9
Personal	0.1	0.4	0.7
Total UK Retail	1.5	2.0	2.6
UK Corporate			
Manufacturing and infrastructure	0.1	0.3	0.3
Property and construction	5.9	11.4	14.1
Transport	4.5	5.4	—
Financial institutions	0.6	0.8	—
Lombard	1.0	1.7	2.9
Other	7.5	7.4	17.6
Total UK Corporate	19.6	27.0	34.9
Ulster Bank			
Mortgages	—	—	6.0
Commercial real estate			
- investment	3.9	4.0	2.1
- development	8.5	8.4	6.3
Other corporate	1.6	2.2	1.3
Other EMEA	0.4	0.4	1.0
Total Ulster Bank	14.4	15.0	16.7
US Retail & Commercial			
Auto and consumer	0.8	2.6	3.2
Cards	0.1	0.1	0.5
SBO/home equity	2.5	3.2	3.7
Residential mortgages	0.6	0.7	0.8
Commercial real estate	1.0	1.5	1.9
Commercial and other	0.4	0.5	0.9
Total US Retail & Commercial	5.4	8.6	11.0
International Banking			
Manufacturing and infrastructure	6.6	8.7	17.5
Property and construction	15.3	19.6	25.7
Transport	3.2	5.5	5.8
Telecoms, media and technology	0.7	0.9	3.2
Financial institutions	5.6	12.0	16.0
Other	7.0	9.3	14.3
Total International Banking	38.4	56.0	82.5
Other			
Wealth	0.2	0.4	2.6
Direct Line Group	-	0.2	0.2

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Central items	(0.2)	(1.0)	(3.2)
Total Other	-	(0.4)	(0.4)
Gross loans and advances to customers (excluding reverse repurchase agreements)	79.3	108.2	147.3

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Non-Core third party assets fell to £94 billion, below the revised year end target of £96 billion and significantly ahead of the original guidance of £118 billion. Further reductions will include the sale of RBS Aviation Capital for £4.7 billion, which was signed in January 2012. Since the division was formed in 2009, the reduction totals £164 billion, or 64%. By the end of 2011, the Non-Core funded balance sheet equated to less than 10% of the Group funded balance sheet compared with 21% when the division was created.

The division focused on reducing capital intensive trading assets, with activity including the restructuring of monoline exposures, which, at a cost of c.£600 million in 2011, achieved a reduction of £60 billion in risk-weighted assets.

An operating loss of £4,221 million for 2011 was £1,494 million lower than 2010. Income declined by £1,566 million reflecting continued divestment, including business and country exits. The decrease was partially offset by a reduction in expenses of £961 million, largely driven by the fall in headcount. Impairment losses fell by £1,557 million despite ongoing challenges in the real estate and Ulster Bank portfolios.

#### 2011 compared with 2010

Operating loss of £4,221 million in 2011 was £1,494 million lower than the loss recorded in 2010. The continued divestment of Non-Core businesses and portfolios has reduced revenue streams as well as the cost base.

Losses from trading activities increased by £704 million compared with 2010, principally as a result of the disposal of RBS Sempra Commodities in 2010 and costs incurred as part of the division's focus on reducing capital intensive trading assets and mitigating future regulatory uplifts in risk-weighted assets.

Impairment losses fell by £1,557 million despite ongoing challenges in the real estate and Ulster Bank portfolios, reflecting improvements in other asset classes.

Third party assets declined by £44 billion (32%) reflecting disposals of £22 billion and run-off of £22 billion.

Risk-weighted assets were £60 billion lower than 2010, principally driven by significant disposal activity on trading book assets combined with run-off.

Headcount declined by 2,189 (32%) to 4,669 in 2011, largely reflecting the divestment activity in relation to Asia, Non-Core Insurance and RBS Sempra Commodities.

#### 2010 compared with 2009

By the end of 2010 third party assets (excluding derivatives) had decreased to £138 billion, £5 billion lower than the end of year target, as a result of a successful disposal strategy, managed portfolio run-off and impairments.

2010 operating losses in Non-Core were 60% lower than those recorded in 2009. The improvement in performance was driven by significantly lower trading losses, reduced expenses and a marked decline in impairments.

Losses from trading activities declined from £5,122 million for 2009 to £16 million for 2010 as underlying asset prices recovered, offset by continuing weakness in credit spreads. The division has recorded profits on the disposal of many asset-backed securities positions. In addition, a significantly smaller loss of £82 million was recorded on banking book hedges as spreads tightened, compared with £1,727 million in 2009.

Staff expenses fell by 14% over the year, largely driven by the impact of business divestments, including a number of country exits and the disposal of substantially all of the Group's interest in the RBS Sempra Commodities JV.



Impairments were £3,745 million lower than 2009. The decline reflects the overall improvement in the economic environment, although still high loss rates reflect the difficult conditions experienced in specific sectors, including both UK and Irish commercial property sectors.

Wholesale country exits completed during 2010 were Chile, Colombia, Pakistan and Taiwan.

Risk-weighted assets decreased by £18 billion (10%), reflecting active management to reduce trading book risk and disposals, partially offset by the impact of regulatory changes (£30 billion) and more conservative weightings applied to large corporate exposures.

## Consolidated balance sheet at 31 December 2011

	2011 £m	2010 £m	2009 £m
<b>Assets</b>			
Cash and balances at central banks	79,269	57,014	52,261
Net loans and advances to banks	43,870	57,911	56,656
Reverse repurchase agreements and stock borrowing	39,440	42,607	35,097
Loans and advances to banks	83,310	100,518	91,753
Net loans and advances to customers	454,112	502,748	687,353
Reverse repurchase agreements and stock borrowing	61,494	52,512	41,040
Loans and advances to customers	515,606	555,260	728,393
Debt securities	209,080	217,480	267,254
Equity shares	15,183	22,198	19,528
Settlement balances	7,771	11,605	12,033
Derivatives	529,618	427,077	441,454
Intangible assets	14,858	14,448	17,847
Property, plant and equipment	11,868	16,543	19,397
Deferred tax	3,878	6,373	7,039
Prepayments, accrued income and other assets	10,976	12,576	20,985
Assets of disposal groups	25,450	12,484	18,542
<b>Total assets</b>	<b>1,506,867</b>	<b>1,453,576</b>	<b>1,696,486</b>
<b>Liabilities</b>			
Bank deposits	69,113	66,051	104,138
Repurchase agreements and stock lending	39,691	32,739	38,006
Deposits by banks	108,804	98,790	142,144
Customers deposits	414,143	428,599	545,849
Repurchase agreements and stock lending	88,812	82,094	68,353
Customer accounts	502,955	510,693	614,202
Debt securities in issue	162,621	218,372	267,568
Settlement balances	7,477	10,991	10,413
Short positions	41,039	43,118	40,463
Derivatives	523,983	423,967	424,141
Accruals, deferred income and other liabilities	23,125	23,089	30,327
Retirement benefit liabilities	2,239	2,288	2,963
Deferred tax	1,945	2,142	2,811
Insurance liabilities	6,312	6,794	10,281
Subordinated liabilities	26,319	27,053	37,652
Liabilities of disposal groups	23,995	9,428	18,890
<b>Total liabilities</b>	<b>1,430,814</b>	<b>1,376,725</b>	<b>1,601,855</b>
Non-controlling interests	1,234	1,719	16,895
Owners' equity	74,819	75,132	77,736
<b>Total equity</b>	<b>76,053</b>	<b>76,851</b>	<b>94,631</b>
<b>Total liabilities and equity</b>	<b>1,506,867</b>	<b>1,453,576</b>	<b>1,696,486</b>



Commentary on consolidated balance sheet

2011 compared with 2010

Total assets of £1,506.9 billion at 31 December 2011 were up £53.3 billion, 4%, compared with 31 December 2010. This principally reflects an increase in cash and balances at central banks and the mark-to-market value of derivatives in Markets, partly offset by decreases in debt securities and equity shares and the continuing disposal and run-off of Non-Core assets.

Cash and balances at central banks were up £22.3 billion, 39%, to £79.3 billion due to improvements in the Group's structured liquidity position during 2011.

Loans and advances to banks decreased by £17.2 billion, 17%, to £83.3 billion. Reverse repurchase agreements and stock borrowing ('reverse repos') were down £3.2 billion, 7%, to £39.4 billion and bank placings declined £14.0 billion, 24%, to £43.9 billion, primarily as a result of the reduction in exposure to eurozone banks and lower cash collateral requirements.

Loans and advances to customers were down £39.7 billion, 7%, to £515.6 billion. Within this, reverse repurchase agreements were up £9.0 billion, 17%, to £61.5 billion. Customer lending decreased by £48.7 billion, 10%, to £454.1 billion or £46.9 billion, 9%, to £473.9 billion before impairment provisions. This reflected the transfer to disposal groups of £19.5 billion of customer balances relating to the UK branch-based businesses. There were also planned reductions in Non-Core of £28.1 billion, together with declines in International Banking, £4.7 billion, UK Corporate, £3.0 billion and Ulster Bank, £2.0 billion, together with the effect of exchange rate and other movements, £1.9 billion. These were partially offset by growth in Markets, £6.4 billion, Wealth, £0.8 billion, UK Retail, £2.3 billion and US Retail & Commercial, £2.8 billion.

Debt securities were down £8.4 billion, 4%, to £209.1 billion driven mainly by a reduction in holdings of government and financial institution bonds in Markets and Group Treasury.

Equity shares decreased £7.0 billion, 32%, to £15.2 billion which largely reflects the closure of positions to reduce the Group's level of unsecured funding requirements to mitigate the potential impact of unfavourable market conditions.

Settlement balances declined £3.8 billion, 33% to £7.8 billion as a result of decreased customer activity.

Movements in the value of derivative assets up £102.5 billion, 24%, to £529.6 billion, and liabilities, up £100.0 billion, 24%, to £524.0 billion, primarily reflect increases in interest rate contracts as a result of a significant downward shift in interest rates across all major currencies, together with increases in the mark-to-market value of credit derivatives as a result of widening credit spreads and rising credit default swap prices.

Property, plant and equipment declined £4.7 billion, 28%, to £11.9 billion, primarily as a result of the transfer of RBS Aviation Capital's operating lease assets to disposal groups.

Deferred taxation was down £2.5 billion, 39%, to £3.9 billion, largely as a result of the utilisation of brought forward tax losses in the UK.

The increase in assets and liabilities of disposal groups reflects the reclassification of the UK branch-based businesses and RBS Aviation Capital pending their disposal, partly offset by the completion of disposals, primarily RBS Sempra Commodities JV and certain Non-Core project finance assets.

Deposits by banks increased £10.0 billion, 10%, to £108.8 billion, with higher repurchase agreements and stock lending ('repos'), up £6.9 billion, 21%, to £39.7 billion and higher inter-bank deposits, up £3.1 billion, 5%, to £69.1

billion.

Customer accounts fell £7.7 billion, 2%, to £503.0 billion. Within this, repos increased £6.7 billion, 8%, to £88.8 billion. Excluding repos, customer deposits were down £14.4 billion, 3%, to £414.1 billion, reflecting the transfer to disposal groups of £21.8 billion of customer accounts relating to the UK branch-based businesses. This was partly offset by the net effect of growth in International Banking £1.7 billion, UK Corporate, £1.8 billion, UK Retail, £5.8 billion, US Retail & Commercial, £0.5 billion and Wealth, £1.8 billion, together with exchange rate and other movements of £0.5 billion and declines in Markets, £1.1 billion, Ulster Bank, £0.8 billion and Non-Core, £2.9 billion.

Debt securities in issue were down £55.8 billion, 26% to £162.6 billion driven by reductions in the level of certificates of deposit and commercial paper in Markets and Group Treasury.

Settlement balances declined £3.5 billion, 32%, to £7.5 billion and short positions were down £2.1 billion, 5%, to £41.0 billion due to decreased customer activity.

Subordinated liabilities were down £0.7 billion, 3%, to £26.3 billion, primarily reflecting the redemption of £0.2 billion US dollar and £0.4 billion Euro denominated dated loan capital.

The Group's non-controlling interests decreased by £0.5 billion, 28%, to £1.2 billion, primarily due to the disposal of the majority of the RBS Sempra Commodities JV business, £0.4 billion.

Owners' equity decreased by £0.3 billion to £74.8 billion. This was driven by the attributable loss for the year, £2.0 billion, together with the recognition of actuarial losses in respect of the Group's defined benefit pension schemes, net of tax, £0.5 billion and exchange rate and other movements of £0.3 billion. Offsetting these reductions were gains in available-for-sale reserves, £1.1 billion and cashflow hedging reserves, £1.0 billion and the issue of shares under employee share schemes, £0.4 billion.

Business review continued

Commentary on consolidated balance sheet  
2010 compared with 2009

Total assets of £1,453.6 billion at 31 December 2010 were down £242.9 billion, 14%, compared with 31 December 2009. This principally reflects the disposal of the RFS minority interest, the continuing planned disposal of Non-Core assets, together with a reduction in the level of debt securities and the mark-to-market value of derivatives.

Cash and balances at central banks were up £4.8 billion, 9%, to £57.0 billion principally due to an improvement in the Group's structural liquidity position during 2010.

Loans and advances to banks increased by £8.8 billion, 10%, to £100.5 billion. Adjusting for the disposal of the RFS minority interest, the increase was £16.6 billion, 20%. Reverse repurchase agreements and stock borrowing ('reverse repos') were up £7.5 billion, 21% to £42.6 billion and bank placings rose £9.1 billion, 19%, to £57.9 billion, primarily as a result of the investment of surplus liquidity in short-term assets.

Loans and advances to customers decreased £173.1 billion, 24%, to £555.3 billion. Excluding the disposal of the RFS minority interest, lending to customers was down £40.4 billion, 7%. Within this, reverse repurchase agreements were up £11.5 billion, 28%, to £52.5 billion. Customer lending decreased by £51.9 billion to £502.7 billion or £48.9 billion before impairment provisions. This reflected planned reductions in Non-Core of £39.6 billion along with declines in Markets, £11.9 billion, International Banking, £3.6 billion, US Retail & Commercial, £2.6 billion and Ulster Bank, £1.9 billion. These were partially offset by growth in UK Retail, £5.4 billion, Wealth, £2.4 billion and UK Corporate, £0.8 billion, together with the effect of exchange rate and other movements, £2.1 billion.

Debt securities were down £49.8 billion, 19%, to £217.5 billion, or £31.6 billion, 13%, adjusting for the disposal of the RFS minority interest, driven mainly by reductions in Markets.

The value of derivative assets were down £14.4 billion, 3%, to £427.1 billion, primarily reflecting a decrease in interest contracts, movements in five to ten year interest yields, and the combined effect of currency movements, with Sterling weakening against the dollar but strengthening against the Euro.

The reduction in assets and liabilities of disposal groups resulted from the completion of disposals of certain of the Group's Asian and Latin American businesses, and substantially all of the RBS Sempra Commodities JV business.

Deposits by banks declined £43.4 billion, 31%, to £98.8 billion or £66.1 billion, 36% following the disposal of the RFS minority interest, with reduced inter-bank deposits, down £49.7 billion, 43%, to £66.1 billion and lower repurchase agreements and stock lending ('repos'), down £5.3 billion, 14%, to £32.7 billion.

Customer accounts decreased £103.5 billion, 17%, to £510.7 billion but excluding the disposal of the RFS minority interest were up £28.1 billion, 6%. Within this, repos increased £13.7 billion, 20%, to £82.1 billion. Excluding repos, customer deposits were up £14.3 billion, 3%, to £428.6 billion, reflecting growth in UK Corporate, £13.7 billion, International Banking, £5.4 billion, UK Retail, £7.0 billion, Ulster Bank, £1.7 billion and Wealth, £0.7 billion, together with exchange rate and other movements of £3.4 billion. This was partially offset by decreases in Markets, £7.8 billion, US Retail & Commercial, £3.8 billion and Non-Core, £6.0 billion.

Debt securities in issue were down £49.2 billion, 18%, to £218.4 billion. Excluding the RFS minority interest disposal, they declined £28.0 billion, 11%, to £218.4 billion. Reductions in the level of certificates of deposit and commercial paper in Markets were partially offset by a programme of new term issuances totalling £38.4 billion.

Subordinated liabilities decreased by £10.6 billion, 28% to £27.1 billion or £4.5 billion, 14% excluding the disposal of the RFS minority interest. This reflected the redemption of £2.6 billion undated loan capital, debt preference shares and trust preferred securities under the liability management exercise completed in May, together with the conversion of £0.8 billion US dollar and Sterling preference shares and the redemption of £1.6 billion of other dated and undated loan capital, which were partially offset by the effect of exchange rate movements and other adjustments of £0.5 billion.

The Group's non-controlling interests decreased by £15.2 billion, primarily reflecting the disposal of the RFS minority interest, £14.4 billion, the majority of the RBS Sempra Commodities JV business, £0.6 billion, and the life assurance business, £0.2 billion.

Owner's equity decreased by £2.6 billion, 3%, to £75.1 billion. This was driven by the partial redemption of preference shares and paid-in equity, £3.1 billion less related gains of £0.6 billion, the attributable loss for the period, £1.1 billion, together with an increase in own shares held of £0.7 billion and higher losses in available-for-sale reserves, £0.3 billion. Offsetting these reductions were the issue of £0.8 billion ordinary shares on conversion of US dollar and Sterling non-cumulative preference shares classified as debt and exchange rate and other movements, £1.2 billion.

Business review [continued](#)

## Cash flow

	2011	2010	2009
	£m	£m	£m
Net cash flows from operating activities	3,325	19,291	(992)
Net cash flows from investing activities	14	3,351	54
Net cash flows from financing activities	(1,741)	(14,380)	18,791
Effects of exchange rate changes on cash and cash equivalents	(1,473)	82	(8,592)
Net increase in cash and cash equivalents	125	8,344	9,261

## 2011

The major factors contributing to the net cash inflow from operating activities of £3,325 million were the elimination of foreign exchange differences of £2,702 million, depreciation and amortisation of £1,875 million and inflow from other items of £2,900 million, partially offset by the net operating loss before tax of £708 million from continuing and discontinued operations and the decrease of £3,444 million in operating assets and liabilities.

Net cash inflows from investing activities of £14 million related to the net inflows from sales of securities of £3,074 million, and sale of property, plant and equipment of £1,840 million offset by net cash outflows from investments in business interests and intangible assets of £1,428 million and from the purchase of property, plant and equipment of £3,472 million.

Net cash outflows from financing activities of £1,741 million relate primarily to interest on subordinated liabilities of £714 million, repayment of subordinated liabilities of £627 million and redemption of non-controlling interests of £382 million.

## 2010

The major factors contributing to the net cash inflow from operating activities of £19,291 million were the increase of £17,095 million in operating assets less operating liabilities, depreciation and amortisation of £2,220 million and income taxes received of £565 million, partly offset by the net operating loss before tax of £940 million from continuing and discontinued operations.

Net cash flows from investing activities of £3,351 million relate to the net inflows from sales of securities of £4,119 million and investments in business interests and intangibles of £3,446 million. This was partially offset by the outflow of £4,112 million from investing activities of discontinued operations.

Net cash outflow from financing activities of £14,380 million primarily arose from the redemption of non-controlling interests of £5,282 million, dividends paid of £4,240 million, repayment of subordinated liabilities of £1,588 million and the redemption of preference shares of £2,359 million.

## 2009

The major factors contributing to the net cash outflow from operating activities of £992 million were the net operating loss before tax of £2,696 million from continuing and discontinued operations, the decrease of £15,964 million in operating liabilities less operating assets, partly offset by the elimination of foreign exchange differences of £12,217 million and other items of £5,451 million.

Net cash flows from investing activities of £54 million relate to the net sales and maturities of securities of £2,899 million and a net cash inflow of £105 million in respect of other acquisitions and disposals less the net cash outflow on disposals of property, plant and equipment of £2,950 million.



Net cash flows from financing activities of £18,791 million primarily arose from the capital raised from the issue of B shares of £25,101 million, the placing and open offer of £5,274 million and the issue of subordinated liabilities of £2,309 million. This was offset in part by the cash outflow on repayment of subordinated liabilities of £5,145 million, redemption of preference shares of £5,000 million, interest paid on subordinated liabilities of £1,746 million and dividends paid of £1,248 million.

## Capital resources

The following table analyses the Group's regulatory capital resources on a fully consolidated basis at 31 December as monitored by the FSA for regulatory purposes.

	2011	2010	2009	2008	2007
	£m	£m	£m	£m	£m
Capital base					
Tier 1 capital	56,990	60,124	76,421	69,847	44,364
Tier 2 capital	8,546	9,897	15,389	32,223	33,693
Tier 3 capital	—	—	—	260	200
	65,536	70,021	91,810	102,330	78,257
Less: Supervisory deductions	(4,828)	(4,732)	(4,565)	(4,155)	(10,283)
Total regulatory capital	60,708	65,289	87,245	98,175	67,974
Risk-weighted assets (1)					
Credit risk	344,300	385,900	513,200	551,300	
Counterparty risk	61,900	68,100	56,500	61,100	
Market risk	64,000	80,000	65,000	46,500	
Operational risk	37,900	37,100	33,900	36,900	
	508,100	571,100	668,600	695,800	
Asset Protection Scheme relief	(69,100)	(105,600)	(127,600)	n/a	
	439,000	465,500	541,000	695,800	
Banking book:					
On-balance sheet					480,200
Off-balance sheet					84,600
Trading book					44,200
					609,000
Risk asset ratios	%	%	%	%	%
Core Tier 1	10.6	10.7	11.0	6.6	4.5
Tier 1	13.0	12.9	14.1	10.0	7.3
Total	13.8	14.0	16.1	14.1	11.2

## Note:

(1) The data for 2008 onwards are on a Basel II basis; 2007 is on a Basel I basis.

It is the Group's policy to maintain a strong capital base, to expand it as appropriate and to utilise it efficiently throughout its activities to optimise the return to shareholders while maintaining a prudent relationship between the capital base and the underlying risks of the business. In carrying out this policy, the Group has regard to the supervisory requirements of the Financial Services Authority (FSA). The FSA uses Risk Asset Ratio (RAR) as a measure of capital adequacy in the UK banking sector, comparing a bank's capital resources with its risk-weighted assets (the assets and off-balance sheet exposures are 'weighted' to reflect the inherent credit and other risks); by international agreement, the RAR should be not less than 8% with a Tier 1 component of not less than 4%. At 31 December 2011, the Group's total RAR was 13.8% (2010 - 14.0%) and the Tier 1 RAR was 13.0% (2010 - 12.9%). For further information refer to Balance sheet management: Capital management on pages 68 to 73.



## Business review Risk and balance sheet management

### Risk and balance sheet management

In this section (pages 58 to 207) of the Business review, certain information has been audited and is part of the Group's financial statements as permitted by IFRS 7. Other disclosures are unaudited and are labelled with an asterisk (\*). In this section, the 2009 data relate to the Group before RFS Holdings minority interest (RFS MI).

### Introduction\*

All the disclosures in this section (pages 58 to 67) are unaudited as indicated by an asterisk (\*).

Risk management plays an integral role in the delivery of the Group's strategic goal to be a safe and secure banking group. The implementation of a stronger and more effective culture of risk management and control provides the platform necessary to address historical vulnerabilities, rebuild upon the Group's core strengths and position it on a sustainable and profitable path for future growth.

Financial strength and resilience are at the heart of the Group's Strategic Plan. The Group has defined this level of robustness as that which is capable of achieving and sustaining a standalone credit rating (i.e. without government support) that is in line with those of its strongest international peers.

Given this central aim, in 2009 the Group Board set out four key strategic risk objectives, aligned to the Group's Strategic Plan. These are to:

- maintain capital adequacy: to ensure that the Group has sufficient (and easily accessible) capital resources to meet regulatory requirements and to cover the potential for unexpected losses in its asset portfolio;
- deliver stable earnings growth: to ensure that strategic growth is based around a longer-term risk versus reward consideration, with significantly lower volatility in underlying profitability than was seen over the previous five years;
- ensure stable and efficient access to funding and liquidity: such that the Group has sufficient funding to meet its obligations, taking account of the constraint that some forms of funding may not be available when they are most needed; and
- maintain stakeholder confidence: to ensure that stakeholders have confidence in the Group's recovery plan, its ability to deliver its strategic objectives and the effectiveness of its business culture and operational controls.

Each objective is essential in its own right, but also mutually supportive of the others.

These strategic risk objectives are the bridge between the Group-level business strategy and the frameworks, limits and tolerances that are used to set risk appetite and manage risk in the business divisions on a day-to-day basis.

In 2011, the Group made significant progress in strengthening its approach to risk management in an external environment that remained challenging.

The task of setting a comprehensive risk appetite and aligning it with the Group's business strategy demands a clear understanding of the types of risk the Group faces and their potential size. With this goal in mind, over the past year the Group has developed a catalogue of the risks it faces (a risk taxonomy) and undertaken a Group-wide material risk assessment to analyse the scale of each risk and the potential interactions between them (for a detailed discussion of risk appetite, see page 59).

The delivery of proactive and effective risk management relies on high quality data inputs on which to make assessments. It also requires robust forward-looking measurement and stress testing capabilities (see stress testing on page 60). Both of these areas continue to be enhanced and improvements embedded across the Group.

Risk control frameworks are used to identify and address concentrations of risk. These systems are reinforced by a Group Policy Framework (see page 60), which was enhanced during 2011, with assurance activity ongoing to ensure the policy standards it comprises remain appropriate.

Effective risk management also requires a robust governance framework. During 2011, the roles and responsibilities of the Executive Risk Forum and its supporting committees were reviewed and more clearly defined (see pages 62 to 64).

The Group has launched a common set of values for the risk community that impact directly on behaviours and help to engender a risk management function that is widely respected and valued across the Group. A Group-wide policy that explicitly aligns remuneration with effective risk management has also been put in place.

The focus is now on fully embedding the Group's strategy for risk management into the day-to-day management of its businesses, as well as preparing the Group to face future challenges in a rapidly evolving external environment. More detailed discussions on how the Group strengthened its approach to risk management in 2011 and the areas of focus going forward is contained within the relevant sub-sections on the following pages.

\* unaudited

#### Risk appetite\*

The Group's focus on setting a clear risk appetite and embedding a strong culture of risk management and control is designed to ensure it is able to proactively identify and reduce risk exposures and has the resilience to respond effectively to any unforeseen shocks.

The Group's risk appetite identifies and establishes the level and type of risks that it is able and willing to take in order to:

- meet its strategic objectives - this includes the Group's stated objective of achieving and sustaining a standalone credit rating in line with those of its strongest international peers; and
- meet its wider obligations to stakeholders - the Group's Strategic Plan is built on the core foundations of serving its customers well, acting responsibly and creating sustainable value for its shareholders.

A clear risk appetite provides a greater understanding across the Group of the acceptable levels of risk for each business. It provides a solid platform from which the Group can focus on its key business strengths and competitive advantages over the long-term.

#### Approach and key principles

The Strategic Plan set key performance indicators for capital, leverage, liquidity and funding, aligned with the Group's strategic objectives. It also established a Non-Core division to manage, dispose of and run-off assets that the Group was seeking to exit from, which by definition were outside its appetite.

Building on these core foundations, the Group has developed a framework that sets and implements an appropriate risk appetite for the Group (and its main businesses), supported by a regular monitoring and review process.

Under this framework, risk appetite targets - based on both the quantitative and qualitative aspects of risk - have been set by the Group Board, aligned with Group and divisional strategic objectives. These targets support and augment the strategic, financial and risk controls that are already in place and help to shape the way the Group operates at all levels. Clear roles and responsibilities are established to measure, cascade and report performance against risk appetite and to provide assurances that business is being conducted within approved risk limits and tolerances.

The development of this framework has been based on the following best practice principles:

- strong leadership from the Group Board in establishing and setting risk appetite and in ensuring its purpose is understood and its use promoted as good business practice;
- a strong risk management culture, in which risk is clearly and meaningfully aligned with business behaviours and outcomes;
- a close collaborative partnership between the risk, strategy, treasury and finance functions that facilitates a broader internal debate on key issues; and
- clear accountability by each division (and business unit) for the level of risk it is prepared to take to achieve its business objectives.

Group-wide stress testing is used to assess whether strategic plans are consistent with risk appetite and to measure the key drivers of risk (down to business unit level), with mitigating actions identified whenever the risk profile is considered to be outside (or close to) acceptable levels (see page 60).

#### Design to delivery

The Group's risk appetite has been set by the Group Board and is now operational. Significant progress has been made in establishing the underlying framework and rolling it out across the Group and its divisions.

The key channels through which risk appetite is cascaded throughout and embedded in each division are:

- divisional risk appetite statements - each division has developed its own risk appetite statement, which is based on the four strategic risk objectives and is appropriate for its business plans but also aligned with the Group's risk appetite targets;
- risk control frameworks and limits - risk control frameworks set clear guidance on acceptable limits and tolerances for all material risk types (e.g. credit, market and country risk), aligned with the Group's risk appetite targets;
- Group operational and conduct risk appetite - the Group has developed a robust control environment to ensure it conducts its activities in accordance with its regulatory and other obligations; and
- culture, values and remuneration - a programme of communication, engagement and training is being rolled out across the Group to engender a wide understanding of the purpose of risk appetite.

The Group regards the implementation of its risk appetite framework as an essential step in driving the cultural change required to achieve its strategic objectives and a dynamic, ongoing process. The Board Risk Committee (see the Report of the Board Risk Committee on pages 226 to 229) reviews both the targets and the framework on a regular basis, to ensure they remain aligned to strategic objectives, business performance, emerging risks and changes in the external environment.

\* unaudited

Business review Risk and balance sheet management [continued](#)

Introduction\*: Stress testing

Stress testing describes the evaluation of a bank's financial position under severe but plausible stress scenarios. Stress testing refers to the application of individual stress tests and the broader framework under which these tests are developed, evaluated and used within the Group's decision-making process in the context of the wider economic environment.

Internal stress tests

The Group's stress testing framework is designed to embed stress testing as a key risk management technique into mainstream risk reporting, capital planning and business processes at both Group and divisional levels.

The Executive Risk Forum (see Risk governance on page 61) is the main body overseeing the Group's stress testing approach, processes and results. The forum is primarily responsible for reviewing and challenging the results of any Group-wide stress test and ensuring that, where necessary, appropriate management actions are undertaken. The Board Risk Committee will provide oversight and challenge as appropriate.

Stress testing forms part of the Group's risk and capital management framework and is a major component of the Basel III requirements. It highlights to senior management potential adverse unexpected outcomes related to a mixture of risks and provides an indication of how much capital might be required to absorb losses should adverse scenarios materialise.

Stress testing is used at both divisional and Group levels to assess risk concentrations and estimate the impact of stressed earnings, impairments and write-downs on capital as well as the liquidity and funding position of the Group. It determines overall capital adequacy under a variety of adverse scenarios.

A series of stress events are monitored on a regular basis to assess the potential impact of a severe yet plausible event on the Group. There are four core types of scenario stress testing:

- macroeconomic stress testing, which considers the impact on both earnings and capital for a range of scenarios;
- enterprise-wide stress testing, which considers scenarios that are not macroeconomic in nature but are sufficiently broad to entail multiple risks or affect multiple divisions and are likely to affect earnings, capital and funding;
- cross-divisional stress testing, which includes scenarios that affect multiple divisions due to their sensitivity to a common risk factor; and
- divisional and risk-specific stress testing, which is undertaken to support risk identification and management.

Portfolio analysis, using historical performance and forward-looking indicators of change, uses stress testing to assess potential exposure to events and seeks to quantify the impact of an adverse change in factors that drive the performance and profitability of a portfolio.

Industry-wide stress tests

The Group takes part in a number of industry-wide stress tests, in particular, the European Banking Authority Stress Test and IMF UK Financial Sector Assessment Program, results of which were published in July 2011. These confirmed that the Group remains well capitalised with a strong Core Tier 1 capital ratio and a strong Total capital



ratio under both baseline and adverse scenarios. During 2011, the Group also undertook the FSA anchor scenario test.

In December 2011, the European Banking Authority published the results of its recapitalisation exercise - a review of banks' actual capital positions on sovereign exposures - showing the Group had no overall capital shortfall after including the sovereign capital buffer.

#### Group Policy Framework\*

Achieving and sustaining a robust control framework in line with those of the Group's strongest international peers is critical to achieving the successful delivery of the Group's risk objectives.

With this goal in mind, the Group Policy Framework (GPF) has been revised and broadened. The GPF consolidates a large number of individual policies under a consistent and structured overarching framework for conduct, control and governance. It provides clear guidance and controls on how the Group does business, linked to its risk appetite, its business conduct and compliance responsibilities and its focus on delivering a control environment consistent with best practice against relevant external benchmarks.

The GPF and related initiatives aim to ensure that:

- the Group has clear control standards and ethical principles to cover the risks that it faces to support effective risk management and meet regulatory and legal requirements;
- policies are followed across the Group and compliance can be clearly evidenced, assessed and reported by line management; and
- the control environment is monitored and overseen through good governance.

Communication and training programmes are provided to all relevant staff as the policies are embedded, ensuring that staff are aware of their responsibilities. The GPF is structured to ensure that policy standard owners and sponsors review their policies on a regular basis, with any identified shortfalls against industry best practice documented and addressed within an agreed time frame.

\* unaudited

The GPF was introduced in 2009. Enhancements applied in 2011 included the following:

- the Group's policy standards, which comprise the GPF, were rewritten to ensure they clearly express the mandatory controls required to mitigate the key risks the Group faces;
- all of the Group's policy standards were benchmarked against relevant external reference points such as peer organisations to challenge and verify the content of the policy standards. Where identified, further improvements to the policy standards are now being implemented;
- for each policy standard, appropriate risk based assurance activity was introduced to ensure each division is appropriately controlled and compliance with policy can be demonstrated; and
- risk appetite has its own policy standard within the GPF that clearly sets out roles and responsibilities in relation to the implementation of the risk appetite framework and provides assurance that risks are being actively managed within approved levels and tolerances.

The GPF will continue to be improved and embedded. The results of assurance activity, monitoring and analysis of the internal and external environment will be used to reassess the policy standards on a regular basis.

#### Risk governance\*

The Group is committed to the highest standards of corporate governance in every aspect of the business, including risk management. A key aspect of the Group Board's responsibility as the main decision making body at Group level is the setting of Group risk appetite to ensure that the levels of risk that the Group is willing to accept in the attainment of its strategic business and financial objectives are clearly understood.

To enable the Group Board to carry out its objectives, it has delegated authority to senior Board and executive committees, as required and appropriate. A number of key committees specifically consider risk across the Group, as set out in the diagram below.

#### Notes:

- (1) The Capital and Stress Testing Committee is a sub-committee of the Group Asset and Liability Management Committee.
- (2) The following specialist sub-committees report directly to the Group Risk Committee: Global Markets Risk Committee, Group Country Risk Committee, Group Models Committee, Group Credit Risk Committee and Operational Risk Executive Committee. In addition, Divisional Risk Committees report to the Group Risk Committee.

\* unaudited



Business review Risk and balance sheet management [continued](#)

Introduction\*: Risk governance continued

The key risk responsibilities of each of these committees as well as their membership are set out in the table below. Further information on the Group Board and Board Committees is available on page 210.

These committees are supported at a divisional level by a risk governance structure embedded in the business. These committees play a key role in ensuring that the Group's risk appetite is supported by effective risk management frameworks, limits and policies, together with clear accountabilities for approval, monitoring, oversight, reporting and escalation.

During 2011, the roles and responsibilities of the Executive Risk Forum and its supporting committees were reviewed and more clearly defined, to meet the future needs of the Group.

In particular, the Executive Risk Forum was repositioned as a strategic committee focusing on strategic level risks and issues, and retaining the approval authority for the most material risk limits and decisions. The Group Risk Committee was refocused to operate primarily as an oversight committee across risk types, concentrating particularly on thematic and emerging risks and issues.

The committees that sit below the Group Risk Committee were streamlined significantly, aligned more closely to key risk types and given clearer empowerment and accountability where required.

A Capital and Stress Testing Committee was created as a sub-committee of the Group Asset and Liability Management Committee to cover risk and capital matters.

The improvements made in 2011 provide further clarity of roles and responsibilities, as well as clear reporting lines and accountabilities. They promote clearer and timelier decision making and more effective risk management and oversight.

The role and remit of the Group committees is set out below. These committees are supported at a divisional level by a risk governance structure embedded in the business.

Board/Committee	Risk focus	Membership
Group Board	The Group Board ensures that the Group manages risk effectively through approving and monitoring the Group's risk appetite, considering Group stress scenarios and agreed mitigants and identifying longer-term strategic threats to the Group's business operations.	The Board of directors
Executive Committee	The Executive Committee considers recommendations on risk management matters referred by the Executive Risk Forum and/or Group Risk Committee, including recommendations on risk appetite, risk policies and risk	Group Chief Executive Group Finance Director Chief Administrative Officer Chief Executive Officers of divisions Head of Restructuring and Risk

management strategies.

Board Risk  
Committee

The Board Risk Committee provides oversight and advice to the Group Board on current and potential future risk exposures of the Group and future risk strategy, including determination of risk appetite and tolerance. It also provides a risk review of remuneration arrangements and provides advice to the Remuneration Committee. It operates under delegated authority from the Group Board.

At least three independent non-executive directors, one of whom is the Chairman of the Group Audit Committee.

\* unaudited

Board/Committee	Risk focus	Membership
Group Audit Committee	The Group Audit Committee reviews accounting policies and practices, controls and procedures established by management for compliance with regulatory and financial reporting requirements and requirements of external regulations. It has responsibility for monitoring relationships with regulatory authorities. It operates under delegated authority from the Group Board.	At least three independent non-executive directors, at least one of whom is a financial expert as defined in the SEC rules under the US Exchange Act and one of whom is Chairman of the Board Risk Committee.
Group Remuneration Committee	The Group Remuneration Committee is responsible for the overview of the Group's policy on remuneration and receives advice from Risk Management and the Board Risk Committee to ensure that there is thorough risk input into incentive plan design and target setting as well as risk review of performance bonus pools and clawback. It operates under delegated authority from the Group Board.	At least three independent non-executive directors
Executive Risk Forum	<p>The Executive Risk Forum operates as a committee of the Executive Committee with full authority to act on all risk and control matters across the Group.</p> <p>The Executive Risk Forum approves the most material limits and decisions above defined thresholds and delegates decisions below these thresholds to sub-committees and appropriate individuals.</p>	<p>Group Chief Executive Group Finance Director Chief Administrative Officer Chief Executive Officers of divisions Head of Restructuring and Risk Deputy Chief Risk Officer</p>
Group Asset and Liability Management Committee	The Group Asset and Liability Management Committee (GALCO) is a sub-committee of the Executive Risk Forum and is responsible for identifying, managing and controlling Group balance sheet risks in executing its chosen business strategy.	<p>Group Finance Director Group Treasurer Chief Executive Officers of divisions Head of Restructuring and Risk Key Group Finance function heads Global Head of Markets</p>
Group Risk Committee	The Group Risk Committee is a sub-committee of the Executive Risk Forum. It is an oversight committee which reviews and challenges risks and limits across the functional areas and plays a key role exercising and demonstrating effective risk oversight across the Group.	<p>Deputy Chief Risk Officer Divisional Chief Risk Officers Key Group Risk function heads</p>

It reviews risks and issues on a thematic as well as a specific basis and focuses on forward-looking, emerging risks. It considers the overall risk profile across the Group and identifies any key issues for escalation to the Executive Risk Forum.

\* unaudited

Business review Risk and balance sheet management [continued](#)

Introduction\*: Risk governance continued

Board/Committee	Risk focus	Membership
Capital and Stress Testing Committee	The Capital and Stress Testing Committee is a sub-committee of the Group Asset and Liability Management Committee and focuses on the broad risk capital agenda, including risk appetite, capital usage, stress testing, Internal Capital Adequacy Assessment Process, capital planning, allocation and management, economic capital and prudential developments, including Basel oversight.	Group Finance Director Key Group Finance function heads Key Group Risk function heads
Executive Credit Group	The Executive Credit Group decides on requests for the extension of existing or new credit limits on behalf of the Group Board where the proposed aggregate facility limits are in excess of the credit approval authorities granted to individuals in divisions or in Group Risk Management, or where an appeal against a decline decision of the Group Chief Credit Officer (or delegates) or Group Chief Risk Officer is referred for final decision.	Group A members (1) Head of Restructuring and Risk Deputy Chief Risk Officer Group Chief Credit Officer/Chief Credit Officer N.V. Head of Global Restructuring Group Chief Risk Officer, Non-Core division/APS (alternate)  Group B members (1) Group Chief Executive Group Finance Director Chief Executive officers of divisions  (1) Decisions require input from at least one member from each of Group A and Group B.
Divisional Risk and Audit Committees	Divisional Risk and Audit Committees report to the Board Risk Committee and the Group Audit Committee on a quarterly basis. Their main responsibilities are to: <ul style="list-style-type: none"> <li>· monitor the performance of the divisions relative to divisional and Group risk appetite;</li> <li>· review matters relative to accounting policies, internal control, financial reporting, internal audit, external audit and regulatory compliance as set out in their terms of reference; and</li> </ul>	Members: at least three non-executive members who are executives of the Group who do not have executive responsibility in the relevant division.  Attendees: at least two executives of the division, as appropriate. Representatives from finance, risk, internal audit and external audit.  Members of the Board Risk Committee and Group Audit Committee also have the right to attend.



· assist on such other matters as may be referred to them by the relevant divisional Executive Committee, the Group Audit Committee or the Board Risk Committee.

\* unaudited

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## Introduction\*:Risk coverage

The main risk types faced by the Group are presented below, together with a summary of the key areas of focus and how the Group managed these risks in 2011.

Risk type	Definition	Features	How the Group managed risk and the focus in 2011
Capital, liquidity and funding risk	The risk that the Group has insufficient capital or is unable to meet its financial liabilities as they fall due.	<p>Potential to disrupt the business model and stop normal functions of the Group.</p> <p>Potential to cause the Group to fail to meet the supervisory requirements of regulators.</p> <p>Significantly driven by credit risk losses.</p>	<p>The Group plans for and maintains an adequate amount and mix of capital consistent with its risk profile. This ensures that in any foreseeable scenario the Group holds minimum capital to meet the standards and requirements of investors, regulators and depositors. The amount of capital required is determined through risk assessments and stress testing.</p> <p>Active run-off of capital intensive assets in Non-Core and other risk mitigation left the Core Tier 1 ratio strong at 10.6%, despite a £21 billion uplift in RWAs from the implementation of CRD III in December 2011. Refer to pages 68 to 73.</p> <p>Maintaining the structural integrity of the Group's balance sheet requires active management of both asset and liability portfolios as necessary. Strong term debt issuance and planned reductions in the funded balance sheet enabled the Group to strengthen its liquidity and funding position as market conditions worsened. Refer to pages 74 to 88.</p>
Credit risk (including counterparty risk)	The risk that the Group will incur losses owing to the failure of a customer to meet its obligation to settle outstanding amounts.	<p>Loss characteristics vary materially across portfolios.</p> <p>Significant link between losses and the macroeconomic environment.</p> <p>Can include concentration risk - the risk of loss due to the concentration of credit risk to a specific product, asset class, sector or counterparty.</p>	<p>The Group manages credit risk based on a suite of credit approval and risk concentration frameworks and associated risk management systems and tools. It also continues to reduce the risk associated with legacy exposures through further reductions in Non-Core assets.</p> <p>During 2011, asset quality continued to improve, resulting in loan impairment charges 21% lower than in 2010 despite continuing challenges in Ulster Bank Group (Core and Non-Core) and corporate real estate portfolios. The Group continued to make progress in reducing key credit concentration risks, with credit exposures in excess of single name concentration limits</p>

declining 15% during the year and exposure to commercial real estate declining 14%. Refer to pages 92 to 165.

Country risk	The risk of material losses arising from significant country-specific events.	Can arise from sovereign events, economic events, political events, natural disasters or conflicts.	All country exposures are covered by the Group's country risk management framework. This includes active management of portfolios either when these have been identified as exhibiting signs of stress through the Group's country Watchlist process or when it is otherwise considered appropriate. Portfolio reviews are undertaken to align country risk profiles to the Group's country risk appetite in light of economic and political developments.
		Potential to affect parts of the Group's credit portfolio that are directly or indirectly linked to the country in question.	Sovereign risk increased in 2011, resulting in rating downgrades for a number of countries, including several eurozone members. This resulted in an impairment charge recognised by the Group in 2011 in respect of available-for-sale Greek government bonds. In response, the Group further strengthened its country risk appetite setting and risk management systems during the year and brought a number of advanced countries under limit control. This contributed to a reduction in exposure to a range of countries. Refer to pages 166 to 186.

\* unaudited

Business review Risk and balance sheet management [continued](#)

## Introduction\*: Risk coverage continued

Risk type	Definition	Features	How the Group managed risk and the focus in 2011
Market risk	The risk arising from changes in interest rates, foreign currency, credit spreads, equity prices and risk related factors such as market volatilities.	Frequent small losses which are material in aggregate.  Infrequent large material losses due to stress events.	<p>A comprehensive structure is in place aimed at ensuring the Group does not exceed its qualitative and quantitative tolerance for market risk.</p> <p>The Group's market risk policy statements set out its qualitative tolerance for market risk. They define the governance, responsibilities and requirements for the identification, measurement, analysis, management and communication of the market risk arising from the Group's trading and non-trading investment activities.</p> <p>The Group Market Risk limit framework expresses the Group's quantitative tolerance for market risk. The Group limit metrics capture, in broad terms, the full range of market risk exposures, ensuring the risk is appropriately defined and communicated.</p> <p>During 2011, the Group continued to manage down its market risk exposure in Non-Core and reduce the asset-backed securities trading inventory such that the trading portfolio became less exposed to credit risk. Refer to pages 187 to 193.</p>
Insurance risk	The risk of financial loss through fluctuations in the timing, frequency and/or severity of insured events, relative to the expectations at the time of underwriting.	Frequent small losses which are material in aggregate.  Infrequent large material losses.	<p>The Group's framework for managing insurance risk, with associated risk appetite and policy frameworks, is designed to ensure insurance risks are appropriately identified, controlled, managed, monitored, reported and mitigated.</p> <p>Procedures are in place to address any issues, such as breaches of risk appetite that are identified through monitoring and reporting activities. If a breach occurs, an action plan to address the issue is developed, implemented and monitored to ensure the risk is adequately mitigated or a decision is taken to accept it.</p>

During 2011, focus on insurance risk appetite resulted in the de-risking and significant re-pricing of certain classes of business and exiting some altogether. Refer to page 194.

Operational risk	The risk of loss resulting from inadequate or failed processes, people, systems or from external events.	Frequent small losses. Infrequent material losses.	The objective of operational risk management is to manage it to an acceptable level. Processes to achieve this objective take into account the cost of minimising the risk against the resultant reduction in exposure.
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During 2011, the Group took steps to enhance its management of operational risks. This was particularly evident in respect of risk appetite, the Group Policy Framework, risk assessment, scenario analysis and statistical modelling for capital requirements.

The level of operational risk remains high due to the scale of structural change occurring across the Group, the pace of regulatory change, the economic downturn and other external threats, such as e-crime. Refer to pages 194 to 197.

\* unaudited

Risk type	Definition	Features	How the Group managed risk and the focus in 2011
Compliance risk	The risk arising from non-compliance with national and international laws, rules and regulations.	<p>Adverse impacts on strategy, capital structure, business models and operational effectiveness.</p> <p>Financial cost of adapting to changes in laws, rules or regulations or of penalties for non-compliance.</p>	<p>Management of compliance risk entails early identification and effective management of changes in legislative, regulatory and other requirements that may affect the Group.</p> <p>It also requires active engagement with regulators, close analysis of emerging regulatory themes, and interaction with rule-makers and legislators.</p> <p>Within the GPF, compliance risk policies define minimum standards to which all businesses must adhere. GPF policies are supplemented, where appropriate, by divisional policies to meet local product or market requirements.</p> <p>During 2011, the Group managed the increased levels of scrutiny and legislation by enlarging the capacity of its compliance, anti-money laundering and regulatory affairs teams and taking steps to improve its operating models, tools, systems and processes. Refer to pages 197 to 202.</p>
Reputational risk	The risk of brand damage arising from financial and non-financial events arising from the failure to meet stakeholders' expectations of the Group's performance and behaviour.	<p>Potential to put the entire business at risk. Otherwise, could lead to negative publicity, loss of revenue, costly litigation or a decline in customer base.</p> <p>Can arise from actions taken by the Group or a failure to take action.</p>	<p>The Group Sustainability Committee and risk committees continue to assess reputational risk issues. In 2011, an Environmental, Social and Ethical (ESE) Risk Policy was developed with sector ESE risk appetite positions drawn up to assess the Group's appetite to support customers in sensitive sectors including defence, oil and gas. This also included the establishment of divisional reputational risk committees.</p> <p>Stakeholder engagement was broadened with the implementation of formal sessions between the Group Sustainability Committee and relevant advocacy groups and non-governmental organisations. Refer to page 202.</p>
Business risk	The risk of lower-than-expected revenues and/or	Influenced by many factors such as pricing, sales volume,	Forecasts of revenues and costs are tested against a range of stress scenarios to identify key risk drivers and the

	higher-than-expected operating costs.	input costs, regulations and market and economic conditions.	appropriate actions to address and manage them.  Business risk is incorporated within the Group's risk appetite target for earnings volatility that was set in 2011. Refer to page 202.
Pension risk	The risk that the Group will have to make additional contributions to its defined benefit pension schemes.	Funding position can be volatile due to the uncertainty of future investment returns and the projected value of schemes' liabilities.	The Group manages pension risk from a sponsor perspective using a framework that encompasses risk reporting and monitoring, stress testing, modelling and an associated governance structure that helps ensure the Group is able to fulfil its obligation to support the defined benefit pension schemes to which it has exposure.  In 2011, the Group focused on improved stress testing and risk governance mechanisms. This included the establishment of the Pension Risk Committee and the articulation of its view of risk appetite for the various Group pension schemes. Refer to pages 203 and 204.

Each risk type maps into the Group's risk appetite framework and contributes to the overall achievement of its strategic objectives with underlying frameworks and limits. The key frameworks and developments over the past year are described in the relevant sections of the following pages.

\* unaudited

Business review Risk and balance sheet management [continued](#)

#### Balance sheet management

All disclosures in this section (pages 68 to 91) are audited unless otherwise indicated by an asterisk (\*).

Two of the Group's four key strategic risk objectives relate to the maintenance of capital adequacy and ensuring stable and efficient access to liquidity and funding. This section on balance sheet management explains how the Group is performing on achieving these objectives.

#### Capital management

##### Introduction\*

The Group aims to maintain an appropriate level of capital to meet its business needs and regulatory requirements as capital adequacy and risk management are closely aligned. The Group operates within an agreed risk appetite whilst optimising the use of shareholders' funds to deliver sustainable returns.

The appropriate level of capital is determined based on the dual aims of: (i) meeting minimum regulatory capital requirements; and (ii) ensuring the Group maintains sufficient capital to uphold investor and rating agency confidence in the organisation, thereby supporting the business franchise and funding capacity.

##### Governance\*

The Group Asset and Liability Management Committee (GALCO) is responsible for ensuring the Group maintains adequate capital at all times. The newly established Capital and Stress Testing Committee (CAST) is a cross-functional body driving and directing integrated risk capital activities including stress testing economic capital and capital allocation. These activities have linkages to capital planning, risk appetite and regulatory change. CAST reports through GALCO and comprises senior representatives from Risk Management, Group Finance and Group Treasury.

##### Determining appropriate capital\*

The minimum regulatory capital requirements are identified by the Group through the Internal Capital Adequacy Assessment Process and then agreed between the Group Board and the appropriate supervisory authority.

The Group's own determination of how much capital is sufficient is derived from the desired credit rating level and the application of both internally and externally defined stress tests that identify potential changes in capital ratios over time.

##### Monitoring and maintenance\*

Based on these determinations, which are continually reassessed, the Group aims to maintain capital adequacy both at Group level and in each regulated entity.

The Group operates a rigorous capital planning process aimed at ensuring the capital position is controlled within the agreed parameters. This incorporates regular re-forecasts of the capital positions of the regulated entities and the overall Group. In the event that the projected position deteriorates beyond acceptable levels, the Group would issue further capital and/or revise business plans accordingly.

Stress testing approaches are used to determine the level of capital required to ensure the Group remains adequately capitalised.

##### Capital allocation\*



Capital resources are allocated to the Group's businesses based on key performance parameters agreed by the Group Board in the annual strategic planning process. Principal among these is a profitability metric which assesses the effective use of the capital allocated to the business. Projected and actual return on equity is assessed against target returns set by the Group Board. The allocations also reflect strategic priorities and balance sheet and funding metrics.

Economic profit is also planned and measured for each division during the annual planning process. It is calculated by deducting the cost of equity utilised in the particular business from its operating profit and measures the value added over and above the cost of equity.

The Group aims to deliver sustainable returns across the portfolio of businesses with projected business returns stressed to test key vulnerabilities.

The divisions use return on capital metrics when making pricing decisions on products and transactions with a view to ensuring customer activity is appropriately aligned with Group and divisional targets and allocations.

The FSA uses the risk asset ratio as a measure of capital adequacy in the UK banking sector, comparing a bank's capital resources with its RWAs (the assets and off-balance sheet exposures are weighted to reflect the inherent credit and other risks); by international agreement the risk asset ratios should not be less than 8% with a Tier 1 component of not less than 4%.

\* unaudited

## Capital adequacy\*

The Group's RWAs and risk asset ratios, calculated in accordance with FSA definitions, are set out below.

	Statutory		Proportional	
	2011	2010	2009	2009
Risk-weighted assets by risk	£bn	£bn	£bn	£bn
Credit risk	344.3	385.9	513.2	410.4
Counterparty risk	61.9	68.1	56.5	56.5
Market risk	64.0	80.0	65.0	65.0
Operational risk	37.9	37.1	33.9	33.9
	508.1	571.1	668.6	565.8
Asset Protection Scheme relief	(69.1)	(105.6)	(127.6)	(127.6)
	439.0	465.5	541.0	438.2
Risk asset ratios	%	%	%	%
Core Tier 1	10.6	10.7	11.0	11.0
Tier 1	13.0	12.9	14.1	14.4
Total	13.8	14.0	16.1	16.3

## Key points\*

- Market risk RWAs were impacted by the new CRD III rules but decreased overall by £16 billion in 2011 reflecting de-risking of Non-Core and a reduction in trading VaR.
- APS relief decreased by £36.5 billion, reflecting pool movements, assets moving into default and changes in risk parameters.

## Pillar 3\*

The Group publishes its Pillar 3 Disclosures on its website, providing a range of additional information relating to Basel II and risk and capital management across the Group. The disclosures focus on capital resources and adequacy and discuss a range of credit risk measures and management methods (such as credit risk mitigation, counterparty credit risk and provisions) and their associated RWAs under the various Basel II approaches. Detailed disclosures are also made on equity exposures, securitisations, operational risk, market risk and interest rate risk in the banking book.

\* unaudited

Business review Risk and balance sheet management [continued](#)

## Balance sheet management: Capital management continued

## Capital resources

The Group's regulatory capital resources in accordance with FSA definitions were as follows:

	Statutory		Proportional*	
	2011	2010	2009	2009
	£m	£m	£m	£m
Shareholders' equity (excluding non-controlling interests)				
Shareholders' equity per balance sheet	74,819	75,132	77,736	77,736
Preference shares - equity	(4,313)	(4,313)	(7,281)	(7,281)
Other equity instruments	(431)	(431)	(565)	(565)
	70,075	70,388	69,890	69,890
Non-controlling interests				
Non-controlling interests per balance sheet	1,234	1,719	16,895	2,227
Non-controlling preference shares	(548)	(548)	(656)	(656)
Other adjustments to non-controlling interests for regulatory purposes	(259)	(259)	(497)	(497)
	427	912	15,742	1,074
Regulatory adjustments and deductions				
Own credit	(2,634)	(1,182)	(1,057)	(1,057)
Unrealised losses on AFS debt securities	1,065	2,061	1,888	1,888
Unrealised gains on AFS equity shares	(108)	(25)	(134)	(134)
Cash flow hedging reserve	(879)	140	252	252
Other adjustments for regulatory purposes	571	204	(193)	41
Goodwill and other intangible assets	(14,858)	(14,448)	(17,847)	(14,786)
50% excess of expected losses over impairment provisions (net of tax)	(2,536)	(1,900)	(2,558)	(2,558)
50% of securitisation positions	(2,019)	(2,321)	(1,353)	(1,353)
50% of APS first loss	(2,763)	(4,225)	(5,106)	(5,106)
	(24,161)	(21,696)	(26,108)	(22,813)
Core Tier 1 capital	46,341	49,604	59,524	48,151
Other Tier 1 capital				
Preference shares - equity	4,313	4,313	7,281	7,281
Preference shares - debt	1,094	1,097	3,984	3,984
Innovative/hybrid Tier 1 securities	4,667	4,662	5,213	2,772
	10,074	10,072	16,478	14,037
Tier 1 deductions				
50% of material holdings	(340)	(310)	(601)	(310)
Tax on excess of expected losses over impairment provisions	915	758	1,020	1,020
	575	448	419	710
Total Tier 1 capital	56,990	60,124	76,421	62,898

\* unaudited

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	Statutory		Proportional*	
	2011	2010	2009	2009
	£m	£m	£m	£m
Qualifying Tier 2 capital				
Undated subordinated debt	1,838	1,852	4,950	4,200
Dated subordinated debt - net of amortisation	14,527	16,745	20,063	18,120
Reserves arising on revaluation of property	—	—	73	73
Unrealised gains on AFS equity shares	108	25	134	134
Collectively assessed impairment provisions	635	778	796	796
Non-controlling Tier 2 capital	11	11	11	11
	17,119	19,411	26,027	23,334
<b>Tier 2 deductions</b>				
50% of securitisation positions	(2,019)	(2,321)	(1,353)	(1,353)
50% excess of expected losses over impairment provisions	(3,451)	(2,658)	(3,578)	(3,578)
50% of material holdings	(340)	(310)	(601)	(310)
50% of APS first loss	(2,763)	(4,225)	(5,106)	(5,106)
	(8,573)	(9,514)	(10,638)	(10,347)
<b>Total Tier 2 capital</b>	<b>8,546</b>	<b>9,897</b>	<b>15,389</b>	<b>12,987</b>
<b>Supervisory deductions</b>				
Unconsolidated investments				
- Direct Line Group	(4,354)	(3,962)	(4,068)	(4,068)
- Other investments	(239)	(318)	(404)	(404)
Other deductions	(235)	(452)	(93)	(93)
	(4,828)	(4,732)	(4,565)	(4,565)
<b>Total regulatory capital (1)</b>	<b>60,708</b>	<b>65,289</b>	<b>87,245</b>	<b>71,320</b>
				2011
<b>Movement in Core Tier 1 capital</b>				<b>£m</b>
At beginning of the year				49,604
Attributable loss net of movements in fair value of own debt				(3,449)
Foreign currency reserves				(363)
Decrease in non-controlling interests				(485)
Decrease in capital deductions including APS first loss				1,128
Other movements				(94)
At end of the year				46,341

## Note:

(1) Total capital includes certain instruments issued by RBS N.V. Group that are treated consistent with the local implementation of the Capital Requirements Directive (including the transitional provisions of that Directive). The FSA formally confirmed this treatment in 2012.

\* unaudited



Business review Risk and balance sheet management [continued](#)

## Balance sheet management: Capital management continued

## Risk-weighted assets by division\*

Risk-weighted assets by risk category and division are set out below:

	Credit risk	Counterparty risk	Market risk	Operational risk	Gross RWAs
	£bn	£bn	£bn	£bn	£bn
2011					
UK Retail	41.1	-	-	7.3	48.4
UK Corporate Wealth	71.2	-	-	8.1	79.3
International Banking	10.9	-	0.1	1.9	12.9
Ulster Bank	38.9	-	-	4.3	43.2
US Retail & Commercial	33.6	0.6	0.3	1.8	36.3
Retail & Commercial	53.6	1.0	-	4.7	59.3
Markets	249.3	1.6	0.4	28.1	279.4
Other	16.7	39.9	50.6	13.1	120.3
Core	9.8	0.2	-	2.0	12.0
Non-Core	275.8	41.7	51.0	43.2	411.7
Group before RFS MI	65.6	20.2	13.0	(5.5)	93.3
RFS MI	341.4	61.9	64.0	37.7	505.0
Group	2.9	-	-	0.2	3.1
APS relief	(59.6)	(9.5)	-	-	(69.1)
Net RWAs	284.7	52.4	64.0	37.9	439.0
2010					
UK Retail	41.7	-	-	7.1	48.8
UK Corporate Wealth	76.4	-	-	7.8	84.2
International Banking	10.4	-	0.1	2.0	12.5
Ulster Bank	44.0	-	-	7.7	51.7
US Retail & Commercial	29.2	0.5	0.1	1.8	31.6
Retail & Commercial	52.1	0.9	-	4.4	57.4
Markets	253.8	1.4	0.2	30.8	286.2
Other	21.5	34.5	44.7	9.6	110.3
Core	16.4	0.3	0.2	1.0	18.0
Non-Core	291.7	36.3	45.1	41.4	414.5
Group before RFS MI	91.3	31.8	34.9	(4.3)	153.7
RFS MI	383.0	68.1	80.0	37.1	568.2
Group	2.9	-	-	-	2.9
APS relief	(88.2)	(17.4)	-	-	(105.6)
Net RWAs	297.7	50.7	80.0	37.1	465.5

## Asset Protection Scheme\*

The Group acceded to the Asset Protection Scheme (APS or 'the Scheme') in December 2009.

Following the accession to the APS, HM Treasury provides loss protection against potential losses arising in a pool of assets. HM Treasury also subscribed to £25.5 billion of capital in the form of B shares and a Dividend Access Share, with a further £8 billion of capital in the form of B shares potentially available as contingent capital. The Group pays fees in respect of the protection and contingent capital. The Group has the option, subject to HM Treasury consent, to pay the premium, contingent capital and the exit fee payable in connection with any termination of the Group's participation in the APS in whole or in part, by waiving the entitlements of members of the Group to certain UK tax reliefs.

Following accession to the APS, arrangements were put in place within the Group that extended effective APS protection to all other regulated entities holding assets covered by the APS.

\* unaudited



## Regulatory capital impact of the APS\*

### Methodology

The regulatory capital requirements for assets covered by the Scheme are calculated using the securitisation framework under the FSA prudential rules. The calculation is as follows (the output is known as 'the uncapped amount'):

- First loss - the residual first loss, after impairments and write-downs, to date, is deducted from available capital split equally between Core Tier 1 and Tier 2 capital;
- HM Treasury share of covered losses - after the first loss has been deducted, 90% of assets covered by HM Treasury are risk-weighted at nil; and
- RBS share of covered losses - the remaining 10% share of loss is borne by RBS and is risk-weighted in the normal way.

Should the uncapped amount be higher than the capital requirements for the underlying assets calculated as normal, ignoring the Scheme, the capital requirements for the Scheme are capped at the level of the requirements for the underlying assets ('capped amount'). Where capped, the Group apportions the capped amount up to the level of the first loss as calculated above; any unused capped amount after the first loss capital deduction will be taken as RWAs for the Group's share of covered losses.

Adjustments to the regulatory capital calculation can be made for either currency or maturity mismatches. These occur where there is a difference between the currency or maturity of the protection and that of the underlying asset. These mismatches will have an impact upon the timing of the removal of the cap and level of regulatory capital benefit on the uncapped amount, but this effect is not material.

### Impact

The Group calculates its capital requirements in accordance with the capped basis. Accordingly, the APS has no impact on the Pillar 1 regulatory capital requirement in respect of the assets covered by the APS. It does, however, improve the Core Tier 1 capital ratio of the Group. The protection afforded by the APS assists the Group in satisfying the forward-looking stress testing framework applied by the FSA.

### Future regulatory capital effects

As impairments or write-downs on the pool of assets are recognised, they reduce Core Tier 1 capital in the normal way. This will reduce the first loss deduction for the Scheme, potentially leading to a position where the capital requirement on the uncapped basis would no longer, for the assets covered by the APS, exceed the non-APS requirement and as a result, the Group would expect to start reporting the regulatory capital treatment on the uncapped basis.

For further information on the assets covered by APS see pages 205 to 207.

### Basel III\*

The rules issued by the Basel Committee on Banking Supervision (BCBS), commonly referred to as Basel III, are a comprehensive set of reforms designed to strengthen the regulation, supervision, risk and liquidity management of the banking sector. In the EU they will be enacted through a revised Capital Requirements Directive referred to as CRD IV.

In December 2010, the BCBS issued the final text of the Basel III rules, providing details of the global standards agreed by the Group of Governors and Heads of Supervision, the oversight body of the BCBS and endorsed by the G20 leaders at their November 2010 Seoul summit. There are transition arrangements proposed for implementing these new standards as follows:

- National implementation of increased capital requirements will begin on 1 January 2013;
- There will be a phased five year implementation of new deductions and regulatory adjustments to Core Tier 1 capital commencing on 1 January 2014;
- The de-recognition of non-qualifying non-common Tier 1 and Tier 2 capital instruments will be phased in over 10 years from 1 January 2013; and
- Requirements for changes to minimum capital ratios, including conservation and countercyclical buffers, as well as additional requirements for Global Systemically Important Banks, will be phased in from 2013 to 2019.

The Group, in conjunction with the FSA, regularly evaluates its models for the assessment of RWAs ascribed to credit risk across various classes. This, together with the changes introduced by CRD IV relating primarily to counterparty risk, is expected to increase RWA requirements by the end of 2013 by £50 billion to £65 billion. These estimates are still subject to change; a degree of uncertainty remains around implementation details as the guidelines are not finalised and must still be enacted into EU law. There could be other future changes and associated impacts from these model reviews.

#### Other regulatory capital changes\*

The Group is in the process of implementing changes to the RWA requirements for commercial real estate portfolios consistent with revised industry guidance from the FSA. This is projected to increase RWA requirements by circa £20 billion by the end of 2013, of which circa £10 billion will apply in 2012.

The Group is managing the changes to capital requirements from new regulation and model changes and the resulting impact on the common equity Tier 1 ratio, focusing on risk reduction and deleveraging. This is principally being achieved through the continued run-off and disposal of Non-Core assets and deleveraging in Markets as the business focuses on the most productive returns on capital.

The major categories of new deductions and regulatory adjustments which are being phased in over a five year period from 1 January 2014 include:

- Expected loss net of provisions;
- Deferred tax assets not relating to timing differences;
- Unrealised losses on available-for-sale securities; and
- Significant investments in non-consolidated financial institutions.

The net impact of these changes is expected to be manageable as the aggregation of these drivers is projected to be lower by 2014 and declining during the phase-in period.

\* unaudited

Business review Risk and balance sheet management [continued](#)

Balance sheet management: Liquidity and funding risk

All disclosures in this section (pages 74 to 91) are audited unless otherwise indicated with an asterisk (\*).

Liquidity risk

Liquidity risk is the risk that the Group is unable to meet its obligations, including financing maturities as they fall due. Liquidity risk is heavily influenced by the maturity profile and mix of the Group's funding base, as well as the quality and liquidity value of its liquidity portfolio.

Liquidity risk is dynamic, being influenced by movements in markets and perceptions that are driven by firm specific or external factors. Managing liquidity risk effectively is a key component of the Group's risk reduction strategy. The Group's 2011 performance demonstrates continued improvements in managing liquidity risk and reflects actions taken in light of an uncertain economic outlook, which resulted in improvements in key measures:

- Deposit growth - Core Retail & Commercial deposits increased, and together with Non-Core deleveraging, took the Group loan:deposit ratio to 108%, compared with 118% at the end of 2010.
- Wholesale funding - £21 billion of net term wholesale debt was issued in 2011 from secured and unsecured funding programmes, across a variety of maturities and currencies.
- Short-term wholesale funding (STWF) - the overall level of STWF fell by £27 billion to £102 billion, below the 2013 target of circa £125 billion.
- Liquidity portfolio - the liquidity portfolio of £155 billion was maintained above the 2013 target level of £150 billion against a backdrop of heightened market uncertainty in the second half of the year and was higher than STWF. This represents a £53 billion cushion over STWF.

Funding issuance

The Group has access to a variety of funding sources across the globe, including short-term money markets, repurchase agreement markets and term debt investors through its secured and unsecured funding programmes. Diversity in funding is provided by its active role in the money markets, along with access to global capital flows through its international client base. The Group's wholesale funding franchise is well diversified by currency, geography, maturity and type.

The Group has been a regular issuer in the debt capital markets in both secured and unsecured arrangements. 2011 net new term debt issuance was £21 billion, with 49% secured and 51% unsecured, of which 71% were public transactions and 29% were private.

Balance sheet composition

The Group's balance sheet composition is a function of the broad array of product offerings and diverse markets served by its Core divisions. The structural composition of the balance sheet is augmented as needed through active management of both asset and liability portfolios. The objective of these activities is to optimise liquidity transformation in normal business environments, while ensuring adequate coverage of all cash requirements under extreme stress conditions.

Diversification of the Group's funding base is central to its balance sheet management strategy. The Group's businesses have developed large customer franchises based on strong relationship management and high quality service. These

customer franchises are strongest in the UK, the US and Ireland, but extend into Europe and Asia. Customer deposits provide large pools of stable funding to support the majority of the Group's lending. Improvement of the Group's loan:deposit ratio to 100% or better, by 2013, is a strategic objective.

The Group also accesses professional markets funding by way of public and private debt issuances on an unsecured and secured basis. These debt issuance programmes are spread across multiple currencies and maturities, to appeal to a broad range of investor types and preferences around the world. This market-based funding supplements the Group's structural liquidity needs and, in some cases, achieves certain capital objectives.

#### Stress testing

The strength of a bank's liquidity risk management can only be evaluated based on its ability to survive under stress. The Group evaluates the survivability of the major legal entities and legal entity groups when subjected to simulated stress conditions.

Simulated liquidity stress testing is periodically performed for each business as well as the major operating subsidiaries. A variety of firm-specific and market-related scenarios are used at the consolidated level and in individual countries. These scenarios include assumptions about significant changes in key funding sources, credit ratings, contingent uses of funding, and political and economic conditions in certain countries.

The Group's actual experiences from the 2008 and 2009 period factor heavily into the liquidity analysis. This systemic and name-specific crisis provides important data points in estimating stress severity.

Stress scenarios are applied to both on-balance sheet and off-balance sheet commitments, to provide a comprehensive view of potential cash flows.

#### Contingency planning

The Group has a Contingency Funding Plan (CFP), which is updated as the balance sheet evolves. The CFP is linked to stress test results and forms the foundation for liquidity risk limits. Limits in the business-as-usual environment are bounded by capacity to satisfy the Group's liquidity needs in the stress environments. The CFP provides a detailed description of the availability, size and timing of all sources of contingent liquidity available to the Group in a stress event. These are ranked in order of economic impact and effectiveness to meet the anticipated stress requirement. The CFP includes documented procedures and sign-offs for actions that may require businesses to provide access to customer assets for collateralised borrowing, securitisation or sale. Roles and responsibilities for the effective implementation of the CFP are also documented.

#### Liquidity reserves

The Group maintains liquidity reserves sufficient to satisfy cash requirements, in the event of a severe disruption in its access to funding sources. The reserves consist of cash held on deposit at central banks, high quality unencumbered government securities and other unencumbered collateral. Government securities vary by type and jurisdiction based on local regulatory considerations. The currency mix of the reserves reflects the underlying balance sheet composition.

#### Regulatory oversight

The Group operates in multiple jurisdictions and is subject to a number of regulatory regimes.

The Group's lead regulator is the UK Financial Services Authority (FSA). The FSA implemented a new liquidity regime on 1 June 2010. The new rules provide a standardised approach applied to all UK banks. At RBS Group, the rules focus on the UK Defined Liquidity Group (a subset comprising the Group's five UK banks, The Royal Bank of Scotland plc, National Westminster Bank Plc, Ulster Bank Limited, Coutts & Co and Adam & Co) and cover adequacy of liquidity resources, controls, stress testing and the Individual Liquidity Adequacy Assessment (ILAA). The ILAA informs the Group Board and the FSA of the assessment and quantification of the Group's liquidity risks and their mitigation, and how much current and future liquidity is required.

In the US, the Group's operations must meet liquidity requirements set out by the US Federal Reserve Bank, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Financial Industry Regulatory Authority. In the Netherlands, the Group is subject to the De Nederlandsche Bank liquidity oversight regime.

Regulatory developments\*

There have been a number of significant developments in the regulation of liquidity risk.

In December 2010, the Basel Committee on Banking Supervision issued the 'International framework for liquidity risk measurement, standards and monitoring' which confirmed the introduction of two liquidity ratios: the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR).

The introduction of both of these ratios will be subject to an observation period, which includes review clauses to identify and address any unintended consequences.

After an observation period beginning in 2011, the LCR, including any revisions, will be introduced on 1 January 2015. The NSFR, including any revisions, will move to a minimum standard by 1 January 2018.

\* unaudited

Business review Risk and balance sheet management [continued](#)

## Balance sheet management: Liquidity and funding risk continued

## Funding sources

The table below shows the Group's primary funding sources including deposits in disposal groups and excluding repurchase agreements.

	2011		2010		2009	
	£m	%	£m	%	£m	%
Deposits by banks						
- central banks	3,680	0.5	6,655	0.9	8,535	1.0
- derivative cash collateral	31,807	4.6	28,074	3.8	32,552	4.0
- other	33,627	4.8	31,588	4.3	75,173	9.2
	69,114	9.9	66,317	9.0	116,260	14.2
Debt securities in issue						
- conduit asset backed commercial paper (ABCP)	11,164	1.6	17,320	2.3	25,583	3.1
- other commercial paper (CP)	5,310	0.8	8,915	1.2	18,724	2.3
- certificates of deposit (CDs)	16,367	2.4	37,855	5.1	58,195	7.1
- medium-term notes (MTNs)	105,709	15.2	131,026	17.6	125,800	15.4
- covered bonds	9,107	1.3	4,100	0.6	—	—
- securitisations	14,964	2.1	19,156	2.6	18,027	2.2
	162,621	23.4	218,372	29.4	246,329	30.1
Subordinated liabilities	26,319	3.8	27,053	3.6	31,538	3.9
Notes issued	188,940	27.2	245,425	33.0	277,867	34.0
Wholesale funding	258,054	37.1	311,742	42.0	394,127	48.2
Customer deposits						
- cash collateral	9,242	1.4	10,433	1.4	9,934	1.2
- other	427,511	61.5	420,433	56.6	413,224	50.6
Total customer deposits	436,753	62.9	430,866	58.0	423,158	51.8
Total funding	694,807	100.0	742,608	100.0	817,285	100.0
Disposal group deposits included above						
- banks	1		266		618	
- customers	22,610		2,267		8,907	
	22,611		2,533		9,525	
Short-term wholesale funding				2011	2010	2009
				£bn	£bn	£bn
Deposits				32.9	34.7	77.3
Notes issued				69.5	95.0	139.0
STWF excluding derivative collateral				102.4	129.7	216.3
Derivative collateral				31.8	28.1	32.6
STWF including derivative collateral				134.2	157.8	248.9
Interbank funding excluding derivative collateral						
- bank deposits				37.3	38.2	83.7

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- bank loans	(24.3)	(31.3)	(31.3)
Net interbank funding	13.0	6.9	52.4

Key points

- Short-term wholesale funding excluding derivative collateral declined £27.3 billion in 2011, from £129.7 billion to £102.4 billion. This is £52.9 billion lower than the Group's liquidity portfolio. Deleveraging in Non-Core and Markets has led to the reduced need for funding.
- The Group's customer deposits excluding cash collateral grew by approximately £7.1 billion in 2011.



The table below shows the Group's debt securities in issue and subordinated liabilities by remaining maturity.

	Debt securities in issue						Subordinated liabilities	Total notes issued	Total notes issued
	Conduit	Other		Covered	Securitisations	Total			
	ABCP	CP and CDs	MTNs	bonds					
	£m	£m	£m	£m	£m	£m	£m	£m	%
2011									
Less than 1 year	11,164	21,396	36,302	—	27	68,889	624	69,513	36.8
1-3 years	—	278	26,595	2,760	479	30,112	3,338	33,450	17.7
3-5 years	—	2	16,627	3,673	—	20,302	7,232	27,534	14.6
More than 5 years	—	1	26,185	2,674	14,458	43,318	15,125	58,443	30.9
	11,164	21,677	105,709	9,107	14,964	162,621	26,319	188,940	100.0
2010									
Less than 1 year	17,320	46,051	30,589	—	88	94,048	964	95,012	38.7
1-3 years	—	702	47,357	1,078	12	49,149	754	49,903	20.3
3-5 years	—	12	21,466	1,294	34	22,806	8,476	31,282	12.8
More than 5 years	—	5	31,614	1,728	19,022	52,369	16,859	69,228	28.2
	17,320	46,770	131,026	4,100	19,156	218,372	27,053	245,425	100.0
2009									
Less than 1 year	25,583	76,008	33,696	—	1,614	136,901	2,144	139,045	50.0
1-5 years	—	895	69,400	—	142	70,437	4,235	74,672	26.9
More than 5 years	—	16	22,704	—	16,271	38,991	25,159	64,150	23.1
	25,583	76,919	125,800	—	18,027	246,329	31,538	277,867	100.0

#### Key point

- Debt securities in issue with a maturity of less than one year declined £25.1 billion from £94.0 billion at 31 December 2010 to £68.9 billion at 31 December 2011, largely due to the maturity of £20.1 billion of notes issued under the UK Government's Credit Guarantee Scheme (CGS). The remaining notes issued under the CGS are due to mature in 2012, £15.6 billion in the first quarter of the year and £5.7 billion in the second quarter.

#### Short-term borrowings\*

Short-term borrowings comprise repurchase agreements, borrowings from financial institutions, commercial paper and certificates of deposit. Derivative collateral received from financial institutions is excluded from the table below, as are certain long-term borrowings.

The table below shows details of the Group's short-term borrowings.

	Financial institutions				Financial institutions				2010 Total	2009 Total	
	Repurchase agreements	(1,2)	CP	CDs	2011 Total	Repurchase agreements	(1,2)	CP			CDs
At year end											
- balance (£bn)	129	93	16	16	254	115	92	26	38	271	242
- weighted average interest rate	0.6%	0.9%	0.9%	1.4%	0.8%	0.5%	0.6%	0.7%	0.6%	0.6%	0.8%

During the year

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- maximum balance (£bn)	175	111	32	39	357	157	127	37	57	378	357
- average balance (£bn)	142	93	22	31	288	137	109	34	50	330	292
- weighted average interest rate	0.9%	1.1%	0.7%	1.2%	1.0%	0.6%	0.8%	0.9%	1.0%	0.7%	1.9%

Notes:

- (1) Excludes derivative cash collateral of £41 billion at 31 December 2011 (2010 - £38 billion; 2009 - £33 billion), 2011 average of £35 billion (2010 - £34 billion; 2009 - £40 billion).
- (2) Excludes Federal Home Loan Bank's long-term borrowings of £1 billion at 31 December 2011 (2010 - £1 billion), 2011 average of £1 billion (2010 - £1 billion).

Balances are generally based on monthly data. Average interest rates during the year are computed by dividing total interest expense by the average amount borrowed. Average interest rates at year end are average rates for a single day and as such may reflect one-day market distortions, which may not be indicative of generally prevailing rates.

\* unaudited

Business review Risk and balance sheet management [continued](#)

## Balance sheet management: Liquidity and funding risk continued

## Long-term debt issuances

The table below shows debt securities issued by the Group with an original maturity of one year or more. The Group also executes other long-term funding arrangements (predominantly term repurchase agreements) which are not reflected in the following tables.

	2011 £m	2010 £m	2009 £m
<b>Public</b>			
- unsecured	5,085	12,887	8,386
- unsecured: guaranteed	—	—	19,663
- secured	9,807	8,041	—
<b>Private</b>			
- unsecured	12,414	17,450	14,895
- unsecured: guaranteed	—	—	15,459
- secured	500	—	—
Gross issuance	27,806	38,378	58,403
Buybacks	(6,892)	(6,298)	(7,264)
Net issuance	20,914	32,080	51,139

## Key points

- In line with the Group's Strategic Plan, it has been an active issuer in recent years as it improved its liquidity and funding profile. Secured funding has increased as a proportion of total wholesale funding more recently as market dislocation and uncertainty over future regulatory developments have made unsecured markets less liquid.
- As the Group delevers, with Non-Core and Markets third party assets decreasing and Retail & Commercial deposits increasing, net term debt issuance decreased from £32 billion in 2010 to £21 billion in 2011. The net requirement in 2012 is not expected to exceed £10 billion as further deleveraging should cover the differences.\*
- The Group undertakes voluntary buybacks of its privately issued debt in order to maintain client relationships and as part of its normal market making activities. These transactions are conducted at prevailing market rates.

The table below shows the original maturity of public long-term debt securities issued.

	1-3 years £m	3-5 years £m	5-10 years £m	>10 years £m	Total £m
2011					
MTNs	904	1,407	1,839	935	5,085
Covered bonds	—	1,721	3,280	—	5,001
Securitisations	—	—	—	4,806	4,806
	904	3,128	5,119	5,741	14,892
% of total	6	21	34	39	100
2010					
MTNs	1,445	2,150	6,559	2,733	12,887

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Covered bonds	—	1,030	1,244	1,725	3,999
Securitisations	—	—	—	4,042	4,042
	1,445	3,180	7,803	8,500	20,928
% of total	7	15	37	41	100
2009 MTNs	13,450	7,457	3,477	3,665	28,049
% of total	48	27	12	13	100

\* unaudited

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The table below shows the currency breakdown of public and private long-term debt securities issued.

	GBP £m	EUR £m	USD £m	AUD £m	Other £m	Total £m
2011						
Public						
- MTNs	—	1,808	2,181	1,096	—	5,085
- covered bonds	—	5,001	—	—	—	5,001
- securitisations	478	1,478	2,850	—	—	4,806
Private	2,872	3,856	3,183	302	2,701	12,914
	3,350	12,143	8,214	1,398	2,701	27,806
% of total	12	44	29	5	10	100
2010						
Public						
- MTNs	1,260	3,969	5,131	1,236	1,291	12,887
- covered bonds	—	3,999	—	—	—	3,999
- securitisations	663	1,629	1,750	—	—	4,042
Private	2,184	10,041	2,879	174	2,172	17,450
	4,107	19,638	9,760	1,410	3,463	38,378
% of total	11	51	25	4	9	100
2009						
Public						
- MTNs	7,267	4,795	10,940	3,173	1,874	28,049
Private	4,932	9,773	9,668	2,738	3,243	30,354
	12,199	14,568	20,608	5,911	5,117	58,403
% of total	21	25	35	10	9	100

#### Key points

- In line with the Group's plan to diversify its funding mix, issuances were spread across G10 currencies and maturity bands, including £5.7 billion of public issuance with an original maturity of greater than 10 years.
- The Group has issued approximately £2.8 billion since year end, including a £1 billion public covered bond issuance and a US\$1.2 billion securitisation.

#### Secured funding

The Group has access to secured funding markets through own-asset securitisation and covered bond funding programmes to complement existing wholesale funding programmes and access to the repo markets. The Group monitors and manages encumbrance levels related to these secured funding programmes. This includes the potential encumbrance of Group assets that could be used in own-asset securitisations and/or covered bonds that could be used as contingent liquidity.

For information on the Group's own-asset securitisations, covered bond programme and securities repurchase agreements, refer to Note 30 on the consolidated accounts on pages 355 and 356.

#### Liquidity management

Liquidity risk management requires ongoing assessment and calibration of: how the various sources of the Group's liquidity risk interact with each other; market dynamics; and regulatory developments to determine the overall size of the Group's liquid asset buffer. In addition to the size determination, the composition of the buffer is also important. The composition is reviewed on a continuous basis in order to ensure that the Group holds an appropriate portfolio of high quality assets that can provide a cushion against market disruption and dislocation, even in the most extreme stress circumstances.

Business review Risk and balance sheet management [continued](#)

Balance sheet management: Liquidity and funding risk continued

Liquidity portfolio

The table below shows the composition of the Group's liquidity portfolio (at estimated liquidity value). All assets within the liquidity portfolio are unencumbered.

	2011	2010	2009
	Average	Period end	Period end
	£m	£m	£m
Cash and balances at central banks	74,711	69,932	53,661
Treasury bills	5,937	—	14,529
Central and local government bonds (1)			
- AAA rated governments and US agencies	37,947	29,632	41,435
- AA- to AA+ rated governments (2)	3,074	14,102	3,744
- governments rated below AA	925	955	1,029
- local government	4,779	4,302	5,672
	46,725	48,991	51,880
Other assets (3)			
- AAA rated	21,973	25,202	17,836
- below AAA rated and other high quality assets	12,102	11,205	16,693
	34,075	36,407	34,529
Total liquidity portfolio	161,448	155,330	154,599
			170,661

Notes:

- (1) Includes FSA eligible government bonds of £36.7 billion at 31 December 2011 (2010 - £34.7 billion; 2009 - £19.9 billion).
- (2) Includes AAA rated US government guaranteed and US government sponsored agencies. The US government was downgraded from AAA to AA+ by S&P on 5 August 2011, although not by Moody's or Fitch. These securities are reflected here.
- (3) Includes assets eligible for discounting at central banks.

Key point

- In view of the continuing uncertain market conditions, the liquidity portfolio was maintained above the Group's target level of £150 billion at £155.3 billion, with an average balance in 2011 of £161.4 billion. In anticipation of challenging market conditions, the composition was altered to become more liquid and conservative, as cash and balances at central banks rose to 45% of the total portfolio at 31 December 2011, from 35% at 31 December 2010.

Liquidity and funding metrics

The Group continues to improve and augment liquidity and funding risk management practices, in light of market experience and emerging regulatory and industry standards. The Group monitors a range of liquidity and funding indicators. These metrics encompass short and long-term liquidity requirements under stress and normal operating conditions. Two key structural ratios are described below.

Loan to deposit ratio and funding gap

The table below shows the Group's loan:deposit ratio and customer funding gap, including disposal groups.

Loan:deposit ratio	Customer
Group	Core

	%	%	funding gap Group £bn
2011	108	94	37
2010	118	96	77
2009	132	103	137

Note:

(1) Loans are net of provisions, excluding repos. For Group before RFS MI only for 2009.

Key points

- The Group's loan:deposit ratio improved 1,000 basis points to 108% during 2011, as loans declined and deposits grew.
- The customer funding gap almost halved with Non-Core contributing £27 billion of the £40 billion reduction.



## Net stable funding ratio\*

The table below shows the Group's net stable funding ratio (NSFR), estimated by applying the Basel III guidance issued in December 2010, which represents a non-GAAP measure as described on page 2. The Group is aiming to meet the minimum required NSFR of 100% over the longer term. This measure seeks to show the proportion of structural term assets which are funded by stable funding, including customer deposits, long-term wholesale funding and equity. One of the main components of the ratio entails categorising retail and SME deposits as either 'more stable' or 'less stable'. The Group's NSFR will also continue to be refined over time in line with regulatory developments. It may be calculated on a basis that is not consistent with that used by other financial institutions.

	2011		2010		2009		Weighting %
	ASF(1) £bn	ASF(1) £bn	ASF(1) £bn	ASF(1) £bn	ASF(1) £bn	ASF(1) £bn	
Equity	76	76	77	77	80	80	100
Wholesale funding > 1 year	124	124	154	154	144	144	100
Wholesale funding < 1 year	134	—	157	—	250	—	—
Derivatives	524	—	424	—	422	—	—
Repurchase agreements	129	—	115	—	106	—	—
Deposits							
- Retail and SME - more stable	227	204	172	155	166	149	90
- Retail and SME - less stable	31	25	51	41	50	40	80
- Other	179	89	206	103	199	99	50
Other (2)	83	—	98	—	105	—	—
Total liabilities and equity	1,507	518	1,454	530	1,522	512	
Cash	79	—	57	—	52	—	—
Inter-bank lending	44	—	58	—	49	—	—
Debt securities > 1 year							
- central and local governments AAA to AA-	77	4	89	4	84	4	5
- other eligible bonds	73	15	75	15	87	17	20
- other bonds	14	14	10	10	9	9	100
Debt securities < 1 year	45	—	43	—	69	—	—
Derivatives	530	—	427	—	438	—	—
Reverse repurchase agreements	101	—	95	—	76	—	—
Customer loans and advances > 1 year							
- residential mortgages	145	94	145	94	137	89	65
- other	173	173	211	211	241	241	100
Customer loans and advances < 1 year							
- retail loans	19	16	22	19	24	20	85
- other	137	69	125	63	153	77	50
Other (3)	70	70	97	97	103	103	100
Total assets	1,507	455	1,454	513	1,522	560	
Undrawn commitments	240	12	267	13	289	14	5
Total assets and undrawn commitments	1,747	467	1,721	526	1,811	574	
Net stable funding ratio		111%		101%		89%	

## Notes:

- (1) Available stable funding.  
(2) Deferred tax, insurance liabilities and other liabilities.

(3) Prepayments, accrued income, deferred tax and other assets.

Key points\*

- The NSFR increased by 10% in the year to 111%, with the funding cushion over term assets and undrawn commitments increasing from £4 billion to £51 billion.
- Available stable funding decreased by £12 billion in the year as a result of a £30 billion reduction in long-term wholesale funding, including the move into short-term of approximately £20 billion of balances under the CGS. This was offset by a £19 billion increase in qualifying deposit balances, including classification of certain deposits as more stable, as some assumptions and methodologies were refined.
- Term assets decreased in the year by £38 billion primarily reflecting Non-Core disposals and run-offs. The decrease in other assets is primarily due to the closure of certain equities businesses in Markets and other asset movements.

\* unaudited

Business review Risk and balance sheet management [continued](#)

Balance sheet management: Liquidity and funding risk continued

Special purpose entities

The Group arranges securitisations to facilitate client transactions and undertakes securitisations to sell financial assets or to fund specific portfolios of assets. The Group also acts as an underwriter and depositor in securitisation transactions involving both client and proprietary transactions. In a securitisation, assets, or interests in a pool of assets, are transferred generally to a special purpose entity (SPE) which then issues liabilities to third party investors. SPEs are vehicles established for a specific, limited purpose, usually do not carry out a business or trade and typically have no employees. They take a variety of legal forms - trusts, partnerships and companies - and fulfil many different functions. As well as being a key element of securitisations, SPEs are also used in fund management activities to segregate custodial duties from the fund management advice provided by the Group.

The Group applies the guidance in IAS 27 'Consolidated and Separate Financial Statements' and SIC 12 'Consolidation - Special Purpose Entities' in determining whether or not to consolidate an SPE. SPEs are consolidated where the substance of the relationship between the Group and the SPE is such that the SPE is controlled by the Group. In determining whether the SPE is controlled by the Group, the Group considers whether the activities of the SPE are being conducted on its behalf so that it obtains benefits from its operation; whether the Group has the decision-making powers to obtain the majority of the benefits of the SPE's activities; whether the Group has rights to obtain the majority of the benefits of the SPE; and whether the Group retains the majority of the residual or ownership risks related to the SPE or its assets so as to obtain benefits from its activities. As a result of applying these principles, the Group does not consolidate those SPEs where its interests in the SPE do not provide the Group with a majority of the benefits and/or residual or ownership risks and therefore the SPE is not controlled by the Group. SPEs that are in substance controlled by the Group are consolidated. The Group accounts for its interests, for example, holdings of securities issued and liquidity commitments, in SPEs it does not consolidate in accordance with its accounting policy for these items.

The Group sponsors and arranges own-asset securitisations, whereby the sale of assets or interests in a pool of assets into an SPE is financed by the issuance of securities to investors. The pool of assets held by the SPE may be originated by the Group, or (in the case of whole loan programmes) purchased from third parties, and may be of varying credit quality. Investors in the debt securities issued by the SPE are rewarded through credit-linked returns, according to the credit rating of their securities. The majority of securitisations are supported through liquidity facilities, other credit enhancements and derivative hedges extended by financial institutions, some of which offer protection against initial defaults in the pool of assets. Thereafter, losses are absorbed by investors in the lowest ranking notes in the priority of payments. Investors in the most senior ranking debt securities are typically shielded from loss, since any subsequent losses may trigger repayment of their initial principal.

The Group also employs synthetic structures, where assets are not sold to the SPE, but credit derivatives are used to transfer the credit risk of the assets to an SPE. Securities may then be issued by the SPE to investors, on the back of the credit protection sold to the Group by the SPE.

Residential and commercial mortgages and credit card receivables form the types of assets generally included in cash securitisations, while corporate loans and commercial mortgages typically serve as reference obligations in synthetic securitisations.

The Group sponsors own-asset securitisations primarily as a way of diversifying funding sources. The Group purchases the securities issued in own-asset securitisations and may pledge as collateral for repurchase agreements with major central banks.

Refer to Note 30 on the consolidated accounts on page 355 for the asset categories, together with the carrying value of the assets and associated liabilities for those securitisations and other asset transfers, other than conduits (refer to page 83), where the assets continue to be recorded on the Group's balance sheet.

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## Conduits

The Group sponsors and administers a number of asset-backed commercial paper (ABCP) conduits. A conduit is a SPE that issues commercial paper and uses the proceeds to purchase or fund a pool of assets. The commercial paper is secured on the assets and is redeemed by further commercial paper issuance, repayment of assets or funding from liquidity facilities. Commercial paper is typically short-dated, usually up to three months.

Group-sponsored conduits can be divided into multi-seller conduits and own-asset conduits. In determining whether or not to consolidate a conduit the Group applies the same criteria as to SPEs. Liquidity commitments from the Group to the conduit exceed the nominal amount of assets funded by the conduit as liquidity commitments are sized to cover the funding cost of the related assets.

The ways the Group may be involved with conduits and other special purpose entities are described on page 82.

The Group's involvement in conduits takes a number of forms. It may:

- Sponsor an ABCP programme i.e. establish the programme and approve the sellers permitted to participate in the programme and the asset pools to be purchased by the programme;
- Administer an ABCP programme;
- Provide the ABCP conduit with liquidity facilities;
- Provide the ABCP conduit with a programme-wide credit enhancement facility; or
- Purchase commercial paper from an ABCP conduit.

Total assets and other aspects relating to the Group's conduits are set out below.

	2011			2010			2009		
	Core £m	Non-Core £m	Total £m	Core £m	Non-Core £m	Total £m	Core £m	Non-Core £m	Total £m
Total assets held by the conduits	11,208	1,893	13,101	16,390	3,624	20,014	23,409	3,957	27,366
Commercial paper issued (1)	10,590	859	11,449	15,522	2,540	18,062	22,644	2,939	25,583

## Liquidity and credit enhancements

### Deal specific liquidity

- drawn	321	1,051	1,372	868	1,109	1,977	738	1,059	1,797
- undrawn	15,324	1,144	16,468	21,935	2,980	24,915	28,628	3,852	32,480
PWCE (2)	795	193	988	1,025	257	1,282	1,167	341	1,508
	16,440	2,388	18,828	23,828	4,346	28,174	30,533	5,252	35,785
Maximum exposure to loss (3)	15,646	2,194	17,840	22,803	4,089	26,892	29,365	4,911	34,276

## Notes:

(1) Includes £0.3 billion of ABCP issued to RBS plc at 31 December 2011 (2010 - £0.7 billion).

(2) Programme-wide credit enhancement (PWCE) is an additional programme-wide credit support which would absorb first loss on transactions where liquidity support is provided by a third party.

(3)

Maximum exposure to loss quantifies the Group's exposure to its sponsored conduits. It is determined as the Group's liquidity commitment to its sponsored conduits and additional PWCE which would absorb first loss on transactions where liquidity support is provided by third parties. Historically, PWCE has been greater than third party liquidity. Therefore the maximum exposure to loss is total deal specific liquidity.

(4) Liquidity commitments from the Group to the conduit exceed the nominal amount of assets funded by the conduit given that liquidity commitments are sized to cover the accrued funding cost of the related assets.

#### Key points

- During 2011, both multi-seller and own-asset conduit assets decreased, as deals terminated and Non-Core assets were sold. The total assets held by Group-sponsored conduits were £13.1 billion at 31 December 2011 (2010 - £20.0 billion; 2009 - £27.4 billion).
- The average maturity of ABCP issued by the Group's conduits at 31 December 2011 was 42.6 days (2010 - 69.4 days; 2009 - 58.4 days).
- The maturity of the commercial paper issued by the Group's conduits is managed to mitigate the short-term contingent liquidity risk of providing back-up facilities. The Group's limits sanctioned for such liquidity facilities in 2011 totalled approximately £16.8 billion for multi-seller conduits (2010 - £22.6 billion; 2009 - £25.0 billion).
- The weighted average life of the funded assets was 1.9 years at 31 December 2011 (2010 - 2.3 years; 2009 - 1.9 years).
- The Group's maximum exposure to loss on its multi-seller conduits is £16.7 billion (2010 - £22.8 billion; 2009 - £25.2 billion), being the total amount of the Group's liquidity commitments plus the extent of the programme-wide credit enhancement of conduit assets for which facilities were not provided by third parties.
- The Group holds a single own-asset conduit, which has assets funded by the Group. The Group's maximum exposure to loss on own-asset conduits was £1.1 billion in 2011 (2010 - £4.1 billion; 2009 - £9.1 billion), with no ABCP outstanding at that date (2010 - £2.2 billion; 2009 - £7.7 billion).
- Multi-seller conduits accounted for 93% of the total liquidity and credit enhancements committed by the Group at 31 December 2011 (2010 - 84%; 2009 - 73%). The Group's multi-seller conduits have continued to fund the vast majority of their assets solely through ABCP issuance.

Business review Risk and balance sheet management [continued](#)

## Balance sheet management: Liquidity and funding risk continued

## Conduits continued

The Group has not utilised its own-asset conduit with a committed liquidity of £26 billion (2010 - £26 billion) to access the Bank of England's open market operations for contingent funding purposes. This conduit is not included above, or in the tables on pages 84 and 85.

Collateral analysis, profile, credit ratings and weighted average lives relating to the Group's consolidated conduits are detailed below.

	Funded assets			Undrawn commitments to fund assets	Liquidity from third parties	Total exposure
	Loans	Securities	Total			
	£m	£m	£m	£m	£m	£m
2011						
Auto loans	3,663	390	4,053	2,241	—	6,294
Corporate loans	146	72	218	16	—	234
Credit card receivables	865	—	865	699	—	1,564
Trade receivables	1,136	126	1,262	649	—	1,911
Student loans	488	—	488	352	—	840
Consumer loans	1,362	—	1,362	101	—	1,463
Mortgages						
- prime	2,239	—	2,239	308	—	2,547
- non-conforming	727	—	727	34	—	761
- commercial	21	489	510	8	—	518
Other	760	617	1,377	331	—	1,708
	11,407	1,694	13,101	4,739	—	17,840
2010						
Auto loans	4,943	346	5,289	2,964	—	8,253
Corporate loans	115	2,340	2,455	106	—	2,561
Credit card receivables	2,088	—	2,088	1,209	—	3,297
Trade receivables	761	—	761	1,090	—	1,851
Student loans	757	—	757	532	(132)	1,157
Consumer loans	1,889	—	1,889	111	—	2,000
Mortgages						
- prime	2,569	3	2,572	752	—	3,324
- non-conforming	1,371	—	1,371	20	—	1,391
- sub-prime	103	—	103	19	—	122
- commercial	210	450	660	76	(21)	715
Other	1,072	997	2,069	(1)	(10)	2,058
	15,878	4,136	20,014	6,878	(163)	26,729
2009						
Auto loans	4,293	356	4,649	2,526	—	7,175
Corporate loans	106	7,695	7,801	161	—	7,962
Credit card receivables	4,083	—	4,083	1,058	—	5,141
Trade receivables	806	—	806	1,351	—	2,157

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Student loans	915	—	915	263	(132)	1,046
Consumer loans	1,686	—	1,686	222	—	1,908
Mortgages						
- prime	2,739	3	2,742	750	—	3,492
- non-conforming	1,548	—	1,548	193	—	1,741
- commercial	413	458	871	155	(22)	1,004
Other	872	1,393	2,265	232	(12)	2,485
	17,461	9,905	27,366	6,911	(166)	34,111



## CP funded assets

	CP funded assets					Credit ratings (S&P equivalent)				
	UK	Europe	US	RoW	Total	AAA	AA	A	BBB	Below BBB
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
2011										
Auto loans	518	1,145	2,141	249	4,053	3,323	683	40	7	—
Corporate loans	—	160	58	—	218	9	94	27	88	—
Credit card receivables	—	—	865	—	865	774	—	91	—	—
Trade receivables	—	567	695	—	1,262	449	343	426	44	—
Student loans	—	—	488	—	488	488	—	—	—	—
Consumer loans	716	—	646	—	1,362	—	—	1,362	—	—
Mortgages										
- prime	182	—	—	2,057	2,239	1,446	737	39	17	—
- non-conforming	667	60	—	—	727	157	265	287	18	—
- commercial	489	—	—	21	510	2	5	498	5	—
Other	124	201	531	521	1,377	363	42	402	180	390
	2,696	2,133	5,424	2,848	13,101	7,011	2,169	3,172	359	390
2010										
Auto loans	429	962	3,434	464	5,289	4,827	354	101	7	—
Corporate loans	22	1,513	709	211	2,455	2,166	161	128	—	—
Credit card receivables	144	—	1,944	—	2,088	1,912	125	—	51	—
Trade receivables	—	261	500	—	761	265	353	95	48	—
Student loans	116	—	641	—	757	641	116	—	—	—
Consumer loans	766	462	661	—	1,889	16	—	1,873	—	—
Mortgages										
- prime	161	—	—	2,411	2,572	1,043	1,476	32	21	—
- non-conforming	712	659	—	—	1,371	782	273	316	—	—
- sub-prime	103	—	—	—	103	—	68	—	35	—
- commercial	627	—	—	33	660	16	5	635	4	—
Other	447	455	353	814	2,069	95	52	1,242	680	—
	3,527	4,312	8,242	3,933	20,014	11,763	2,983	4,422	846	—
2009										
Auto loans	476	982	2,621	570	4,649	2,965	1,547	137	—	—
Corporate loans	312	5,213	1,411	865	7,801	7,584	111	106	—	—
Credit card receivables	177	—	3,823	83	4,083	2,781	759	420	123	—
Trade receivables	—	334	438	34	806	446	266	60	34	—
Student loans	117	—	798	—	915	798	117	—	—	—
Consumer loans	733	800	153	—	1,686	68	50	1,553	15	—
Mortgages										
- prime	138	—	—	2,604	2,742	949	1,746	28	3	16
- non-conforming	599	949	—	—	1,548	1,070	379	99	—	—
- commercial	641	194	—	36	871	25	3	840	—	3
Other	121	670	298	1,176	2,265	170	249	950	896	—
	3,314	9,142	9,542	5,368	27,366	16,856	5,227	4,193	1,071	19



Business review Risk and balance sheet management [continued](#)

## Balance sheet management: Liquidity and funding risk continued

## Assets and liabilities by contractual cash flow maturity

The tables below show the contractual undiscounted cash flows receivable and payable, up to a period of twenty years, including future receipts and payments of interest of on-balance sheet assets by contractual maturity. The balances in the table below do not agree directly with the consolidated balance sheet, as the table includes all cash flows relating to principal and future coupon payments, presented on an undiscounted basis. The tables have been prepared on the following basis:

The contractual maturity of on-balance sheet assets and liabilities highlights the maturity transformation which underpins the role of banks to lend long-term, but to fund themselves predominantly by short-term liabilities such as customer deposits. This is achieved through the diversified funding franchise of the Group across an extensive retail, wealth and SME customer base, and across a wide geographic network. In practice, the behavioural profiles of many assets and liabilities exhibit greater stability and longer maturity than the contractual maturity.

Financial assets have been reflected in the time band of the latest date on which they could be repaid, unless earlier repayment can be demanded by the Group. Financial liabilities are included at the earliest date on which the counterparty can require repayment, regardless of whether or not such early repayment results in a penalty. If the repayment of a financial instrument is triggered by, or is subject to, specific criteria such as market price hurdles being reached, the asset is included in the time band that contains the latest date on which it can be repaid, regardless of early repayment. The liability is included in the time band that contains the earliest possible date on which the conditions could be fulfilled, without considering the probability of the conditions being met.

For example, if a structured note is automatically prepaid when an equity index exceeds a certain level, the cash outflow will be included in the less than three months period, whatever the level of the index at the year end. The settlement date of debt securities in issue, issued by certain securitisation vehicles consolidated by the Group, depends on when cash flows are received from the securitised assets. Where these assets are prepayable, the timing of the cash outflow relating to securities assumes that each asset will be prepaid at the earliest possible date. As the repayments of assets and liabilities are linked, the repayment of assets in securitisations is shown on the earliest date that the asset can be prepaid, as this is the basis used for liabilities.

The principal amounts of financial assets and liabilities that are repayable after twenty years or where the counterparty has no right to repayment of the principal are excluded from the table, as are interest payments after twenty years.

	0-3 months £m	3-12 months £m	1-3 years £m	3-5 years £m	5-10 years £m	10-20 years £m
2011						
Assets by contractual maturity						
Cash and balances at central banks	79,269	—	—	—	—	—
Loans and advances to banks	26,326	1,294	544	121	114	—
Debt securities	7,237	9,569	23,137	21,003	39,148	15,869
Settlement balances	7,759	8	—	1	—	—
Other financial assets	397	158	—	16	738	—
Total maturing assets	120,988	11,029	23,681	21,141	40,000	15,869
Loans and advances to customers	97,318	90,894	108,331	55,785	62,085	56,259
Derivatives held for hedging	519	1,556	3,438	1,695	596	138
	218,825	103,479	135,450	78,621	102,681	72,266

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Liabilities by contractual maturity						
Deposits by banks	39,139	5,104	5,513	461	1,121	364
Debt securities in issue	66,253	15,756	25,099	17,627	18,833	4,190
Subordinated liabilities	133	1,116	4,392	7,872	8,654	3,488
Settlement balances and other liabilities	9,015	37	36	62	16	15
Total maturing liabilities	114,540	22,013	35,040	26,022	28,624	8,057
Customer accounts	379,692	23,068	12,643	5,389	1,483	779
Derivatives held for hedging	525	788	1,981	1,186	1,101	821
	494,757	45,869	49,664	32,597	31,208	9,657
Maturity gap	6,448	(10,984)	(11,359)	(4,881)	11,376	7,812
Cumulative maturity gap	6,448	(4,536)	(15,895)	(20,776)	(9,400)	(1,588)
Guarantees and commitments notional amount						
Guarantees (1)	24,886	—	—	—	—	—
Commitments (2)	239,963	—	—	—	—	—

For notes relating to this table refer to page 88.

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2010	0-3 months £m	3-12 months £m	1-3 years £m	3-5 years £m	5-10 years £m	10-20 years £m
<b>Assets by contractual maturity</b>						
Cash and balances at central banks	56,988	—	—	1	—	25
Loans and advances to banks	33,809	1,377	711	120	193	79
Debt securities	11,247	9,816	25,059	22,400	40,600	22,128
Settlement balances	11,334	231	—	—	41	—
Other financial assets	458	221	207	15	405	—
<b>Total maturing assets</b>	<b>113,836</b>	<b>11,645</b>	<b>25,977</b>	<b>22,536</b>	<b>41,239</b>	<b>22,232</b>
Loans and advances to customers	112,465	86,592	120,139	69,304	78,131	63,015
Derivatives held for hedging	530	1,588	2,612	638	210	101
	226,831	99,825	148,728	92,478	119,580	85,348
<b>Liabilities by contractual maturity</b>						
Deposits by banks	43,396	4,417	1,243	304	651	374
Debt securities in issue	89,583	43,032	31,862	22,569	24,209	6,697
Subordinated liabilities	2,485	2,611	6,570	8,691	8,672	4,607
Settlement balances and other liabilities	12,423	59	136	177	385	25
<b>Total maturing liabilities</b>	<b>147,887</b>	<b>50,119</b>	<b>39,811</b>	<b>31,741</b>	<b>33,917</b>	<b>11,703</b>
Customer accounts	402,457	18,580	8,360	4,651	4,393	2,384
Derivatives held for hedging	608	936	2,103	969	681	253
	550,952	69,635	50,274	37,361	38,991	14,340
<b>Maturity gap</b>	<b>(34,051)</b>	<b>(38,474)</b>	<b>(13,834)</b>	<b>(9,205)</b>	<b>7,322</b>	<b>10,529</b>
<b>Cumulative maturity gap</b>	<b>(34,051)</b>	<b>(72,525)</b>	<b>(86,359)</b>	<b>(95,564)</b>	<b>(88,242)</b>	<b>(77,713)</b>
<b>Guarantees and commitments notional amount</b>						
Guarantees (1)	31,026	—	—	—	—	—
Commitments (2)	266,822	—	—	—	—	—

For notes relating to this table refer to page 88.

Business review Risk and balance sheet management [continued](#)

## Balance sheet management: Liquidity and funding risk continued

## Assets and liabilities by contractual cash flow maturity continued

	0-3 months £m	3-12 months £m	1-3 years £m	3-5 years £m	5-10 years £m	10-20 years £m
2009						
Assets by contractual maturity						
Cash and balances at central banks	52,239	—	—	1	25	—
Loans and advances to banks	42,615	1,757	966	282	868	71
Debt securities	17,581	14,484	29,675	26,788	52,104	30,335
Settlement balances	12,020	6	1	—	8	1
Other financial assets	265	215	402	127	421	—
Total maturing assets	124,720	16,462	31,044	27,198	53,426	30,407
Loans and advances to customers	126,238	65,946	130,323	101,984	180,595	202,809
Derivatives held for hedging	488	1,547	3,049	1,076	751	10
	251,446	83,955	164,416	130,258	234,772	233,226
Liabilities by contractual maturity						
Deposits by banks	65,966	15,541	3,934	2,301	632	12
Debt securities in issue	100,220	49,300	56,869	25,915	27,326	3,819
Subordinated liabilities	1,929	1,892	3,654	4,963	20,157	6,105
Settlement balances and other liabilities	12,048	100	139	104	239	83
Total maturing liabilities	180,163	66,833	64,596	33,283	48,354	10,019
Customer accounts	521,400	15,619	5,944	4,221	8,490	4,392
Derivatives held for hedging	660	1,566	3,232	1,264	1,674	1,508
	702,223	84,018	73,772	38,768	58,518	15,919
Maturity gap	(55,443)	(50,371)	(33,552)	(6,085)	5,072	20,388
Cumulative maturity gap	(55,443)	(105,814)	(139,366)	(145,451)	(140,379)	(119,991)
Guarantees and commitments notional amount						
Guarantees (1)	39,952	—	—	—	—	—
Commitments (2)	291,634	—	—	—	—	—

## Notes:

- (1) The Group is only called upon to satisfy a guarantee when the guaranteed party fails to meet its obligations. The Group expects most guarantees it provides to expire unused.
- (2) The Group has given commitments to provide funds to customers under undrawn formal facilities, credit lines and other commitments to lend subject to certain conditions being met by the counterparty. The Group does not expect all facilities to be drawn, and some may lapse before drawdown.

Held-for-trading assets of £763 billion and liabilities of £708 billion (2010 - £665 billion assets, £586 billion liabilities; 2009 - £651 billion assets, £568 billion liabilities) have been excluded from the table in view of their short-term nature.



#### Interest rate risk

The banking book consists of interest bearing assets, liabilities and derivative instruments used to mitigate risks which are accounted for on an accrual basis, as well as non-interest bearing balance sheet items, which are not subjected to fair value accounting.

The Group provides financial products to satisfy a variety of customer requirements. Loans and deposits are designed to meet customer objectives with regard to repricing frequency, tenor, index, prepayment, optionality and other features. When aggregated, they form portfolios of assets and liabilities with varying degrees of sensitivity to changes in market rates.

However, mismatches in these sensitivities give rise to net interest income (NII) volatility as interest rates rise and fall. For example, a bank with a floating rate loan portfolio and largely fixed rate deposits will see its NII rise as interest rates rise and fall as rates decline. Due to the long-term nature of many banking book portfolios, varied interest rate repricing characteristics and maturities, it is likely the NII will vary from period to period, even if interest rates remain the same. New business volumes originated in any period will alter the interest rate sensitivity of a bank if the resulting portfolio differs from portfolios originated in prior periods.

The Group assesses interest rate risk in the banking book (IRRBB) using a set of standards to define, measure and report the market risk. It is the Group's policy to minimise interest rate sensitivity in banking book portfolios and where interest rate risk is retained, to ensure that appropriate measures and limits are applied. Key measures used to evaluate IRRBB are subjected to approval of divisional Asset and Liability Management Committees (ALCOs) and the Group Asset and Liability Management Committee (GALCO).

Limits on IRRBB are proposed by the Group Treasurer for approval by the Executive Risk Forum annually.

The Group uses a variety of approaches to quantify its interest rate risk. IRRBB is measured using a version of the same value-at-risk (VaR) methodology that is used for the Group's trading portfolios. Net interest income exposures are measured in terms of sensitivity over time to movements in interest rates. Additionally, Citizens measures the sensitivity of the market value of equity to changes in forward interest rates.

With the exception of Citizens and Markets, divisions are required to manage IRRBB through internal transactions with Group Treasury, to the greatest extent possible. Residual risks in divisions must be measured and reported as described below.

Group Treasury aggregates exposures arising from its own external activities and positions transferred to it from divisions. Where appropriate, Group Treasury nets off-setting risk exposures to determine a residual exposure to interest rate movements. Hedging transactions using cash and derivative instruments are executed to manage IRRBB exposures, within the GALCO approved VaR limits.

Citizens and Markets manage their own IRRBB exposures within approved limits to satisfy their business objectives.

IRRBB VaR for the Group's retail and commercial banking activities at a 99% a confidence level was as follows:

	Average	Period end	Maximum	Minimum
	£m	£m	£m	£m
2011	63	51	80	44
2010	58	96	96	30
2009	86	101	123	53



A breakdown of the Group's IRRBB VaR by currency is shown below.

	2011	2010	2009
Currency	£m	£m	£m
Euro	26	33	32
Sterling	57	79	111
US dollar	61	121	42
Other	5	10	9

Key points

- Interest rate exposure at 31 December 2011 was considerably lower than at 31 December 2010 but average exposure was 9% higher in 2011 than in 2010.
- The reduction in US dollar VaR reflects, in part, changes in holding period assumptions following changes in Non-Core assets.\*

\* unaudited

Business review Risk and balance sheet management [continued](#)

## Balance sheet management: Interest rate risk continued

## Sensitivity of net interest income\*

The Group seeks to mitigate the effect of prospective interest rate movements, which could reduce future net interest income (NII) in the Group's businesses, whilst balancing the cost of such activities on the current net revenue stream. Hedging activities also consider the impact on market value sensitivity under stress.

The following table shows the sensitivity of NII, over the next twelve months, to an immediate upward or downward change of 100 basis points to all interest rates. In addition, the table includes the impact of a gradual 400 basis point steepening and a gradual 300 basis point flattening of the yield curve at tenors greater than a year. This scenario differs from that applied in the previous year in both the severity of the rate shift and the tenors to which this is applied.

	2011	2010	2009
	£m	£m	£m
Potential favourable/(adverse) impact on NII			
+ 100 basis points shift in yield curves	244	232	510
- 100 basis points shift in yield curves	(183)	(352)	(687)
Bear steepener	443		
Bull flattener	(146)		

## Key points\*

- The Group's interest rate exposure remains slightly asset sensitive, driven in part by changes to underlying business assumptions as rates rise. The impact of the steepening and flattening scenarios is largely driven by the investment of net free reserves.
- The reported sensitivity will vary over time due to a number of factors such as market conditions and strategic changes to the balance sheet mix and should not therefore be considered predictive of future performance.

\* unaudited

## Structural foreign currency exposures

Structural foreign exchange exposures represent net investment in subsidiaries, associates and branches, the functional currencies of which are currencies other than sterling. The Group hedges structural foreign currency exposures only in limited circumstances. The Group's objective is to ensure, where practical, that its consolidated capital ratios are largely protected from the effect of changes in exchange rates. The Group seeks to limit the sensitivity to its Core Tier 1 ratio to 20 basis points in a 10% rate shock scenario. The Group's structural foreign currency position is reviewed by GALCO regularly.

The table below shows the Group's structural foreign currency exposures.

	Net assets of overseas operations	RFS MI	Net investments in foreign operations	Net investment hedges	Structural foreign currency exposures pre-economic hedges	Economic hedges (1)	Residual structural foreign currency exposures
	£m	£m	£m	£m	£m	£m	£m
2011							
US dollar	17,570	1	17,569	(2,049)	15,520	(4,071)	11,449
Euro	8,428	(3)	8,431	(621)	7,810	(2,236)	5,574
Other non-sterling	5,224	272	4,952	(4,100)	852	—	852
	31,222	270	30,952	(6,770)	24,182	(6,307)	17,875
2010							
US dollar	17,137	2	17,135	(1,820)	15,315	(4,058)	11,257
Euro	8,443	33	8,410	(578)	7,832	(2,305)	5,527
Other non-sterling	5,320	244	5,076	(4,135)	941	—	941
	30,900	279	30,621	(6,533)	24,088	(6,363)	17,725
2009							
US dollar	15,589	(2)	15,591	(3,846)	11,745	(5,696)	6,049
Euro	21,900	13,938	7,962	(2,351)	5,611	(3,522)	2,089
Other non-sterling	5,706	511	5,195	(4,001)	1,194	—	1,194
	43,195	14,447	28,748	(10,198)	18,550	(9,218)	9,332

## Note:

(1) The economic hedges represent US dollar and euro preference shares in issue that are treated as equity under IFRS, and do not qualify as hedges for accounting purposes.

## Key points

- The Group's structural foreign currency exposure at 31 December 2011 was £24.2 billion and £17.9 billion before and after economic hedges respectively, broadly unchanged from the end of 2010 position.
- Changes in foreign currency exchange rates will affect equity in proportion to structural foreign currency exposure. A 5% strengthening in foreign currencies against sterling would result in a gain of £1.27 billion (2010 - £1.27 billion; 2009 - £0.98 billion) in equity, while a 5% weakening would result in a loss of £1.15 billion (2010 - £1.15 billion; 2009 - £0.88 billion) in equity.

## Equity risk

The Group holds equity positions in the banking book in order to achieve strategic objectives, such as membership of an exchange or clearing house, or to support venture capital transactions or customer restructuring arrangements. The

Group is exposed to market risk on these banking book equity positions because they are measured at fair value. Fair values are based on available market prices where possible. In the event that market prices are not available, fair value is based on appropriate valuation techniques or management estimates.

The table below sets out the Group's banking book equity positions.

	Listed	Unlisted	Total
	£m	£m	£m
2011			
Group	576	1,768	2,344
2010			
Group	535	2,080	2,615
2009			
Group before RFS Holdings minority interest	401	2,388	2,789
RFS Holdings minority interest	60	211	271
Group	461	2,599	3,060

Note:

(1) The table above excludes equity exposures held-for-trading and those held by insurance/assurance entities.

Business review Risk and balance sheet management [continued](#)

## Risk management

### Introduction

This section focuses on each of the key types of risk that RBS Group faces - explaining how the Group manages these risks and highlighting the enhancements made as a result of progress under the Group's ongoing initiatives to strengthen its approach to risk management.

### Credit risk

All the disclosures in this section (pages 92 to 118) are audited unless otherwise indicated by an asterisk (\*).

Credit risk is the risk of financial loss owing to the failure of a customer to meet its obligation to settle outstanding amounts. The quantum and nature of credit risk assumed across the Group's different businesses vary considerably, while the overall credit risk outcome usually exhibits a high degree of correlation with the macroeconomic environment.

### Organisation

The existence of a strong credit risk management function is vital to support the ongoing profitability of the Group. The potential for loss through economic cycles is mitigated through the embedding of a robust credit risk culture within the business units and through a focus on the importance of sustainable lending practices. The role of the credit risk management function is to own the credit approval, concentration and credit risk control frameworks and to act as the ultimate authority for the approval of credit. This, together with strong independent oversight and challenge, enables the business to maintain a sound lending environment within risk appetite.

Responsibility for development of Group-wide policies, credit risk frameworks, Group-wide portfolio management and assessment of provision adequacy, sits within the Group Credit Risk (GCR) function under the management of the Group Chief Credit Officer. Execution of these policies and frameworks is the responsibility of the risk management functions, located within the Group's business divisions. These divisional credit risk functions work together with GCR to ensure that the Group Board's expressed risk appetite is met, within a clearly defined and managed control environment. The credit risk function within each division is managed by a Chief Credit Officer, who reports jointly to a divisional Chief Risk Officer and to the Group Chief Credit Officer. Divisional activities within credit risk include credit approval, transaction and portfolio analysis, early problem recognition and ongoing credit risk stewardship.

GCR is additionally responsible for verifying compliance by the divisions with all Group credit policies.

In the final quarter of 2011, the Executive Risk Forum (ERF) approved a change to the management of the credit portfolio, delegating greater authority to the Group Chief Credit Officer as chair of the functional credit committees that analyse and recommend the limits to the ERF. With effect from October 2011, the Group Chief Credit Officer chairs a single Credit Risk Committee, with the authority to approve limits for the majority of portfolios across the Group. The ERF retains its strategic role as the most senior risk committee outside the Group Board and will continue to approve material portfolio concentrations and higher risk portfolios such as commercial real estate. This change strengthens individual accountability across the risk organisation and encourages the engagement of business leaders in first line of defence risk activity.

### Risk appetite

Credit concentration risk is managed and controlled through a series of frameworks designed to limit concentration by product/asset class, sector, single name and country. These are supported by a suite of Group-wide and divisional policies, setting out the risk parameters within which business units may operate. Information on the Group's credit portfolios is reported to the Group Board by way of the divisional and Group-level risk committees.

Throughout 2011, GCR's emphasis was on embedding the new risk management frameworks introduced in 2009 and 2010 and on ensuring alignment with the strategic risk objectives being pursued across the Group. Risk appetite has been expressed by the Group Board by reference to earnings volatility and stable capital and these principles underpin the frameworks that GCR has established, and is continuing to refine, to manage the Group's concentration risks in the Core balance sheet, by product/asset class, sector, single name and country.

In the two years since the new concentration framework was rolled out across the Group, the ERF has reviewed all material industry and product portfolios and agreed a risk appetite commensurate with the franchises represented in these reviews. In particular, limits have been reviewed and re-sized, to refine the Group's risk appetite in areas where it faces significant balance sheet concentrations or franchise challenges. The product/asset class, sector, single name and country limits are now firmly embedded in the risk management processes of the Group and form a pivotal part of the Risk function's engagement with the businesses on the appropriateness of risk appetite choices.

The new sector and asset class limits have been informed by the work undertaken to stress the portfolios and historical loss experience. In addition, they factor in the future consequences for risk and return in asset classes likely to be affected by the introduction of new regulatory capital rules under Basel III.

#### Product/asset class concentration framework

- Retail - a formal framework establishes Group-level statements and thresholds that are cascaded through all retail franchises in the Group and to granular business lines. These include measures that relate both to aggregate portfolios and to asset quality at origination, which are tracked frequently to ensure consistency with Group standards and appetite. This appetite setting and tracking then informs the processes and parameters employed in origination activities, which require a large volume of small-scale credit decisions, particularly those involving an application for a new product or a change in facilities on an existing product. The majority of these decisions are based upon automated strategies utilising credit and behaviour scoring techniques. Scores and strategies are typically segmented by product, brand and other significant drivers of credit risk. These data driven strategies utilise a wide range of credit information relating to a customer including, where appropriate, information across customer holdings. A small number of credit decisions are subject to additional manual underwriting by authorised approvers in specialist units. These include higher-value, more complex, small business and personal unsecured transactions and some residential mortgage applications.
- Wholesale - formal policies, specialised tools and expertise, tailored monitoring and reporting and, in certain cases, specific limits and thresholds are deployed to address certain lines of business across the Group, where the nature of credit risk incurred could represent a concentration or a specific/heightened risk in some other form. For example, in response to volatile conditions in the syndicated loan, fixed income and equities markets during 2011, the Group engaged in only selective underwriting activity in these markets. In addition to the limit structures the Group has in place to manage its overall exposure to underwriting activity, market-linked controls were introduced in the loan underwriting book in 2011, to align the risk profile more closely to asset price movements. Those portfolios identified as potentially representing a concentration or heightened risk are subject to formal governance, including periodic review, at either Group or divisional level, depending on materiality.

#### Sector concentration framework

Across wholesale portfolios, exposures are assigned to, and reviewed in the context of, a defined set of industry sectors. Through this sector framework, appetite and portfolio strategies are agreed and set at aggregate and more granular levels where exposures have the potential to represent excessive concentration or where trends in both external factors and internal portfolio performance give cause for concern. Formal periodic reviews are undertaken at Group or divisional level depending on materiality. These may include an assessment of the Group's franchise in a particular sector, an analysis of the outlook (including downside outcomes), identification of key vulnerabilities and stress/scenario tests. Specific reporting on trends in sector risk and on status versus agreed appetite and portfolio strategies is provided to senior management and to the Group Board.

As a result of the reviews carried out in 2011, the Group has reduced its risk appetite in the higher-risk sectors of leisure, media, commercial real estate, construction, automotive, and airlines and aerospace.

In response to the severe budgetary cuts mandated by the UK Government in 2010, the UK and Northern Ireland teams conducted a full review of the likely impact of the austerity measures on their corporate and retail lending portfolios. Areas of specific focus, such as local authority lending, where budgetary pressures will be hard felt, and portfolios exposed to discretionary consumer spend, such as the retail and leisure industries, were stressed using downside assumptions on further house price deterioration and higher unemployment. The output of these activities was reviewed by the Executive Risk Forum and actions agreed in the event that these scenarios threaten to materialise.

The impact of the eurozone crisis has been felt most significantly in the financial institutions sector, where widening credit spreads and regulatory demand for increases in Tier 1 capital have exacerbated the risk management challenges already posed by the sector's continued weakness, as provisions and write-downs remain elevated. A material percentage of global banking activity in risk mitigation now passes through the balance sheets of the top global

players, increasing the systemic risks to the sector. The Group's exposures to these banks continue to be closely managed. The increased use of central clearing houses to reduce counterparty credit risk, including settlement risk, among the larger banks is a welcome move but one that will bring its own challenges. The weaker banks in the eurozone have also been the subject of heightened scrutiny and the Group's risk appetite for these banks was adjusted continuously throughout 2011.

Single name concentration framework\*

Within wholesale portfolios, much of the activity undertaken by the credit risk function is organised around the assessment, approval and management of the credit risk associated with a borrower or group of related borrowers.

A formal single name concentration framework addresses the risk of outsized exposure to a borrower or borrower group. The framework includes specific and elevated approval requirements, additional reporting and monitoring, and the requirement to develop plans to address and reduce excess exposures over an appropriate timeframe.

Credit approval authority is discharged by way of a framework of individual delegated authorities, which requires at least two individuals to approve each credit decision, one from the business and one from the credit risk management function. Both parties must hold sufficient delegated authority under the Group-wide authority grid. Whilst both parties are accountable for the quality of each decision taken, the credit risk management approver holds ultimate sanctioning authority. The level of authority granted to individuals is dependent on their experience and expertise, with only a small number of senior executives holding the highest authority provided under the framework. Daily monitoring of individual counterparty limits is undertaken.

At a minimum, credit relationships are reviewed and re-approved annually. The renewal process addresses: borrower performance, including reconfirmation or adjustment of risk parameter estimates; the adequacy of security; and compliance with terms and conditions. For certain counterparties, early warning indicators are also in place to detect deteriorating trends in limit utilisation or account performance, and to prompt additional oversight.

\* unaudited



Business review Risk and balance sheet management [continued](#)

Risk management: Credit risk continued

Risk appetite continued

Since 2009, the Group has been managing its corporate exposures to reduce concentrations and align its appetite for future business to the Group's broader strategies for its large corporate franchises. In the last quarter of 2011, the Group announced further refinements to the single name exposure management controls already in place, which brings them more closely in line with market best practice and which allows the Group to differentiate more consistently between the different risk types. These changes are expected to be implemented during the first quarter of 2012. The Group is continually reviewing its single name concentration framework to ensure that it remains appropriate for current economic conditions and in line with improvements in the Group's risk measurement models.

Reducing the risk arising from concentrations to single names remains a key focus of management attention. Continued progress was made in 2011 and credit exposures in excess of single name concentration limits were reduced by over 15% during the year. The challenges posed by continued market illiquidity and the impact of negative credit migration caused by the current economic environment are expected to continue throughout 2012.

Country

For information on how the Group manages credit risk by country, refer to the Country risk section on page 166.

Controls and assurance\*

A strong independent assurance function is an important element of a sound control environment. During 2011, the Group took the decision to strengthen its credit quality assurance (CQA) activities and moved all divisional CQA resources under the centralised management of Group Credit Risk. The benefits of this action are already apparent in greater consistency of standards and cross utilisation of resources. Reviews planned for 2012 will benefit from the availability of subject matter experts across all material products and classes and an improved ability to track control breaches and strengthen processes.

Work began in the second half of 2011 on a major revision of the Group's key credit policies. This will ensure that the Group's control environment is appropriately aligned to the risk appetite that the Group Board has approved and provide a sound basis for the Group's independent audit and assurance activities across the credit risk function. The work is expected to be concluded by the end of the second quarter of 2012.

The Group Credit Risk function launched an assurance process to provide the Group Chief Credit Officer with additional evidence of the effectiveness of the controls in place across the Group to manage risk. The results of these reviews will be provided to the Executive Risk Forum and to the Board Risk Committee on a regular basis in support of the self-certification that Group Credit Risk is obliged to complete under the Group Policy Framework (refer to Operational risk on page 194 to 197).

Problem debt management

The Group's procedures for managing problem debts differ between wholesale and retail customers, as discussed below.

Wholesale customers

The controls and processes for managing wholesale problem debts are embedded within the divisions' credit approval frameworks and form an essential part of the ongoing credit assessment of customers. Any necessary approvals will be required in accordance with the delegated authority grid governing the extension of credit.

Early problem recognition

Each division has established Early Warning Indicators (EWIs) designed to identify those performing exposures that require close attention due to financial stress or heightened operational issues. Such identification may also take place as part of the annual review cycle. EWIs vary from division to division and comprise both internal parameters (e.g. account level information) and external parameters (e.g. the share price of publicly listed customers).

Customers identified through either the EWIs or annual review are reviewed by portfolio management and/or credit officers within the division, who determine whether or not the customer's circumstances warrant placing the exposure on the Watchlist process (detailed below).

#### Watchlist process\*

There are three Watchlist ratings - amber, red and black - reflecting progressively deteriorating conditions. Watchlist Amber loans are performing loans where the counterparty or sector shows early signs of potential stress or has other characteristics such that they warrant closer monitoring. Watchlist Red loans are performing loans where indications of the borrower's declining creditworthiness are such that the exposure requires active management, usually by the Global Restructuring Group (GRG). Watchlist Black loans comprise risk elements in lending and potential problem loans.

Once on the Watchlist process, customers come under heightened scrutiny. The relationship strategy is reassessed by a forum of experienced credit, portfolio management and remedial management professionals within the division. In accordance with Group-wide policies, a number of mandatory actions will be taken, including a review of the customer's credit grade and facility security documentation. Other appropriate corrective action is taken when circumstances emerge that may affect the customer's ability to service its debt. Such circumstances include deteriorating trading performance, an imminent breach of covenant, challenging macroeconomic conditions, a late payment or the expectation of a missed payment.

For all Watchlist Red cases, the division is required to consult with the GRG on whether the relationship should be transferred to the GRG (see more on the GRG below). Relationships managed by the divisions tend to be with companies operating in niche sectors such as airlines or products such as securitisation special purpose vehicles. The divisions may also manage those exposures when subject matter expertise is available in the divisions rather than within the GRG.

\* unaudited

At 31 December 2011, exposure to customers reported as Watchlist Red and managed within the divisions totalled £4.9 billion.

Strategies that are available within divisions include granting the customer various types of concessions. Any decision to approve a concession will be a function of the division's specific country and sector appetite, the key credit metrics of the customer, the market environment and the loan structure/security. Only those concessions deemed to be outside current market norms are reported as restructurings in the discussions below.

Other potential outcomes of the review of the relationship are to: take the customer off Watchlist and return it to the mainstream loan book; offer further lending and maintain ongoing review; transfer the relationship to the GRG for those customers requiring such stewardship; or exit the relationship altogether.

#### Global Restructuring Group

In cases where the Group's exposure to the customer exceeds £1 million, the relationship may be transferred to the GRG following consultation with the originating division. The GRG's primary function is active management of the exposures to minimise loss for the Group and where feasible return the exposure to the Group's mainstream loan book following an assessment by the GRG that no further losses are expected.

At 31 December 2011, credit risk assets relating to exposures under GRG management (excluding those placed under GRG stewardship for operational reasons rather than concerns over credit quality and those in the AQ10 internal asset quality (AQ) band) totalled £22 billion. Credit risk assets are defined on page 102. The internal asset quality bands are defined on page 103.

The following table shows a sector breakdown of these exposures:

	Core	Non-Core	Total
	£m	£m	£m
Watchlist Red credit risk assets under GRG management			
2011			
Property	6,561	6,011	12,572
Transport	1,159	2,252	3,411
Retail and leisure	1,528	669	2,197
Services	808	141	949
Other	1,952	916	2,868
Total	12,008	9,989	21,997

#### Types of wholesale restructurings

A number of options are available to the Group when corrective action is deemed necessary. The Group may offer a temporary covenant waiver, a recalibration of covenants and/or an amendment of restrictive covenants to mitigate a potential or actual covenant breach. Such relief is usually granted in exchange for fees, increased margin, additional security, or a reduction in maturity profile of the original loan. Such covenant-related concessions are not included in the quantitative loan restructuring disclosures below.

The reported restructurings comprise the following types of concessions:

- Variation in margin - the contractual margin may be amended to bolster the customer's day-to-day liquidity, with the aim of helping to sustain the customer's business as a going concern. This would normally be seen as a short-term solution and is typically accompanied by the Group receiving an exit payment, a payment in kind or a deferred fee.

- Payment holidays and loan rescheduling - payment holidays or changes to the contracted amortisation profile including extensions in contracted maturity or roll-overs may be granted to improve the customer's liquidity. Such concessions often depend on the expectation that the customer's liquidity will recover when market conditions improve or will benefit from access to alternative sources of liquidity, e.g. an issue of equity capital. Recently, these types of concessions have become more common in commercial real estate transactions, particularly where a shortage of market liquidity rules out immediate refinancing and makes short-term forced collateral sales unattractive.
- Forgiveness of all or part of the outstanding debt - debt may be forgiven or exchanged for equity in cases where a fundamental shift in the customer's business or economic environment means that the customer is incapable of servicing current debt obligations and other forms of restructuring are unlikely to succeed in isolation. Debt forgiveness is often an element in leveraged finance transactions, which are typically structured on the basis of projected cash flows from operational activities, rather than underlying tangible asset values. Provided that the underlying business model and strategy are considered viable, maintaining the business as a going concern with a sustainable level of debt is the preferred option, rather than realising the value of the underlying assets.

The vast majority of the restructurings reported by the Group take place within the GRG. Forgiveness of debt and exchange for equity is only available to customers in the GRG.

\* unaudited

Business review Risk and balance sheet management [continued](#)

Risk management: Credit risk continued

Problem debt management continued

The wholesale restructured loan data presented in the tables below include only those arrangements that achieved legal completion during 2011 and that individually exceed respective thresholds set at divisional level, which range from nil to £10 million. This population captures approximately 71% of that proportion of the wholesale portfolio that is either on Watchlist or under GRG stewardship. Within this population, restructurings amounting to £8.6 billion achieved legal completion during 2011. A further £14.7 billion was in the process of being completed at year end (these loans are not included in the tables below). Of the loans that were subject to restructuring during 2011 by the divisions, 82% remained in the performing book at 31 December 2011. Of those restructured within the GRG during the year, 17% had been returned to satisfactory by year end.

The asset quality of the restructured loans, the sectors affected and provision coverage are as follows:

	AQ1-AQ9 (1)	AQ10 (2) provision coverage	AQ10 (2) provision coverage
	£m	£m	%
Wholesale restructurings by sector 2011			
Property	1,980	2,600	18
Transport	686	694	11
Non-bank financial institutions	228	420	65
Retail and leisure	503	148	24
Other	1,078	251	28
Total	4,475	4,113	22

Notes:

- (1) Probability of default less than 100%.  
 (2) Probability of default is 100%.

The incidence of the main types of restructuring is analysed below:

	Loans by value %
Wholesale restructurings by type of arrangement 2011	
Variation in margin	12
Payment holidays and loan rescheduling	87
Forgiveness of all or part of the outstanding debt	31
Other	8

Note:

- (1) The total above exceeds 100% as an individual case can involve more than one type of arrangement.

#### Provisioning for impaired loans

Any one of the above types of restructuring may result in the value of the outstanding debt exceeding the present value of the estimated future cash flows from the restructured loan resulting in the recognition of an impairment loss. Restructurings that include forgiveness of all or part of the outstanding debt account for the majority of such cases.

The customer's financial position, anticipated prospects and the likely effect of the restructuring, including any concessions granted, are considered in order to establish whether an impairment provision is required.

Provisions on exposures greater than £1 million are individually assessed by the GRG. Exposures smaller than £1 million are deemed not to be individually significant and are assessed collectively by the originating division.

In the case of non-performing loans that are restructured, the loan impairment provision assessment (based on management's best estimate of the incurred loss) almost invariably takes place prior to the restructuring. The quantum of the loan impairment provision may change once the terms of the restructuring are known, resulting in an additional provision charge or a release of the provision in the period the restructuring takes place.

Refer to Impairment loss provision methodology on pages 160 and 161.

#### Recoveries and active insolvency management

The ultimate outcome of a restructuring strategy is unknown at the time of execution. It is highly dependent on the cooperation of the borrower and the continued existence of a viable business. The following are generally considered to be options of last resort:

- Enforcement of security or otherwise taking control of assets - where the Group holds collateral or other security interest and is entitled to enforce its rights, it may take ownership or control of the assets. The Group's preferred strategy is to consider other possible options prior to exercising these rights.
- Insolvency - where there is no suitable restructuring option or the business is no longer regarded as sustainable, insolvency will be considered. Insolvency may be the only option that ensures that the assets of the business are properly and efficiently distributed to relevant creditors.

#### Retail customers

##### Early problem recognition and collections

There are collections functions in each of the retail businesses. Their role is to provide support and assistance to customers who are experiencing difficulties in meeting their financial obligations to the Group. Evidence of such difficulties includes, for example, a missed payment on their loan, or a balance that is in excess of the agreed credit limit. Additionally, in UK Retail and Ulster Bank, a dedicated support team aims to identify and help customers who may be facing financial difficulty but who are current with their payments.

Within collections, a range of tools is deployed to initiate contact with the customer, establish the cause of their financial difficulty and, where possible, return the customer to a satisfactory position using, where appropriate, forbearance strategies. If these strategies are unsuccessful, the customer is transferred to the recoveries team.

##### Recoveries

The goal of the recoveries function is to collect the total amount outstanding and reduce the loss to the Group by maximising the level of cash recovery whilst treating customers fairly. A range of treatment options are available within recoveries, including litigation procedures for secured assets. In UK Retail and Ulster Bank, no repossession procedures are initiated until at least six months following the emergence of arrears. Additionally, certain forbearance options are made available to customers within recoveries.

##### Forbearance

Within the Group's retail businesses, forbearance generally occurs when the business, for reasons relating to the actual or potential financial stress of a borrower, grants a permanent or temporary concession to that borrower. Forbearance is granted following an assessment of the customer's ability to pay. It is granted principally to customers with mortgages. Granting of forbearance to unsecured customers is less extensive.

##### Identification of forbearance

Mortgages are identified for forbearance treatment following initial contact from the customer, in the event of payment arrears or when the customer is transferred to collections or recoveries.

##### Types of retail forbearance

A number of forbearance options are utilised by the Group's retail businesses. These include, but are not limited to, reduced repayments, payment holidays, capitalisations of arrears, term extensions and conversions to interest only. Within UK Retail, interest only conversions are generally made available only to those customers who are current on payments and have a defined repayment source.

The principal types of forbearance granted in RBS Citizens' mortgage portfolio are the US government mandated HAMP (Home Affordable Modification Program) and Citizens' proprietary modification programme. Both programmes typically feature a combination of term extensions, capitalisations of arrears, temporary interest rate reductions and conversions from interest only to amortising. These tend to be permanent changes to contractual terms. Borrowers seeking a modification must meet government specified qualifications for HAMP and internal qualifications for Citizens' modification programme. Both are designed to evidence that the borrower is in financial difficulty as well as demonstrating willingness to pay.

For those loans classified as non-performing, the Group's objective in granting forbearance is to minimise the loss on these accounts and wherever possible, return the customer to the performing book. For those loans that are performing, the aim is to enable the customers to continue to service the loan.

The mortgage forbearance population is reviewed regularly to ensure that customers are meeting the agreed terms of the arrangement. Key metrics have been developed to record the proportion of customers who fail to meet the agreed terms over time as well as the proportion of customers who return to a performing state with no arrears.



Business review Risk and balance sheet management [continued](#)

Risk management: Credit risk continued

Problem debt management continued

The mortgage arrears information for retail accounts in forbearance and related provision arrangements are shown in the table below:

Arrears status and provisions	No missed payments		1-3 months in arrears		>3 months in arrears		Total		Accounts forborne %
	Balance	Provision	Balance	Provision	Balance	Provision	Balance	Provision	
	£m	£m	£m	£m	£m	£m	£m	£m	
2011									
UK Retail (1,2)	3,677	16	351	13	407	59	4,435	88	4.7
Ulster Bank (1,2)	893	78	516	45	421	124	1,830	247	9.1
Citizens	—	—	91	10	89	10	180	20	0.8
Wealth	121	—	—	—	2	—	123	—	1.3
Total	4,691	94	958	68	919	193	6,568	355	4.4

Notes:

- (1) Includes all forbearance arrangements regardless of whether or not the customer is experiencing financial difficulty.
- (2) Comprises the current stock position of forbearance deals agreed since January 2008 for UK Retail and since July 2008 for Ulster Bank.
- (3) Refer to page 113 for details of the proportion of UK Retail and Citizens mortgage loans that have missed three or more payments, compared to the forbearance population above.

The incidence of the main types of retail forbearance on the balance sheet as at 31 December 2011 is analysed below. For a small proportion of mortgages, more than one forbearance type applies.

Forbearance arrangements	UK	Ulster	Citizens	Wealth	Total (2)
	Retail (1)	Bank (1)			
	£m	£m	£m	£m	£m
2011					
Interest only conversions	1,269	795	—	3	2,067
Term extensions - capital repayment and interest only	1,805	58	—	97	1,960
Payment concessions/holidays	198	876	180	—	1,254
Capitalisation of arrears	864	101	—	—	965
Other	517	—	—	23	540
Total	4,653	1,830	180	123	6,786

Notes:

- (1) Comprises the current stock position of forbearance deals agreed since January 2008 for UK Retail and since July 2008 for Ulster Bank.
- (2)

As an individual case can include more than one type of arrangement, the analysis in the table above can exceed the total forbearance.

For unsecured portfolios in UK Retail, 1.1% of the total unsecured population was subject to forbearance at 31 December 2011 and comprises either debt consolidation loans provided to customers subject to collections activity who do not meet the Group's standard underwriting criteria or repayment arrangements where the customer's overdraft limit is increased to accommodate account excesses and/or loan arrears. Additionally, support is provided to customers experiencing financial difficulties through 'breathing space initiatives' on all unsecured products, including credit cards, whereby a 30-day period is given to allow customers to establish a debt repayment plan. During this time, the Group suspends collection activity and a further extension of 30 days can be granted if progress is made and discussions are continuing. Arrears continue to accrue for customer loans benefiting from breathing space.

Within Citizens, granting of forbearance is significantly less extensive for non real estate portfolios, as it is predominantly restricted to the granting of short-term (1-3 months) loan extensions to customers to alleviate the financial burden caused by temporary hardship. Such extensions are offered only if a customer has demonstrated a capacity and willingness to pay following the extension term. The number and frequency of extensions are limited per customer. Additionally, in the case of loans secured by vehicles and credit cards, Citizens may offer temporary interest rate modifications but no principal reduction. For loans secured by vehicles, this is now restricted to three-month interest rate modifications. For credit cards, customers may be offered short-term (6-12 months) or longer-term (up to 60 months) interest rate modifications. Citizens may also provide forbearance to student loan borrowers consistent with the policy guidelines of the US Office of the Comptroller of the Currency.

#### Provisioning for retail customers

Within UK Retail and Ulster Bank, provisions are assessed in accordance with the Group's provisioning policies (refer to Impairment loss provision methodology on pages 160 and 161). For the non-performing population, a collective assessment is made. Within the performing book, latent loss provisions are held for those losses that are incurred but not yet identified.

The majority of mortgage accounts subject to forbearance in these divisions remain in the performing book but are identified and monitored separately from other performing accounts. They are subject to higher provisioning rates than the remainder of the performing book (currently approximately five times higher in UK Retail and approximately eight times higher in Ulster Bank). These rates are reviewed quarterly in UK Retail and monthly in Ulster Bank. Once forbearance is granted, the account continues to be assessed separately for latent provisioning for 24 months (UK Retail only) or until the forbearance period expires. After that point, the account is no longer separately identified for latent provisioning.

Non-performing mortgage accounts that have been granted forbearance carry the same provision rate as non-forborne accounts.

In Citizens, the amount of recorded impairment depends upon whether the loan is collateral dependent. If the loan is considered collateral dependent, the excess of the loan's carrying amount over the fair value of the collateral is the impairment amount. If the loan is not deemed collateral dependent, the excess of the loan's carrying amount over the present value of expected future cash flows is the impairment amount.

#### Credit risk mitigation

##### Introduction\*

The Group employs a number of structures and techniques to mitigate credit risk. Netting of debtor and creditor balances is undertaken in accordance with relevant regulatory and internal policies. Exposure on over-the-counter derivative and secured financing transactions is further mitigated by the exchange of financial collateral and the use of market standard documentation. Further mitigation may be undertaken in a range of transactions, from retail mortgage lending to large wholesale financing. This can include: structuring a security interest in a physical or financial asset; use of credit derivatives, including credit default swaps, credit-linked debt instruments and securitisation structures; and use of guarantees and similar instruments (for example, credit insurance) from related and third parties. Such techniques are used in the management of credit portfolios, typically to mitigate credit concentrations in relation to an individual obligor, a borrower group or a collection of related borrowers.

The use and approach to credit risk mitigation varies by product type, customer and business strategy. Minimum standards applied across the Group cover:

- The suitability of qualifying credit risk mitigation types and any conditions or restrictions applicable to those mitigants;
- The means by which legal certainty is to be established, including required documentation and all necessary steps required to establish legal rights;
- Acceptable methodologies for initial and any subsequent valuations of collateral and the frequency with which collateral is to be revalued and the use of collateral haircuts;
- Actions to be taken in the event that the value of mitigation falls below required levels;
- Management of the risk of correlation between changes in the credit risk of the customer and the value of credit risk mitigation;

- Management of concentration risks, for example, by setting thresholds and controls on the acceptability of credit risk mitigants and on lines of business that are characterised by a specific collateral type or structure; and
- Collateral management to ensure that credit risk mitigation remains legally effective and enforceable.

Collateral and other credit enhancements received

Within its secured portfolios, the Group has recourse to various types of collateral and other credit enhancements to mitigate credit risk and reduce the loss to the Group arising from the failure of a customer to meet its obligations. These include: cash deposits; charges over residential and commercial property, debt securities and equity shares; and third-party guarantees. The existence of collateral may affect the pricing of a facility and its regulatory capital requirement. When a collateralised financial asset becomes impaired, the impairment charge directly reflects the realisable value of collateral and any other credit enhancements.

\* unaudited

Business review Risk and balance sheet management [continued](#)

## Risk management: Credit risk continued

## Credit risk mitigation continued

## Corporate exposures

The type of collateral taken by the Group's commercial and corporate businesses and the manner in which it is taken will vary according to the activity and assets of the customer.

- Physical assets - these include business assets such as stock, plant and machinery, vehicles, ships and aircraft. In general, physical assets qualify as collateral only if they can be unambiguously identified, located or traced, and segregated from uncharged assets. Assets are valued on a number of bases according to the type of security that is granted.
- Real estate - the Group takes collateral in the form of real estate, which includes residential and commercial properties. The loan amount will typically exceed the market value of the collateral at origination date. The market value is defined as the estimated amount for which the asset could be sold in an arms length transaction by a willing seller to a willing buyer.
- Receivables - when taking a charge over receivables, the Group assesses their nature and quality and the borrower's management and collection processes. The value of the receivables offered as collateral will typically be adjusted to exclude receivables that are past their due dates.

The security charges may be floating or fixed, with the type of security likely to impact (i) the credit decision; and (ii) the potential loss upon default. In the case of a general charge such as a mortgage debenture, balance sheet information may be used as a proxy for market value if the information is deemed reliable.

The Group does not recognise certain asset classes as collateral: for example, short leasehold property and equity shares of the borrowing company. Collateral whose value is correlated to that of the obligor is assessed on a case-by-case basis and, where necessary, over-collateralisation may be required.

The Group uses industry-standard loan and security documentation wherever possible. Non standard documentation is typically prepared by external lawyers on a case-by-case basis. The Group's business and credit teams are supported by in-house specialist documentation teams.

The existence of collateral has an impact on provisioning. Where the Group no longer expects to recover the principal and interest due on a loan in full or in accordance with the original terms and conditions, it is assessed for impairment. If exposures are secured, the current net realisable value of the collateral will be taken into account when assessing the need for a provision. No impairment provision is recognised in cases where all amounts due are expected to be settled in full on realisation of the security.

	2011		2010	
	Loans £m	Provisions £m	Loans £m	Provisions £m
Corporate risk elements in lending and potential problem loans (excluding commercial real estate)				
Secured	7,782	3,369	6,526	2,564
Unsecured	2,712	1,836	2,769	1,762

Commercial real estate

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The table below analyses commercial real estate lending by loan-to-value (LTV). Due to market conditions in Ireland and to a lesser extent in the UK, there is a shortage of market based data. In the absence of external valuations, the Group deploys a range of alternative approaches including internal expert judgement and indexation.

LTVs	Ulster Bank		Rest of the Group		Group	
	AQ1-AQ9 £m	AQ10 £m	AQ1-AQ9 £m	AQ10 £m	AQ1-AQ9 £m	AQ10 £m
2011						
<= 50%	81	28	7,091	332	7,172	360
> 50% and <= 70%	642	121	14,105	984	14,747	1,105
> 70% and <= 90%	788	293	10,042	1,191	10,830	1,484
> 90% and <= 100%	541	483	2,616	1,679	3,157	2,162
> 100% and <= 110%	261	322	1,524	1,928	1,785	2,250
> 110% and <= 130%	893	1,143	698	1,039	1,591	2,182
> 130%	1,468	10,004	672	2,994	2,140	12,998
Total with LTVs	4,674	12,394	36,748	10,147	41,422	22,541
Other (1)	7	38	8,994	1,844	9,001	1,882
Total	4,681	12,432	45,742	11,991	50,423	24,423
Total portfolio average LTV (2)	140%	259%	69%	129%	77%	201%

Notes:

(1) Other performing loans of £9.0 billion include unsecured lending to commercial real estate clients, such as major UK homebuilders. The credit quality of these exposures is consistent with that of the performing portfolio overall.

Other non-performing loans of £1.9 billion are subject to the Group's standard provisioning policies.

(2) Weighted average by exposure.

## Wholesale market exposures

As set out in the table below, the Group receives collateral for reverse repurchase transactions and for derivatives, typically in the form of cash, quoted debt securities or equities. The risks inherent in both types of transaction are further mitigated through master bilateral netting arrangements. Industry standard documentation such as master repurchase agreements and credit support annexes accompanied by legal opinion, is used for financial collateral taken as part of trading activities.

	2011	2010	2009
	£bn	£bn	£bn
Reverse repurchase agreements	100.9	95.1	76.1
Securities received as collateral (1)	(98.9)	(94.3)	(74.0)
Derivative assets gross exposure	529.6	427.1	441.5
Counterparty netting	(441.6)	(330.4)	(358.9)
Cash collateral held	(37.2)	(31.1)	(33.7)
Securities received as collateral	(5.3)	(2.9)	(3.6)

## Note:

(1) In accordance with normal market practice, at 31 December 2011 £95.4 billion (2010 - £93.5 billion; 2009 - £73.0 billion) had been resold or re-pledged as collateral for the Group's own transactions.

## Retail exposures

Within the Group's retail book, mortgage and home equity lending portfolios are secured by residential property. The Group's portfolio of US automobile loans is secured by motor cars or other vehicles. Student loans and credit card lending are all unsecured. The vast majority of personal loans are also unsecured.

All borrowing applications, whether secured or not, are subject to appropriate credit risk underwriting processes including affordability assessment. Pricing is typically higher on unsecured than secured loans. For secured loans, pricing will typically vary by LTV. Higher LTV products are typically subject to higher interest rates commensurate with the associated risk.

The value of a property intended to secure a mortgage is assessed during the loan underwriting process using industry-standard methodologies. Property values supporting home equity lending reflect either an individual appraisal or valuations generated by statistically valid automated valuation models. Property values are updated each quarter using the relevant house price index (the Halifax Quarterly Regional House Price Index in the UK, the Case-Shiller Home Value Index in the US, and the Central Statistics Office Residential Property Price Index and the Nationwide House Price Index in Ireland).

For automobile lending in the US, new vehicles are valued at cost and used vehicles at the average trade-in value. At 31 December 2011 this portfolio amounted to £4.8 billion (2010 - £5.1 billion; 2009 - £5.7 billion), all of which was fully secured and predominantly (over 99%) in the performing book.

The existence of collateral has an impact on provisioning levels. Once a secured loan is classified as non-performing, the realisable value of the underlying collateral and the costs associated with repossession are used to estimate the provision required.

## Residential mortgages

The table below shows period end LTVs for the Group's residential mortgage portfolio split between performing and non-performing and calculated on a value basis. Loan balances are as at the end of the year whereas property values are calculated using the appropriate index at 30 September 2011.

Residential mortgages by average LTV	2011		2010		2009	
	Performing £m	Non-performing £m	Performing £m	Non-performing £m	Performing £m	Non-performing £m
<= 70%	60,799	1,137	59,598	1,036	55,920	791
> 70% and <= 90%	42,923	1,022	41,964	906	38,807	697
> 90% and <= 110%	17,856	990	20,104	951	23,853	754
> 110% and <= 130%	5,809	573	7,211	622	8,604	507
> 130% (1)	6,684	1,188	3,793	507	3,059	269
Total	134,071	4,910	132,670	4,022	130,243	3,018
Total portfolio average LTV (by value)	73.2%	101.4%	72.4%	91.7%	73.5%	90.1%

Note:

(1) 83% of residential mortgages with LTV > 130% are within Ulster Bank due to the continued challenging economic environment in Ireland.



Business review Risk and balance sheet management [continued](#)

Risk management: Credit risk continued

Credit risk measurement\*

Credit risk models are used throughout the Group to support the quantitative risk assessment element within the credit approval process, ongoing credit risk management, monitoring and reporting and portfolio analytics. Credit risk models used by the Group may be divided into three categories, as follows.

Probability of default/customer credit grade

These models assess the probability that a customer will fail to make full and timely repayment of its obligations. The probability of a customer failing to do so is measured over a one year period through the economic cycle, although certain retail scorecards use longer periods for business management purposes.

Wholesale businesses - as part of the credit assessment process, each counterparty is assigned an internal credit grade derived from a default probability. There are a number of different credit grading models in use across the Group, each of which considers risk characteristics particular to that type of customer. The credit grading models score a combination of quantitative inputs (for example, recent financial performance) and qualitative inputs (for example, management performance or sector outlook).

Retail businesses - each customer account is separately scored using models based on the most material drivers of default. In general, scorecards are statistically derived using customer data. Customers are assigned a score, which in turn is mapped to a probability of default. The probabilities of default are used to support automated credit decision making and to group customers into risk pools for regulatory capital calculations.

Exposure at default

Facility usage models estimate the expected level of utilisation of a credit facility at the time of a borrower's default. For revolving and variable draw down type products which are not fully drawn, the exposure at default (EAD) will typically be higher than the current utilisation. The methodologies used in EAD modelling provide an estimate of potential exposure and recognise that customers may make more use of their existing credit facilities as they approach default.

Counterparty credit risk exposure measurement models are used for derivatives and other traded instruments, where the amount of credit risk exposure may be dependent upon one or more underlying market variables, such as interest or foreign exchange rates. These models drive internal credit risk management activities such as limit and excess management.

Loss given default

These models estimate the economic loss that may be experienced (the amount that cannot be recovered) by the Group on a credit facility in the event of default. The Group's loss given default models take into account both borrower and facility characteristics for unsecured or partially unsecured facilities, as well as the quality of any risk mitigation that may be in place for secured facilities, the cost of collections and a time discount factor for the delay in cash recovery.

Credit risk assets

In the tables and commentary below, exposure refers to credit risk assets, which consist of:

- Lending - cash and balances at central banks and loans and advances to banks and customers (including overdraft facilities, instalment credit and finance leases);
- Rate risk management; and

- Contingent obligations, primarily letters of credit and guarantees.

Reverse repurchase agreements and issuer risk (primarily debt securities - refer to pages 133 to 135) are excluded. Where relevant and unless otherwise stated, the data reflect the effect of credit mitigation techniques.

	2011	2010	2009
	£m	£m	£m
Divisional analysis of credit risk assets			
UK Retail	111,070	108,302	103,029
UK Corporate	105,078	108,663	111,893
Wealth	20,079	18,875	16,553
International Banking	72,737	80,166	90,613
Ulster Bank	37,781	40,750	42,042
US Retail & Commercial	56,546	51,779	52,167
Retail & Commercial	403,291	408,535	416,297
Markets	114,327	124,330	145,456
Other	64,517	36,659	3,305
Core	582,135	569,524	565,058
Non-Core	92,709	125,383	158,499
	674,844	694,907	723,557

\* unaudited

## Key points

- Exposure to retail portfolios within the UK Retail, Ulster Bank and US Retail & Commercial divisions remained broadly constant during the year. A reduction in wholesale portfolios was seen across all divisions, with the exception of Wealth, for which product demand and risk appetite typically have more in common with retail portfolios. Another exception was 'Other', which is driven by Treasury where growth in credit risk assets relates to exposure to central banks in the USA, the UK and Germany and is a function of the Group's liquidity requirements and cash positions.
- Non-Core exposure declined during 2011 as a result of the continued disposal and run-off of assets. Substantial de-risking was achieved though an exposure reduction of £33 billion over the year, in line with balance sheet reduction targets. Significantly, the division was able to take action to reduce exposure within the Middle East & North Africa region, which saw material volatility early in 2011 (exposure down 66%). The division also reduced single name concentration excesses, in part due to disposals in the leveraged finance book. In addition, the division's project finance business achieved a material reduction through asset sales, unwinding of trades within the markets business and legal defeasance of structured finance transactions.

## Asset quality

Using the probability of default models described previously, customers are assigned credit grades and scores, which are used for internal management reporting across portfolios, including a Group level asset quality scale, as shown below.

Internal reporting and oversight of risk assets is principally differentiated by credit grades. Customers are assigned credit grades, based on various credit grading models that reflect the key drivers of default for the customer type. All credit grades across the Group map to both a Group level asset quality scale, used for external financial reporting, and a master grading scale for wholesale exposures, used for internal management reporting across portfolios. Accordingly, measures of risk exposure may be readily aggregated and reported at increasing levels of granularity depending on stakeholder or business need.

The table below shows credit risk assets by asset quality (AQ) band:

Asset quality	Probability of default range	2011			2010			2009				
		Core £m	Non-Core £m	Total £m	Total %	Core £m	Non-Core £m	Total £m	Total %	Core £m	Non-Core £m	Total £m
AQ1	0% - 0.034%	195,826	13,732	209,558	31.1	175,793	17,728	193,521	27.8	149,132	23,226	172,358
AQ2	0.034% - 0.048%	18,366	2,915	21,281	3.2	18,274	2,526	20,800	3.0	18,029	3,187	21,216
AQ3	0.048% - 0.095%	27,082	2,883	29,965	4.4	26,244	4,259	30,503	4.4	26,703	7,613	34,316
AQ4	0.095% - 0.381%	65,491	9,636	75,127	11.1	64,277	15,052	79,329	11.4	78,144	18,154	96,298
AQ5	0.381% - 1.076%	92,503	10,873	103,376	15.3	90,639	18,767	109,406	15.7	92,908	24,977	117,885
AQ6	1.076% - 2.153%	67,260	6,636	73,896	11.0	73,367	12,913	86,280	12.4	76,206	18,072	94,278
AQ7	2.153% - 6.089%	36,567	8,133	44,700	6.6	41,399	10,451	51,850	7.5	44,643	15,732	60,375
AQ8	6.089% - 17.222%	11,921	3,320	15,241	2.3	15,300	4,308	19,608	2.8	18,923	4,834	23,757
AQ9	17.222% - 100%	12,710	5,024	17,734	2.6	11,398	8,621	20,019	2.9	11,589	8,074	19,663
AQ10	100%	20,029	25,020	45,049	6.7	18,003	25,005	43,008	6.2	16,756	22,666	39,422
Other (1)		34,380	4,537	38,917	5.7	34,830	5,753	40,583	5.9	32,025	11,964	43,989
		582,135	92,709	674,844	100.0	569,524	125,383	694,907	100.0	565,058	158,499	723,557

## Note:

(1) 'Other' largely comprises assets covered by the standardised approach, for which a probability of default equivalent to those assigned to assets covered by the internal ratings based approach is not available.

\* unaudited

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Business review Risk and balance sheet management [continued](#)

## Risk management: Credit risk continued

## Credit risk measurement\*: Asset quality continued

	2011		2010		2009	
	AQ10	% of	AQ10	% of	AQ10	% of
	£m	divisional	£m	divisional	£m	divisional
AQ10 credit risk assets by division		credit risk		credit risk		credit risk
		assets		assets		assets
UK Retail	5,097	4.6	5,017	4.6	4,846	4.7
UK Corporate	5,484	5.2	5,198	4.8	5,612	5.0
Wealth	12	0.1	9	—	11	0.1
International Banking	1,736	2.4	2,227	2.8	1,406	1.6
Ulster Bank	6,305	16.7	4,348	10.7	2,741	6.5
US Retail & Commercial	646	1.1	599	1.2	506	1.0
Retail & Commercial	19,280	4.8	17,398	4.3	15,122	3.6
Markets	749	0.6	605	0.5	1,634	1.1
Core	20,029	3.4	18,003	3.2	16,756	3.0
Non-Core	25,020	27.0	25,005	19.9	22,666	14.3
	45,049	6.7	43,008	6.2	39,422	5.5

	2011	2010	2009
	£m	£m	£m
AQ10 credit risk assets by sector			
Personal	8,398	7,620	6,955
Property	25,558	23,672	20,145
Banks and financial institutions	1,934	1,981	1,928
Transport and storage	1,720	1,689	1,026
Other	7,528	8,046	9,368
	45,138	43,008	39,422

## Key points

- Trends in the asset quality of the Group's credit risk exposures in 2011 reflected changes in the composition of the Core portfolio in line with the re-balancing achieved through the Group's sector concentration framework, the run-off of Non-Core assets and changes in the external environment. Significant deposits were placed with central banks and this resulted in a large increase in the Group's exposures within the AQ1 band.
- Overall, the asset quality of the Group's corporate exposure was broadly maintained despite the difficult external conditions in the UK, with moderate weakening of credit quality in the Core divisions.
- A notable exception is Ulster Bank, where weakness in the Irish property sector continued to impact portfolio trends and the stock of defaulted assets in the Core book (AQ10) continued to grow. Refer to the section on Ulster Bank on page 117 for more details.
- In line with expectations, the percentage of defaulted assets in the Non-Core division increased following the run-off and disposal of performing assets. Weaknesses in the commercial real estate market continued to be the main driver of defaulted assets within Non-Core.

\* unaudited

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## Portfolio by sector and geographical region

Sector analysis plays an important part in assessing the potential for concentration risk in the loan portfolio. Particular attention is given to sectors where the Group believes there is a high degree of risk or potential for volatility in the future.

The table below details credit risk assets by sector and geographical region. Sectors are based on mappings aligned to the Group's sector concentration framework. Geographical region is based on country of incorporation.

## Credit risk assets by sector and geographical region

	Western Europe (excl. North America)						Asia Pacific	Latin America	Other (1)	Total	Core	Non-Core
2011	UK £m	UK £m	America £m	Pacific £m	America £m			£m	£m	£m	£m	
Personal	126,945	20,253	33,087	1,604	158	1,114	183,161	176,201	6,960			
Banks	4,720	39,290	3,952	11,149	1,740	7,324	68,175	67,614	561			
Other financial institutions	17,939	17,503	13,595	3,108	5,841	1,159	59,145	48,765	10,380			
Sovereign (2)	21,072	34,258	31,444	3,463	78	1,581	91,896	90,638	1,258			
Property	60,099	27,282	8,052	1,370	3,471	1,480	101,754	58,324	43,430			
Natural resources	6,553	7,218	8,159	3,805	1,078	2,508	29,321	25,191	4,130			
Manufacturing	9,583	7,480	7,098	2,126	1,011	1,381	28,679	26,614	2,065			
Transport (3)	13,790	7,705	4,951	5,433	2,500	5,363	39,742	27,531	12,211			
Retail and leisure	22,775	6,110	5,762	1,488	1,041	675	37,851	32,775	5,076			
Telecommunications, media and technology	5,295	4,941	3,202	1,944	139	609	16,130	12,180	3,950			
Business services	17,851	3,718	6,205	910	629	206	29,519	26,830	2,689			
	306,622	175,758	125,507	36,400	17,686	23,400	685,373	592,663	92,710			
2010 (4)												
Personal	124,594	21,973	34,970	1,864	126	1,531	185,058	174,287	10,771			
Banks	6,819	35,619	5,097	11,072	1,394	6,713	66,714	65,494	1,220			
Other financial institutions	17,550	14,782	14,773	4,200	8,732	1,762	61,799	47,227	14,572			
Sovereign (2)	20,209	24,826	18,088	3,243	125	1,789	68,280	66,556	1,724			
Property	65,622	30,925	9,573	1,980	3,090	1,750	112,940	60,590	52,350			
Natural resources	6,696	7,863	9,771	3,655	1,396	4,143	33,524	24,427	9,097			
Manufacturing	10,599	8,532	6,744	2,673	917	2,059	31,524	28,088	3,436			
Transport (3)	13,842	8,726	5,389	6,161	2,658	6,347	43,123	27,899	15,224			
Retail and leisure	24,716	6,690	5,316	1,438	1,174	918	40,252	34,100	6,152			
Telecommunications, media and technology	5,495	5,764	3,283	2,187	328	786	17,843	12,076	5,767			
Business services	19,757	5,116	6,521	985	1,086	385	33,850	28,780	5,070			
	315,899	170,816	119,525	39,458	21,026	28,183	694,907	569,524	125,383			

For notes relating to this table refer to page 106.

\* unaudited





Business review Risk and balance sheet management [continued](#)

## Risk management: Credit risk continued

## Credit risk measurement\*: Credit risk assets by sector and geographical region continued

	Western Europe (excl. North America, Asia Pacific, Latin America, Other)						Total	Core	Non-Core
	UK	UK	America	Pacific	America	(1)			
2009	£m	£m	£m	£m	£m	£m	£m	£m	£m
Personal	120,193	23,597	37,680	1,374	63	897	183,804	165,143	18,661
Banks	7,850	36,705	4,975	9,121	1,378	2,137	62,166	58,246	3,920
Other financial institutions	14,800	14,125	17,697	4,820	8,441	1,473	61,356	43,762	17,594
Sovereign (2)	18,172	27,421	4,038	3,950	414	2,217	56,212	53,595	2,617
Property	72,768	35,558	11,221	3,507	3,127	1,440	127,621	74,892	52,729
Natural resources	7,876	9,460	9,817	3,029	3,523	4,972	38,677	26,058	12,619
Manufacturing	11,197	14,875	8,718	3,695	1,306	2,633	42,424	33,400	9,024
Transport (3)	14,097	7,033	7,287	5,294	2,604	7,140	43,455	28,362	15,093
Retail and leisure	25,811	8,236	6,148	3,602	1,205	1,691	46,693	35,580	11,113
Telecommunications, media and technology	6,128	8,340	4,854	2,040	680	1,409	23,451	13,645	9,806
Business services	20,497	6,772	6,950	1,137	1,439	903	37,698	32,375	5,323
	319,389	192,122	119,385	41,569	24,180	26,912	723,557	565,058	158,499

## Notes:

- (1) Comprises Central and Eastern Europe, Middle East, Central Asia and Africa, and supranationals such as the World Bank.
- (2) Includes central bank exposures.
- (3) Excludes net investment in operating leases in shipping and aviation portfolios as they are accounted for as property, plant and equipment. However, operating leases are included in the monitoring and management of these portfolios.
- (4) 2010 data were restated due to supranational counterparties being re-mapped from Western Europe to Other.

## Key points

- Conditions in the financial markets and the Group's focus on risk appetite and sector concentration had a direct impact on the composition of its Core portfolio during the year. The following key trends were observed:
  - (i) A 35% increase in exposure to sovereigns, driven by the significant deposits placed with central banks;
  - (ii) A 10% reduction in exposure to the property sector, driven by tightened controls in Core as well as by a reduction in Non-Core;
  - (iii) A modest reduction in exposure to other corporate and financial institution sectors, driven by subdued borrowing activity by larger corporates; and
  - (iv) A broadly flat exposure to the personal sector.
- The Group's sovereign portfolio comprises central governments, central banks and sub-sovereigns such as local authorities, primarily in the Group's key markets in the UK, Western Europe and the US. Exposure predominantly comprises cash balances placed with central banks such as the Bank of England, the Federal Reserve and the Eurosystem (including the European Central Bank and central banks in the eurozone) and consequently, the asset quality of this portfolio is high. Exposure to sovereigns fluctuates according to the Group's liquidity requirements

and cash positions, which determine the level of cash placed with central banks. However, during 2011, there was a marked increase in these balances as the Group boosted its regulatory liquidity position. Information on the Group's exposure to sovereigns, including eurozone peripheral sovereigns, can be found in the Country risk section on page 166.

- The bank sector is one of the largest in the Group's portfolio but the sector is well diversified geographically, largely collateralised and tightly controlled through a combination of the single name concentration framework and a suite of credit policies specifically tailored to the sector and country limits. The largest segment of exposure to the sector remains to globally systemically important financial institutions. The environment remains challenging as a result of low economic growth in advanced economies, higher costs due to increased regulatory requirements and the growing difficulty of returning to historical levels of profitability. Over 2011, there was modest increase in exposure to banks due to mark-to-market movements in derivatives. However, the Group's portfolio was in general characterised by declining limits, a rising number of counterparties subject to heightened credit monitoring due to the problems faced by the peripheral eurozone countries and a corresponding deterioration in asset quality, balanced to some extent by the improved stability of banks outside the eurozone.

\* unaudited

- The other financial institutions sector comprises traded and non-traded products and is spread across a wide range of financial companies including insurance companies, securitisation vehicles, financial intermediaries including central counterparties (CCPs), financial guarantors - monolines and credit derivative product companies (CDPCs) - and unleveraged, hedge and leveraged funds. The size and asset quality of this portfolio are stable and have not changed materially since 2010. However, entities in this sector remain vulnerable to market shocks or contagion from the banking sector crisis. Credit risk for these sectors is managed through both the sector concentration and asset and product class frameworks, with specific sector and product caps introduced where there is a perception of heightened credit risk, such as with leveraged funds and insurance holding companies. Additionally, policies were tightened for riskier products to entities in this portfolio, such as committed lending, to reduce risks from a customer default. During the year, a comprehensive securitisation framework was established to cap the securitisation portfolio and to control concentrations to the underlying asset classes and originators. The Group is currently reassessing its risk appetite framework for CCPs to reflect increases in activity with these entities, as a result of regulatory requirements for derivatives to be cleared through CCPs. In 2011, the Group continued to manage down its exposures to monolines and CDPCs and was successful in commuting trades with entities in this portfolio.
- The Group's exposure to the property sector totals £102 billion (a reduction of 10% during the year), the majority of which is commercial real estate (refer to page 108 for further detail). The remainder comprises lending to construction companies, housing associations and building material companies. The majority of property exposure (with the exception of Non-Core) is within UK Corporate (63%). Asset quality in other property sub-sectors remained stable during the year and whilst there are some material single name concentrations in the construction sector due to industry consolidation, overall appetite remains controlled through the sector concentration limits framework.
- The exposure to the retail sector attracts heightened scrutiny due to its cyclical nature. Stress testing has confirmed that the retail sector has an above average vulnerability to a high UK inflation and interest rate scenario. Certain sub-sectors have proven less vulnerable to macroeconomic volatilities (e.g. food and beverage) as have larger retailers with well established brands and multiple channel offerings. Total exposure declined 6% during 2011. Despite recent high profile failures of UK high street retailers, loss experience on the RBS retail portfolio over 2011 was low, following the earlier exit from some parts of the portfolio. The portfolio is generally well diversified by geography and by counterparty.
- The leisure sector displays weaker credit metrics than the wider corporate portfolio, in line with the industry trend. Default experience in hotels and restaurants is particularly high. The Group's risk appetite towards the sector is driven by the importance of the leisure sector to the UK franchise, especially for the UK Corporate division, but is mitigated through tighter origination policies and guidelines and a reduction in exposure to high risk sub-sectors. The gaming sub-sector is subject to specific controls due to its inherent high credit and reputational risk profile.
- The Group's transport sector includes £11.7 billion of asset-backed exposure to ocean-going vessels. The downturn observed in the shipping sector since 2008 continued during 2011, with further pressure on second-hand values and deliveries of new build vessels into poor markets. A key protection for the Group is the minimum security covenant. This covenant is tested each quarter on an individual vessel basis to ensure that prompt remedial action is taken if values fall significantly below agreed loan coverage ratios. At 31 December 2011, 1% of the Group's exposure to this sector was in Watchlist Red.
- Exposure to the healthcare and education sectors is included in the business services sector and totalled £13.4 billion at year-end. It is mostly UK focused and is heavily biased towards the health sector, which represents 74%

of the exposure. The sector has performed well despite the difficult economic conditions but there are continuing uncertainties over the impact of Government spending reductions. Key concerns remain over the nursing home sub-sector, where the lower end of the elderly care home book saw an increased rate of customers being placed on Watchlist and higher defaults over 2011. Actions were taken to rebalance the portfolio towards the stronger operators.

\* unaudited

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Business review Risk and balance sheet management [continued](#)

## Risk management: Credit risk continued

## Key credit portfolios\*

## Commercial real estate

The commercial real estate lending portfolio totalled £74.8 billion at 31 December 2011, a 14% year-on-year decrease (2010 - £87.4 billion). The commercial real estate sector comprises exposure to entities involved in the development of or investment in commercial and residential properties (including homebuilders). The analysis below excludes rate risk management and contingent obligations.

By division	2011			2010			2009		
	Investment £m	Development £m	Total £m	Investment £m	Development £m	Total £m	Investment £m	Development £m	Total £m
<b>Core</b>									
UK Corporate	25,101	5,023	30,124	24,879	5,819	30,698	27,143	7,331	34,474
Ulster Bank	3,882	881	4,763	4,284	1,090	5,374	6,131	3,838	9,969
US Retail & Commercial	4,235	70	4,305	4,322	93	4,415	2,812	1,084	3,896
Markets	141	61	202	191	275	466	1,275	193	1,468
International Banking	872	299	1,171	940	369	1,309	722	625	1,347
	34,231	6,334	40,565	34,616	7,646	42,262	38,083	13,071	51,154
<b>Non-Core</b>									
UK Corporate	3,957	2,020	5,977	7,591	3,263	10,854	7,390	3,959	11,349
Ulster Bank	3,860	8,490	12,350	3,854	8,760	12,614	2,061	6,271	8,332
US Retail & Commercial	901	28	929	1,325	70	1,395	1,409	431	1,840
International Banking	14,689	336	15,025	19,906	379	20,285	24,638	873	25,511
	23,407	10,874	34,281	32,676	12,472	45,148	35,498	11,534	47,032
<b>Total</b>	<b>57,638</b>	<b>17,208</b>	<b>74,846</b>	<b>67,292</b>	<b>20,118</b>	<b>87,410</b>	<b>73,581</b>	<b>24,605</b>	<b>98,186</b>

By geography	Investment		Development		Total £m	Investment		Development		Total £m
	Commercial £m	Residential £m	Commercial £m	Residential £m		Core £m	Non-Core £m	Core £m	Non-Core £m	
<b>2011</b>										
UK (excluding NI) (1)	28,653	6,359	1,198	6,511	42,721	25,904	9,108	5,118	2,591	42,721
Ireland (ROI & NI) (1)	5,146	1,132	2,591	6,317	15,186	3,157	3,121	793	8,115	15,186
Western Europe	7,649	1,048	9	52	8,758	422	8,275	20	41	8,758
US	5,552	1,279	59	46	6,936	4,521	2,310	71	34	6,936
RoW	785	35	141	284	1,245	227	593	332	93	1,245
	47,785	9,853	3,998	13,210	74,846	34,231	23,407	6,334	10,874	74,846

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2010 (1)

UK (excluding NI) (1)	32,334	7,255	1,520	8,288	49,397	26,168	13,421	5,997	3,811	49,397
Ireland (ROI & NI) (1)	5,056	1,148	2,785	6,578	15,567	3,159	3,044	963	8,401	15,567
Western Europe	10,568	643	25	42	11,278	409	10,802	25	42	11,278
US	7,345	1,296	69	175	8,885	4,636	4,005	173	71	8,885
RoW	1,622	25	138	498	2,283	244	1,404	488	147	2,283
	56,925	10,367	4,537	15,581	87,410	34,616	32,676	7,646	12,472	87,410

2009 (1)

UK (excluding NI) (1)	36,801	7,042	1,875	10,499	56,217	29,230	14,613	7,654	4,720	56,217
Ireland (ROI & NI) (1)	5,314	1,047	3,484	5,961	15,806	4,664	1,697	3,530	5,915	15,806
Western Europe	12,565	840	184	225	13,814	905	12,500	215	194	13,814
US	6,522	1,355	881	778	9,536	3,193	4,684	1,289	370	9,536
RoW	2,068	27	239	479	2,813	91	2,004	383	335	2,813
	63,270	10,311	6,663	17,942	98,186	38,083	35,498	13,071	11,534	98,186

Note:

(1) ROI: Republic of Ireland; NI: Northern Ireland.

\*unaudited

By sub-sector	Ireland					Total £m
	UK (excl NI) £m	(ROI & NI) £m	Western Europe £m	US £m	RoW £m	
2011						
Residential	12,871	7,449	1,096	1,325	319	23,060
Office	7,155	1,354	2,248	404	352	11,513
Retail	8,709	1,641	1,893	285	275	12,803
Industrial	4,317	507	520	24	105	5,473
Mixed/other	9,669	4,235	3,001	4,898	194	21,997
	42,721	15,186	8,758	6,936	1,245	74,846
2010						
Residential	15,543	7,726	685	1,471	523	25,948
Office	8,539	1,178	2,878	663	891	14,149
Retail	10,607	1,668	1,888	1,025	479	15,667
Industrial	4,912	515	711	80	106	6,324
Mixed/other	9,796	4,480	5,116	5,646	284	25,322
	49,397	15,567	11,278	8,885	2,283	87,410
2009						
Residential	17,197	7,352	1,065	2,134	505	28,253
Office	9,381	1,536	5,034	1,614	975	18,540
Retail	5,760	686	998	492	700	8,636
Industrial	11,378	2,599	3,592	2,053	402	20,024
Mixed/other	12,501	3,633	3,125	3,243	231	22,733
	56,217	15,806	13,814	9,536	2,813	98,186

## Note:

(1) Excludes commercial real estate lending in Wealth as these loans are generally supported by personal guarantees in addition to collateral. This portfolio, which totalled £1.3 billion at 31 December 2011 continues to perform in line with expectations and requires minimal provision.

## Key points

- In line with the Group's strategy, exposure to commercial real estate was reduced during 2011, affecting mainly the UK and Western Europe given that these regions account for the majority of the portfolio. Overall this portfolio decreased circa 25% from the end of 2009 to the end of 2011.
- Most of the decrease is in Non-Core due to run-off and asset sales. The Non-Core portfolio totalled £34.3 billion (46% of the portfolio) at 31 December 2011 (2010 - £45.1 billion, or 52% of the portfolio) and includes exposures in Ulster Bank as discussed on page 118.
- With the exception of exposure in Spain and in Ireland, the Group has minimal commercial real estate exposure to other eurozone periphery countries. Exposure in Spain is predominantly in the Non-Core portfolio and totals £2.3 billion, of which 36% is in AQ1-AQ9. The remainder of the Spanish portfolio has already been subject to material write-off and provision levels have been assessed based on re-appraised values. There are significant differences in values based on geographic location and asset type.

- The UK portfolio is focused on London and the South East (44%), with the remainder well spread across the UK regions.
- Short-term lending to property developers without sufficient pre-let revenue at origination to support investment financing after practical completion is classified as speculative. Speculative lending at origination represents approximately 1% of the portfolio. The Group's appetite for originating speculative commercial real estate lending is very limited and any such business requires senior management approval.
- The commercial real estate market is expected to remain challenging in key markets and new business will be accommodated from run-off of existing Core exposure. As liquidity in the market remains tight, the Group is focusing on re-financings and supporting its existing client base.

\* unaudited



Business review Risk and balance sheet management [continued](#)

## Risk management: Credit risk continued

## Key credit portfolios\*: Commercial real estate continued

Maturity profile of portfolio	UK Corporate £m	International Banking £m	Ulster Bank £m	US Retail & Commercial £m	Markets £m	Total £m
<b>2011</b>						
<b>Core</b>						
< 1 year (1)	8,268	142	3,030	1,056	—	12,496
1-2 years	5,187	218	391	638	60	6,494
2-3 years	3,587	231	117	765	132	4,832
> 3 years	10,871	580	1,225	1,846	10	14,532
Not classified (2)	2,211	—	—	—	—	2,211
<b>Total</b>	<b>30,124</b>	<b>1,171</b>	<b>4,763</b>	<b>4,305</b>	<b>202</b>	<b>40,565</b>
<b>Non-Core</b>						
< 1 year (1)	3,224	7,093	11,089	293	—	21,699
1-2 years	508	3,064	692	163	—	4,427
2-3 years	312	1,738	177	152	—	2,379
> 3 years	1,636	3,126	392	321	—	5,475
Not classified (2)	297	4	—	—	—	301
<b>Total</b>	<b>5,977</b>	<b>15,025</b>	<b>12,350</b>	<b>929</b>	<b>—</b>	<b>34,281</b>
<b>2010</b>						
<b>Core</b>						
< 1 year (1)	7,563	448	2,719	1,303	442	12,475
1-2 years	5,154	223	829	766	24	6,996
2-3 years	4,698	221	541	751	—	6,211
> 3 years	10,361	417	1,285	1,595	—	13,658
Not classified (2)	2,922	—	—	—	—	2,922
<b>Total</b>	<b>30,698</b>	<b>1,309</b>	<b>5,374</b>	<b>4,415</b>	<b>466</b>	<b>42,262</b>
<b>Non-Core</b>						
< 1 year (1)	4,829	3,887	10,809	501	—	20,026
1-2 years	1,727	6,178	983	109	—	8,997
2-3 years	831	3,967	128	218	—	5,144
> 3 years	2,904	6,253	694	567	—	10,418
Not classified (2)	563	—	—	—	—	563
<b>Total</b>	<b>10,854</b>	<b>20,285</b>	<b>12,614</b>	<b>1,395</b>	<b>—</b>	<b>45,148</b>

## Notes:

- (1) Includes on demand and past due assets.  
(2) Predominantly comprises multi-option facilities for which there is no single maturity date.

## Key point

- The majority of Ulster Bank Group's commercial real estate portfolio is categorised as < 1 year, including on demand assets, owing to the high level of non-performing assets in the portfolio. Ulster Bank places most

restructured facilities on demand rather than extending the maturity date.

\* unaudited

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## Breakdown of portfolio by asset quality (AQ) band

	AQ1-AQ2	AQ3-AQ4	AQ5-AQ6	AQ7-AQ8	AQ9	AQ10	Total
	£m	£m	£m	£m	£m	£m	£m
2011							
Core	1,094	6,714	19,054	6,254	3,111	4,338	40,565
Non-Core	680	1,287	5,951	3,893	2,385	20,085	34,281
Total	1,774	8,001	25,005	10,147	5,496	24,423	74,846
2010							
Core	1,055	7,087	20,588	7,829	2,171	3,532	42,262
Non-Core	1,003	2,694	11,249	7,608	4,105	18,489	45,148
Total	2,058	9,781	31,837	15,437	6,276	22,021	87,410

## Key points

- Approximately 13% of the commercial real estate exposure is within the AQ1-AQ4 bands. This includes unsecured lending to property companies and real estate investment trusts. The high proportion of the exposure in the AQ10 band is driven by Ulster Bank Group (Core and Non-Core) and International Banking (Non-Core).
- Of the total portfolio of £74.8 billion at 31 December 2011, £34.7 billion (2010 - £45.1 billion) is managed within the Group's standard credit processes and £5.9 billion (2010 - £9.2 billion) is receiving varying degrees of heightened credit management under the Group Watchlist process (this includes all Watchlist Amber cases and Watchlist Red cases managed outside the Global Restructuring Group (GRG)). A further £34.3 billion (2010 - £33.1 billion) is managed within the GRG and includes both Watchlist and non-performing exposures. The increase in the portfolio managed by the GRG is driven by Ulster Bank Group (Core and Non-Core).

The table below analyses commercial real estate lending by loan-to-value (LTV). Due to market conditions in Ireland and to a lesser extent in the UK, there is a shortage of market based data. In the absence of external valuations, the Group deploys a range of alternative approaches including internal expert judgement and indexation.

	Ulster Bank		Rest of the Group		Group	
	AQ1-AQ9	AQ10	AQ1-AQ9	AQ10	AQ1-AQ9	AQ10
LTVs	£m	£m	£m	£m	£m	£m
2011						
<= 50%	81	28	7,091	332	7,172	360
> 50% and <= 70%	642	121	14,105	984	14,747	1,105
> 70% and <= 90%	788	293	10,042	1,191	10,830	1,484
> 90% and <= 100%	541	483	2,616	1,679	3,157	2,162
> 100% and <= 110%	261	322	1,524	1,928	1,785	2,250
> 110% and <= 130%	893	1,143	698	1,039	1,591	2,182
> 130%	1,468	10,004	672	2,994	2,140	12,998
Total with LTVs	4,674	12,394	36,748	10,147	41,422	22,541
Other (1)	7	38	8,994	1,844	9,001	1,882
Total	4,681	12,432	45,742	11,991	50,423	24,423
Total portfolio average LTV (2)	140%	259%	69%	129%	77%	201%

## Notes:

(1) Other performing loans of £9.0 billion include unsecured lending to commercial real estate clients, such as major UK homebuilders. The credit quality of these exposures is consistent with that of the performing portfolio overall. Other non-performing loans of £1.9 billion are subject to the Group's standard provisioning policies.

(2) Weighted average by exposure.

Key points

- Nearly 85% of the commercial real estate portfolio with LTV > 100% is within Ulster Bank Group (Core and Non-Core) and International Banking (Non-Core). A majority of portfolios are managed within the GRG and are subject to monthly reviews. Significant levels of provisions have been taken against these portfolios; provisions as a percentage of risk elements in lending for the Ulster Bank Group commercial real estate portfolio were 53% at 31 December 2011 (2010 - 44%). The reported LTV levels are based on gross loan values. The weighted average LTV for AQ10 excluding Ulster Bank is 129%.
- The average interest coverage ratios (ICR) for UK Corporate (Core and Non-Core) and International Banking (Non-Core) investment properties are 2.71x and 1.25x respectively. The US Retail & Commercial portfolio is managed on the basis of debt service coverage, which includes scheduled principal amortisation. The average debt service interest coverage for this portfolio on this basis was 1.24x at 31 December 2011. There are a number of different approaches used within the Group and across the industry to calculate ICR. Ratios for different portfolio types, and organisations may not therefore be comparable.

\* unaudited

Business review Risk and balance sheet management [continued](#)

## Risk management: Credit risk continued

## Key credit portfolios\* continued

## Retail assets

The Group's retail lending portfolio includes mortgages, credit cards, unsecured loans, auto finance and overdrafts. The majority of personal lending exposures are in the UK, Ireland and the US. The analysis below includes both Core and Non-Core balances.

	2011	2010	2009
	£m	£m	£m
Personal credit loans and receivables			
UK Retail			
- mortgages	96,388	92,592	85,529
- cards, loans and overdrafts	16,004	18,072	20,316
Ulster Bank			
- mortgages	20,020	21,162	22,304
- other personal	1,533	1,017	1,172
Citizens			
- mortgages	23,829	24,575	26,534
- auto and cards	5,731	6,062	6,917
- other (1)	2,111	3,455	4,205
Other (2)	17,545	18,123	16,827
	183,161	185,058	183,804

## Notes:

(1) Mainly student loans and loans secured by recreational vehicles or marine vessels.

(2) Personal exposures in other divisions.

## Residential mortgages

The tables below detail the distribution of residential mortgages by indexed LTV. LTV averages are calculated by transaction volume and transaction value. Refer to the section on Ulster Bank Group on page 117 for analysis of residential mortgages.

LTV distribution calculated on a volume basis	UK Retail			Citizens		
	2011	2010	2009	2011	2010	2009
	%	%	%	%	%	%
<= 70%	62.1	61.6	60.2	43.5	43.4	43.6
> 70% and <= 90%	27.1	26.2	24.5	26.9	27.6	26.8
> 90% and <= 110%	9.4	10.4	12.5	16.7	17.2	18.0
> 110% and <= 130%	1.4	1.7	2.7	6.9	6.0	5.4
> 130%	—	0.1	0.1	6.0	5.8	6.2
Total portfolio average LTV at 31 December	57.8	58.2	59.1	73.8	75.3	74.5
Average LTV on new originations during the year	58.4	64.2	67.2	63.8	64.8	62.6
LTV distribution calculated on a value basis	2011	2010	2009	2011	2010	2009
	£m	£m	£m	£m	£m	£m
<= 70%	47,811	44,522	37,666	9,669	10,375	11,675
> 70% and <= 90%	34,410	32,299	28,280	7,011	7,196	7,440

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> 90% and <= 110%	11,800	12,660	15,112	3,947	4,080	4,569
> 110% and <= 130%	1,713	1,924	3,104	1,580	1,488	1,486
> 130%	74	73	86	1,263	1,252	1,540
Total portfolio average LTV at 31 December	67.2%	68.1%	70.4%	75.9%	75.4%	74.7%
Average LTV on new originations during the year	63.0%	68.0%	70.3%	65.8%	65.3%	64.4%

\* unaudited

	2011	2010	2009
Residential mortgages which are three months or more in arrears (by volume)	%	%	%
UK Retail (1)	1.6	1.7	1.6
Citizens	2.0	1.4	1.5

## Note:

(1) The 'One Account' current account mortgage is excluded (£5.4 billion - 5.6% of assets) at 31 December 2011, 0.9% of these accounts were 90 days continually in excess of the limit (2010 - 0.8%). Consistent with the way the Council of Mortgage Lenders publishes member arrears information, the 3+ months arrears rate now excludes accounts in repossession and cases with shortfalls post property sale.

## Key points

## UK Retail

- The UK Retail mortgage portfolio totalled £96.4 billion (98.6% in Core) at 31 December 2011, an increase of 4.1% from 2010, due to continued strong sales growth and lower redemption rates from before the financial crisis.
- Of the total portfolio, 98.6% is designated as Core business, primarily comprising mortgages branded the Royal Bank of Scotland, NatWest, the One Account and First Active. Non-Core comprises Direct Line Mortgages.
- The assets are prime mortgages and include 7.2% (£6.9 billion) of exposure to residential buy-to-let. There is a small legacy self-certification book (0.3% of total assets). Self-certified mortgages were withdrawn from sale in 2004.
- Gross new mortgage lending in 2011 remained strong at £14.7 billion. The average LTV for new business during 2011 declined in comparison to 2010 and the maximum LTV available to new customers remained at 90%. Based on the Halifax House Price index at September 2011, the book average indexed LTV improved marginally when compared to December 2010, with the proportion of balances with an LTV over 100% also lower. Refer to the table on page 117, which details LTV information on a volume and value basis.
- The arrears rate (more than three payments in arrears, excluding repossessions and shortfalls post property sale) has remained broadly stable since late 2009 at 1.6%.
- The number of properties repossessed in 2011 was 1,671, up from 1,392 in 2010.
- The mortgage impairment charge was £187 million for 2011, an increase of 2% from 2010. A significant part of the mortgage impairment charge related to reduced expectations of cash recovery on already defaulted debt. It also included an additional provision charge for mortgage customers who received forbearance.
- Default and arrears rates remain sensitive to economic developments and are currently supported by the low interest rate environment and strong book growth, with recent business yet to fully mature.

## Citizens

- Citizens' residential mortgage portfolio totalled £23.8 billion at 31 December 2011, a reduction of 3% from 2010 (£24.6 billion).
- The mortgage portfolio comprises £6.4 billion of residential mortgages (99% in first lien position: Core - £5.8 billion; Non-Core - £0.6 billion) and £17.4 billion of home equity loans and lines (41% in first lien position: Core - £14.9 billion; Non-Core - £2.5 billion). Home equity Core consists of 47% in first lien position.

- Citizens continues to focus on the ‘footprint’ states of New England, Mid Atlantic and Mid West, targeting low risk products and maintaining conservative risk policies. At 31 December 2011, the portfolio consisted of £19.5 billion (82% of the total portfolio) within footprint.
- Loan acceptance criteria were tightened during 2009 to address deteriorating economic and market conditions.
- Non-Core comprises 13% of the residential mortgage portfolio. Its largest component (74%) is the serviced by others (SBO) home equity portfolio. The SBO portfolio consists of purchased pools of home equity loans and lines, which resulted in an annualised charge-off rate of 8.7% in 2011. It is characterised by out-of-footprint geographies, high second lien concentration (95%) and high average LTV (113% at 31 December 2011). The SBO book has been closed to new purchases since the third quarter of 2007 and is in run-off, with exposure down from £2.8 billion in 2010, to £2.3 billion at 31 December 2011. The arrears rate of the SBO portfolio decreased from 3.0% in 2010, to 2.3% at 31 December 2011, as the legacy of poorer assets receded, and account servicing and collections became more effective following a servicer conversion in 2009.

\* unaudited



Business review Risk and balance sheet management [continued](#)

## Risk management: Credit risk continued

## Key credit portfolios\* continued

## Retail credit assets: Personal lending

The Group's personal lending portfolio includes credit cards, unsecured loans, auto finance and overdrafts. The majority of personal lending exposures exist in the UK and the US. Impairment charges as a proportion of average loans and receivables are shown in the following table.

	2011		2010		2009	
	Average loans and receivables £m	Impairment charge as a % of average loans and receivables %	Average loans and receivables £m	Impairment charge as a % of average loans and receivables %	Average loans and receivables £m	Impairment charge as a % of average loans and receivables %
Personal lending						
UK Retail cards (1)	5,675	3.0	6,025	5.0	6,101	8.7
UK Retail loans (1)	7,755	2.8	9,863	4.8	12,062	5.9
Citizens cards (2)	936	5.1	1,005	9.9	1,145	9.7
Citizens auto loans (2)	4,856	0.2	5,256	0.6	6,306	1.2

## Notes:

(1) The ratio for UK Retail assets refers to the impairment charges for the year. This is the Core UK loans book and excludes the Non-Core direct loans book that was sold in late 2011.

(2) The ratio for Citizens refers to the impairment charges in the year, net of recoveries realised in the year.

## Key points

## UK Retail

- The UK personal lending portfolio, of which 99.4% is in Core businesses, comprises credit cards, unsecured loans and overdrafts, and totalled £16.0 billion at 31 December 2011 (2010 - £18.1 billion).
- The decrease in portfolio size of 11.6% was driven by continued subdued loan recruitment activity and a continuing general market trend of customers repaying unsecured debt.
- The Non-Core portfolio consists of the direct finance loan portfolios (Direct Line, Lombard, Mint and Churchill) and totalled £0.1 billion at 31 December 2011 (2010 - £0.4 billion). In the last quarter of 2011, a portfolio of £170 million of balances was disposed of.
- Risk appetite continues to be actively managed across all products with investment in collection and recovery processes continuing, addressing both continued support for the Group's customers and the management of impairments.
- Support continues for customers experiencing financial difficulties through 'breathing space initiatives'. Refer to the disclosures on forbearance on page 98 for more information.
- The impairment charge on unsecured lending was £579 million for the year, down 42% on 2010, reflecting the effect of risk appetite tightening. The sale of the direct finance loan book gave rise to a one-off benefit of

approximately £30 million.

- Impairments remain sensitive to the external environment, including unemployment levels and interest rates.
- Industry benchmarks for cards arrears remain stable, with the Group continuing to perform favourably.

#### Citizens

- Citizens' average credit card portfolio totalled £936 million during 2011, with Core assets comprising 90.2% of the portfolio. Citizens' cards business has traditionally adopted conservative risk strategies compared with the US market and given the economic climate, has introduced tighter lending criteria and lower credit limits. These actions have led to improving new business quality and a business performing better than industry benchmarks (provided by VISA). The latest available metrics show the 60+ days delinquency as a percentage of total outstandings at 2.15% at November 2011 (compared to an industry figure of 2.45%) and net contractual charge-offs as a percentage of total outstandings at 2.89% at November 2011 (compared to an industry figure of 3.69%).
- Citizens' average auto loan portfolio totalled £4.9 billion during 2011, of which 98% is considered Core. £101 million (2%) is Non-Core and anticipated to run off by 2013. Citizens' vehicle financing business lends to US consumers through a network of 4,200 auto dealers in 25 US states. Citizens' credit policy is considered conservative, targeting prime customers and has historically experienced credit losses below those of industry peers.
- The net write-off rate on the total auto portfolio fell to 0.18% at 31 December 2011, from 0.34% in 2010. The 30+ days past due delinquency rate fell to 1.04% at 31 December 2011, from 1.57% in 2010.

\*unaudited

## Ulster Bank Group (Core and Non-Core)

At 31 December 2011, Ulster Bank Group accounted for 10% of the Group's total customer loans (2010 - 10%; 2009 - 10%) and 9% of the Group's Core customer loans (2010 - 9%; 2009 - 9%). Ulster Bank's financial performance continues to be overshadowed by the challenging economic climate in Ireland, with impairments remaining elevated as high unemployment, coupled with higher taxation and limited liquidity in the economy, continues to depress the property market and domestic spending.

The impairment charge of £3,717 million for 2011 (2010 - £3,843 million; 2009 - £1,926 million) was driven by a combination of new defaulting customers and deteriorating security values. Provisions as a percentage of risk elements in lending increased from 44% in 2010, to 53% at 31 December 2011, predominantly as a result of the deterioration in the value of the Non-Core commercial real estate development portfolio.

## Core

The impairment charge for the year of £1,384 million (2010 - £1,161 million; 2009 - £649 million) reflects the difficult economic climate in Ireland, with elevated default levels across both mortgage and other corporate portfolios. The mortgage sector accounted for £570 million (41%) of the total 2011 impairment charge.

## Non-Core

The impairment charge for the year was £2,333 million (2010 - £2,682 million; 2009 - £1,277 million), with the commercial real estate sector accounting for £2,160 million (93%) of the total 2011 charge.

## Loans, risk elements in lending (REIL) and impairments by sector

	Gross loans	REIL	Provisions	REIL as a % of gross loans	Provisions as a % of REIL	Provisions as a % of gross loans	Impairment charge	Amounts written-off
	£m	£m	£m	%	%	%	£m	£m
2011								
Core								
Mortgages	20,020	2,184	945	10.9	43	4.7	570	11
Personal unsecured	1,533	201	184	13.1	92	12.0	56	25
Commercial real estate								
- investment	3,882	1,014	413	26.1	41	10.6	225	—
- development	881	290	145	32.9	50	16.5	99	16
Other corporate	7,736	1,834	1,062	23.7	58	13.7	434	72
	34,052	5,523	2,749	16.2	50	8.1	1,384	124
Non-Core								
Commercial real estate								
- investment	3,860	2,916	1,364	75.5	47	35.3	609	1
- development	8,490	7,536	4,295	88.8	57	50.6	1,551	32
Other corporate	1,630	1,159	642	71.1	55	39.4	173	16
	13,980	11,611	6,301	83.1	54	45.1	2,333	49
Ulster Bank Group								
Mortgages	20,020	2,184	945	10.9	43	4.7	570	11
Personal unsecured	1,533	201	184	13.1	92	12.0	56	25

Commercial real estate

- investment	7,742	3,930	1,777	50.8	45	23.0	834	1
- development	9,371	7,826	4,440	83.5	57	47.4	1,650	48
Other corporate	9,366	2,993	1,704	32.0	57	18.2	607	88
	48,032	17,134	9,050	35.7	53	18.8	3,717	173

\* unaudited

Business review Risk and balance sheet management [continued](#)

## Risk management: Credit risk continued

## Key credit portfolios\*: Ulster Bank Group (Core and Non-Core) continued

	Gross loans £m	REIL Provisions £m	Provisions as a % of gross loans £m	REIL Provisions as a % of gross loans %	Provisions as a % of gross loans %	Impairment charge £m	Amounts written-off £m	
2010								
Core								
Mortgages	21,162	1,566	439	7.4	28	2.1	294	7
Personal unsecured	1,282	185	158	14.4	85	12.3	48	30
Commercial real estate								
- investment	4,284	598	332	14.0	56	7.7	259	—
- development	1,090	65	37	6.0	57	3.4	116	—
Other corporate	9,039	1,205	667	13.3	55	7.4	444	11
	36,857	3,619	1,633	9.8	45	4.4	1,161	48
Non-Core								
Mortgages	—	—	—	—	—	—	42	—
Commercial real estate								
- investment	3,854	2,391	1,000	62.0	42	25.9	630	—
- development	8,760	6,341	2,783	72.4	44	31.8	1,759	—
Other corporate	1,970	1,310	561	66.5	43	28.5	251	—
	14,584	10,042	4,344	68.9	43	29.8	2,682	—
Ulster Bank Group								
Mortgages	21,162	1,566	439	7.4	28	2.1	336	7
Personal unsecured	1,282	185	158	14.4	85	12.3	48	30
Commercial real estate								
- investment	8,138	2,989	1,332	36.7	45	16.4	889	—
- development	9,850	6,406	2,820	65.0	44	28.6	1,875	—
Other corporate	11,009	2,515	1,228	22.8	49	11.2	695	11
	51,441	13,661	5,977	26.6	44	11.6	3,843	48
2009								
Core								
Mortgages	16,199	558	102	3.4	18	0.6	74	3
Personal unsecured	2,433	174	145	7.2	83	6.0	66	27
Commercial real estate								
- investment	6,131	250	105	4.1	42	1.7	84	—
- development	3,838	428	284	11.2	66	7.4	221	4
Other corporate	11,106	850	326	7.7	38	2.9	204	—

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	39,707	2,260	962	5.7	43	2.4	649	34
Non-Core								
Mortgages	6,002	324	51	5.4	16	0.8	42	—
Commercial real estate								
- investment	2,061	1,498	308	72.7	21	14.9	286	—
- development	6,271	3,840	822	61.2	21	13.1	732	—
Other corporate	1,373	1,126	322	82.0	29	23.5	217	—
	15,707	6,788	1,503	43.2	22	9.6	1,277	—
Ulster Bank								
Group								
Mortgages	22,201	882	153	4.0	17	0.7	116	3
Personal unsecured	2,433	174	145	7.2	83	6.0	66	27
Commercial real estate								
- investment	8,192	1,748	413	21.3	24	5.0	370	—
- development	10,109	4,268	1,106	42.2	26	10.9	953	4
Other corporate	12,479	1,976	648	15.8	33	5.2	421	—
	55,414	9,048	2,465	16.3	27	4.4	1,926	34

\* unaudited

## Key points

- REIL increased by £3.5 billion during the year, which reflects continuing difficult conditions in both the commercial and residential sectors in Ireland. Growth moderated in the last two quarters of 2011 as default trends for corporate portfolios declined.
- At 31 December 2011, 68% of REIL was in Non-Core (2010 - 74%; 2009 - 75%). The majority of the Non-Core commercial real estate development portfolio (89%) is REIL with a 57% provision coverage.

## Residential mortgages

The tables below show how the continued decrease in property values has affected the distribution of residential mortgages by indexed LTV. LTV is based upon gross loan amounts and whilst including defaulted loans, does not take account of provisions made.

	2011	2010	2009
	%	%	%
LTV distribution calculated on a volume basis*			
<= 70%	45.0	50.3	59.2
> 70% and <= 90%	11.4	13.0	12.0
> 90% and <= 110%	12.0	14.5	13.4
> 110% and <= 130%	10.9	13.5	11.3
> 130%	20.7	8.7	4.1

Total portfolio average LTV at 31 December	81.0	71.2	62.5
Average LTV on new originations during the year	67.0	75.9	72.8

	2011	2010	2009
	£m	£m	£m
LTV distribution calculated on a value basis			
<= 70%	4,526	5,928	7,393
> 70% and <= 90%	2,501	3,291	3,830
> 90% and <= 110%	3,086	4,256	4,907
> 110% and <= 130%	3,072	4,391	4,491
> 130%	6,517	2,958	1,681

Total portfolio average LTV at 31 December	106.1%	91.7%	86.2%
Average LTV on new originations during the year	73.9%	78.9%	78.5%

## Key points

- The residential mortgage portfolio across Ulster Bank Group totalled £20 billion at 31 December 2011, with 89% in the Republic of Ireland and 11% in Northern Ireland.
- The mortgage REIL continued to increase as a result of the continued challenging economic environment. At 31 December 2011, REIL as a percentage of gross mortgages was 10.9% (by value) compared with 7.4% in 2010. The impairment charge for 2011 was £570 million compared with £336 million for 2010. Repossession levels were higher than in 2010, with a total of 161 properties repossessed during 2011 (compared with 76 during 2010). 76% of repossessions during 2011 were through voluntary surrender or abandonment of the property.

- Ulster Bank is assisting customers in this difficult environment. Mortgage forbearance policies which are deployed through the 'Flex' initiative are aimed at assisting customers in financial difficulty. At 31 December 2011, 9.1% (by value) of the mortgage book (£1.8 billion) was on a forbearance arrangement compared with 5.8% (£1.2 billion) at 31 December 2010. The majority of these forbearance arrangements are in the performing book (77%) and not 90 days past due.

\* unaudited



Business review Risk and balance sheet management [continued](#)

## Risk management: Credit risk continued

Key credit portfolios\*: Ulster Bank Group (Core and Non-Core) continued

## Commercial real estate

The commercial real estate lending portfolio for Ulster Bank Group totalled £17.1 billion at 31 December 2011, of which £12.3 billion or 72% is Non-Core. The geographic split of the total Ulster Bank Group commercial real estate portfolio remained similar to 2010, with 26% in Northern Ireland, 63% in the Republic of Ireland and 11% in the UK.

Exposure by geography	Development		Investment		Total
	Commercial	Residential	Commercial	Residential	
	£m	£m	£m	£m	£m
2011					
Ireland (ROI & NI)	2,591	6,317	5,097	1,132	15,137
UK (excluding NI)	95	336	1,371	111	1,913
RoW	—	32	27	4	63
	2,686	6,685	6,495	1,247	17,113
2010					
Ireland (ROI & NI)	2,785	6,578	5,032	1,098	15,493
UK (excluding NI)	110	359	1,869	115	2,453
RoW	—	18	23	1	42
	2,895	6,955	6,924	1,214	17,988
2009					
Ireland (ROI & NI)	3,075	5,961	5,314	1,031	15,381
UK (excluding NI)	217	849	1,692	132	2,890
RoW	—	7	20	3	30
	3,292	6,817	7,026	1,166	18,301

## Key points

- Commercial real estate remains the primary driver of the increase in the defaulted loan book for Ulster Bank Group. The outlook remains challenging, with limited liquidity in the marketplace to support sales or refinancing. The decrease in asset valuations has placed pressure on the portfolio.
- Within its early problem management framework, Ulster Bank may agree various remedial measures with customers whose loans are performing but who are experiencing temporary financial difficulties. During 2011, commercial real estate loans amounting to £0.8 billion (exposures greater than £10 million) benefited from such measures.
- During 2011, impaired commercial real estate loans amounting to £1 billion (exposures greater than £10 million) were restructured and remain in the non-performing book.

\* unaudited



## Balance sheet analysis

All the disclosures in this section (pages 119 to 186) are audited unless otherwise indicated by an asterisk (\*).

The following tables provide an analysis of credit concentration of financial assets by sector, geography and internal credit quality gradings. Credit risk assets analysed on the pages 102 to 107 are reported internally to senior management. However, they exclude certain exposures, primarily securities, and take account of legal netting agreements, that provide a right of legal set-off but do not meet the criteria for offset in IFRS. The analysis below is therefore provided to supplement the credit risk assets analysis and to reconcile to the consolidated balance sheet.

## Credit concentration: Sector and geographical region

The tables on pages 119 to 128 analyse total financial assets gross of provisions by sector (for Group before RFS MI) and geographical region (for Group before RFS MI and RFS MI). Geographical regions are based on the location of the lending or issuing office.

The tables below and on pages 120 and 121 analyse total financial assets by sector.

	Loans and advances				Securities				Derivatives	Other (1)	Total	Netting and offset (2)
	Reverse repos £m	Core £m	Non-Core £m	Total £m	Debt £m	Equity £m	Total £m	£m				
2011												
Central and local government	2,247	8,359	1,383	9,742	126,604	328	126,932	5,541	641	145,103	1,098	
Finance - banks	39,345	43,374	619	43,993	16,940	—	16,940	—	79,269	179,547	18,693	
other (3)	58,478	46,452	3,229	49,681	60,453	5,618	66,071	497,993	7,437	679,660	508,481	
Residential mortgages	—	138,509	5,102	143,611	—	—	—	48	—	143,659	—	
Personal lending	—	31,067	1,556	32,623	—	—	—	52	52	32,727	7	
Property Construction	—	38,704	38,064	76,768	573	175	748	4,599	1	82,116	1,274	
Manufacturing	—	6,781	2,672	9,453	50	53	103	946	—	10,502	1,139	
Service industries and business activities - retail, wholesale and repairs	254	23,201	4,931	28,132	664	1,938	2,602	3,786	306	35,080	2,214	
- transport and storage	—	21,314	2,339	23,653	645	2,652	3,297	1,134	18	28,102	1,671	
- health, education and recreation	436	16,454	5,477	21,931	539	74	613	3,759	—	26,739	241	
	—	13,273	1,419	14,692	310	21	331	885	—	15,908	973	
	—	7,143	1,161	8,304	116	5	121	671	—	9,096	184	

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- hotels and restaurants											
- utilities	—	6,543	1,849	8,392	1,530	554	2,084	3,708	30	14,214	450
- other	23	24,228	3,772	28,000	1,655	3,893	5,548	6,300	595	40,466	855
Agriculture, forestry and fishing	—	3,471	129	3,600	25	11	36	121	—	3,757	148
Finance lease and instalment credit	—	8,440	6,059	14,499	145	2	147	75	—	14,721	16
Interest accruals	151	675	116	791	1,219	—	1,219	—	—	2,161	
Total gross of provisions	100,934	437,988	79,877	517,865	211,468	15,324	226,792	529,618	88,349	1,463,558	537,444
Provisions	—	(8,414)	(11,469)	(19,883)	(2,388)	(141)	(2,529)	—	—	(22,412)	n/a
Group	100,934	429,574	68,408	497,982	209,080	15,183	224,263	529,618	88,349	1,441,146	537,444
Comprising:											
Repurchase agreements											15,246
Derivative balances											478,848
Derivative collateral											31,368
Other											11,982
											537,444

For notes relating to this table refer to page 128.

Business review Risk and balance sheet management [continued](#)

## Risk management: Credit risk continued

## Balance sheet analysis: Credit concentration: Sector and geographical region continued

	Loans and advances				Securities					Total	Netting and offset (2)
	Reverse repos £m	Core £m	Non-Core £m	Total £m	Debt £m	Equity £m	Total £m	Derivatives £m	Other (1) £m		
2010											
Central and local government	645	6,781	1,671	8,452	130,123	767	130,890	7,560	291	147,838	3,916
Finance - banks	42,571	57,033	1,003	58,036	22,474	—	22,474	—	—57,014	180,095	24,673
- other (3)	51,297	46,910	7,651	54,561	54,726	19,562	74,288	399,318	12,185	591,649	378,714
Residential mortgages	—	140,359	6,142	146,501	—	—	—	6	—	146,507	19
Personal lending	—	33,581	3,891	37,472	63	—	63	15	48	37,598	11
Property Construction	—	42,455	47,651	90,106	2,700	237	2,937	3,830	28	96,901	1,046
Manufacturing	—	8,680	3,352	12,032	56	31	87	780	—	12,899	1,406
Service industries and business activities	389	25,797	6,520	32,317	784	113	897	3,229	—	36,832	2,156
- retail, wholesale and repairs	—	21,974	3,191	25,165	520	41	561	1,124	—	26,850	2,468
- transport and storage	—	15,946	8,195	24,141	879	54	933	2,703	—	27,777	224
- health, education and recreation	—	17,456	1,865	19,321	1,495	42	1,537	1,198	—	22,056	1,047
- hotels and restaurants	—	8,189	1,492	9,681	276	123	399	525	—	10,605	253
- utilities	—	7,098	2,110	9,208	1,714	229	1,943	2,491	2	13,644	985
- other	126	24,464	5,530	29,994	1,532	1,172	2,704	4,244	386	37,454	1,378
Agriculture, forestry and fishing	—	3,758	135	3,893	28	1	29	40	—	3,962	115
Finance lease and instalment credit	—	8,321	8,529	16,850	13	2	15	14	—	16,879	134
Interest accruals	91	831	278	1,109	1,398	—	1,398	—	—	2,598	—

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Total gross of provisions	95,119	469,633	109,206	578,839	218,781	28,374	241,155	427,077	69,954	1,412,144	418,545	9
Provisions		— (7,866)	(10,316)	(18,182)	(1,301)	(176)	(1,477)		— (29)	(19,688)	n/a	0
Group before RFS MI	95,119	461,767	98,890	560,657	217,480	22,198	239,678	427,077	69,925	1,392,456	418,545	9
RFS MI gross of provisions		—	—	—	2	—	—	—	—	—	2	—
Group	95,119	461,767	98,890	560,659	217,480	22,198	239,678	427,077	69,925	1,392,458	418,545	9

Comprising:

Repurchase agreements												10,712
Derivative balances												361,493
Derivative collateral												31,015
Other												15,325
												418,545

For notes relating to this table refer to page 128.

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2009	Loans and advances				Securities					Total	Netting and offset (2)	
	Reverse repos £m	Core £m	Non-Core £m	Total £m	Debt £m	Equity £m	Total £m	Derivatives £m	Other (1) £m			
Central and local government Finance - banks - other (3)	260	6,128	1,532	7,660	142,032	780	142,812	6,998	205	157,935	1,725	1,000
Residential mortgages	—	127,975	12,932	140,907	—	—	—	11	—	140,918	7	1,000
Personal lending	—	35,313	6,358	41,671	1	—	1	38	40	41,750	21	1,000
Property Construction	—	49,054	50,372	99,426	4,028	469	4,497	4,184	108	108,215	1,114	1,000
Manufacturing Service industries and business activities - retail, wholesale and repairs - transport and storage - health, education and recreation - hotels and restaurants - utilities - other	182	30,272	14,402	44,674	878	1,076	1,954	5,353	116	52,279	3,184	1,000
Agriculture, forestry and fishing	—	23,385	5,082	28,467	602	283	885	996	29	30,377	2,550	1,000
Finance lease and instalment credit	—	16,693	8,812	25,505	607	198	805	1,820	17	28,147	201	1,000
Interest accruals	22	18,797	3,743	22,540	2,055	188	2,243	1,300	—	26,105	1,057	1,000
Total gross of provisions	—	9,699	1,710	11,409	418	595	1,013	832	90	13,344	284	1,000
Provisions	—	6,772	3,106	9,878	1,298	2,379	3,677	2,613	296	16,464	445	1,000
Group before RFS MI	293	25,092	11,185	36,277	2,814	3,082	5,896	3,619	362	46,447	1,274	1,000
	—	3,726	553	4,279	44	210	254	44	9	4,586	76	1,000
	—	8,147	11,956	20,103	291	15	306	16	—	20,425	39	1,000
	494	1,179	549	1,728	1,571	—	1,571	—	—	3,793	—	1,000
	76,137	469,981	148,623	618,604	250,308	16,222	266,530	438,199	65,706	1,465,176	385,770	1,000
	—	(6,921)	(8,252)	(15,173)	(1,198)	(277)	(1,475)	—	—	(16,648)	n/a	1,000
	76,137	463,060	140,371	603,431	249,110	15,945	265,055	438,199	65,706	1,448,528	385,770	1,000

RFS MI gross of provisions	—	—	-142,688	18,144	3,586	21,730	3,255	9	167,682	55	1	
RFS MI provision	—	—	-(2,110)	—	(3)	(3)	—	—	(2,113)	n/a		
Group	76,137	463,060	140,371	744,009	267,254	19,528	286,782	441,454	65,715	1,614,097	385,825	1,2

For notes relating to this table refer to page 128.

#### Key points

- Financial assets, after taking account of netting and offset arrangements, decreased from £974 billion at 2010 to £903 billion at 2011 (£923 billion including disposal groups), principally reflecting reductions in loans and advances, including planned reductions of £29 billion in Non-Core reflecting disposal strategy as well as reductions in securities. Debt securities declined by £8 billion reflecting lower government and financial institution bond holdings. Equity shares decreased by £7 billion reflecting closure of Markets' global index and emerging markets positions in order to mitigate the potential impact of unfavourable market conditions.
- In terms of sector concentration, 37% of net financial assets related to financial institutions, including central banks, down from 38% in 2010. However, overall balances increased, principally reflecting higher central bank deposits in the Group's liquidity portfolio.
- Central and local government assets represented 16% of total financial assets, broadly unchanged from 2010, predominantly reflecting the Group's government bond holdings, most of which are issued by G10 governments, despite a reduction in holdings in both Group Treasury and Markets.
- Personal sector lending (residential mortgages and other lending) remained broadly flat.
- Commercial and other property related lending declined from £102.1 billion to £86.2 billion, including disposal groups (£4.7 billion). The decline was driven by Non-Core reductions.



Business review [Risk and balance sheet management continued](#)

Risk management: Credit risk continued

Balance sheet analysis: Credit concentration: Sector and geographical region continued

Loans and advances to banks and customers by geographical region

The table below analyses loans and advances, including reverse repos, gross of provisions by geographical region (location of office).

	2011	2010	2009
	£m	£m	£m
Loans and advances to banks (1)			
- UK	55,061	70,400	59,348
- US	7,976	9,810	8,537
- Europe	8,865	10,655	5,535
- RoW	11,531	9,778	10,611
Group before RFS MI	83,433	100,643	84,031
RFS MI	—	2	7,879
	83,433	100,645	91,910
Loans and advances to customers			
- UK	351,147	374,822	386,798
- US	90,329	90,752	93,209
- Europe	74,045	83,586	102,571
- RoW	19,845	24,155	28,132
Group before RFS MI	535,366	573,315	610,710
RFS MI	—	—	-134,809
	535,366	573,315	745,519
Group before RFS MI	618,799	673,958	694,741
RFS MI	—	2	142,688
Group	618,799	673,960	837,429

Note:

(1) Loans and advances to banks includes £95 million of accrued interest (2010 - £36 million; 2009 - £339 million).

## Key points

- Gross loans and advances declined by £55.2 billion during 2011 of which £19.4 billion related to the transfer to disposal groups.
- Customer lending declined £37.9 billion, principally reflecting the transfer to disposal groups and the Non-Core disposal strategy:
  - UK down £23.7 billion;
  - US down £0.4 billion;
  - Europe down £9.5 billion; and
  - Rest of the World down £4.3 billion.



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The tables on pages 123 to 128 analyse financial assets by geographical region (location of office) and sector.

	Loans and advances				Securities						Netting and offsets (2) £m
	Reverse repos £m	Core £m	Non-Core £m	Total £m	Debt £m	Equity £m	Total £m	Derivatives £m	Other (1) £m	Total £m	
2011											
UK											
Central and local government Finance - banks	2,130	8,012	25	8,037	78,892	8	78,900	5,282	548	94,897	1,098
- other (3)	25,204	29,575	207	29,782	1,950	—	1,950	—	40,365	97,301	18,653
Residential mortgages	39,154	30,874	2,361	33,235	25,779	4,462	30,241	301,125	3,259	407,014	312,007
Personal lending	—	99,303	1,423	100,726	—	—	—	48	—	100,774	—
Property Construction	—	20,080	127	20,207	—	—	—	51	24	20,282	7
Manufacturing Service industries and business activities - retail, wholesale and repairs - transport and storage - health, education and recreation - hotels and restaurants - utilities - other	—	31,141	24,610	55,751	278	137	415	4,332	—	60,498	1,265
	—	5,291	1,882	7,173	20	26	46	895	—	8,114	1,115
	254	9,641	835	10,476	499	1,908	2,407	2,259	—	15,396	2,205
	—	11,071	1,441	12,512	574	2,616	3,190	952	18	16,672	1,647
	436	8,589	3,439	12,028	145	67	212	2,217	—	14,893	200
	—	8,734	757	9,491	72	8	80	756	—	10,327	965
	—	5,599	569	6,168	23	—	23	664	—	6,855	178
	—	2,462	922	3,384	1,150	513	1,663	3,207	30	8,284	450
	—	13,963	1,644	15,607	1,017	3,459	4,476	3,988	593	24,664	830
Agriculture, forestry and fishing	—	2,660	76	2,736	18	10	28	111	—	2,875	117
Finance lease and instalment credit	—	5,618	5,598	11,216	1	2	3	73	—	11,292	16
Interest accruals	126	375	—	375	474	—	474	—	—	975	—
Group	67,304	292,988	45,916	338,904	110,892	13,216	124,108	325,960	44,837	901,113	340,753
US	—	177	14	191	22,936	317	23,253	9	1	23,454	—

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Central and local government Finance - banks	7,289	671	15	686	1,245	—	1,245	—	29,426	38,646	15
- other (3)	17,368	8,993	341	9,334	29,885	681	30,566	165,879	3,496	226,643	168,601
Residential mortgages	—	20,311	2,926	23,237	—	—	—	—	—	23,237	
Personal lending	—	7,505	936	8,441	—	—	—	—	—	8,441	
Property Construction	—	2,413	1,370	3,783	26	23	49	38	—	3,870	
Manufacturing	—	412	45	457	21	3	24	11	—	492	
Service industries and business activities	—	6,782	42	6,824	101	12	113	452	—	7,389	
- retail, wholesale and repairs	—	4,975	98	5,073	52	—	52	63	—	5,188	
- transport and storage	—	1,832	937	2,769	26	1	27	1,084	—	3,880	
- health, education and recreation	—	2,946	88	3,034	74	4	78	93	—	3,205	
- hotels and restaurants	—	627	57	684	93	3	96	1	—	781	
- utilities	—	1,033	28	1,061	243	16	259	322	—	1,642	
- other	23	4,927	394	5,321	429	105	534	1,421	—	7,299	
Agriculture, forestry and fishing	—	27	—	27	7	—	7	6	—	40	
Finance lease and instalment credit	—	2,471	—	2,471	17	—	17	—	—	2,488	
Interest accruals	6	181	45	226	259	—	259	—	—	491	
Group	24,686	66,283	7,336	73,619	55,414	1,165	56,579	169,379	32,923	357,186	168,616

For notes relating to this table refer to page 128.

Business review [Risk and balance sheet management continued](#)

## Risk management: Credit risk continued

## Balance sheet analysis: Credit concentration: Sector and geographical region continued

	Loans and advances				Securities					Netting and offset	
	Reverse repos £m	Core £m	Non-Core £m	Total £m	Debt £m	Equity £m	Total £m	Derivatives £m	Other (1) £m	Total £m	(2) £m
2011											
Europe											
Central and local government	—	116	715	831	13,362	3	13,365	60	—	14,256	— 14,
Finance - banks	247	8,361	250	8,611	10,859	—10,859		—	6,701	26,418	— 26,
- other (3)	—	2,534	474	3,008	4,521	240	4,761	289	90	8,148	1 8,
Residential mortgages	—	18,393	553	18,946	—	—	—	—	—	18,946	— 18,
Personal lending	—	1,972	492	2,464	—	—	—	—	28	2,492	— 2,
Property Construction	—	4,846	11,538	16,384	—	—	—	168	—	16,552	9 16,
Manufacturing	—	1,019	735	1,754	—	22	22	18	—	1,794	24 1,
Service industries and business activities	—	4,383	3,732	8,115	57	5	62	23	—	8,200	9 8,
- retail, wholesale and repairs	—	3,992	772	4,764	16	2	18	23	—	4,805	24 4,
- transport and storage	—	5,667	862	6,529	143	—	143	15	—	6,687	6 6,
- health, education and recreation	—	1,235	349	1,584	164	5	169	2	—	1,755	8 1,
- hotels and restaurants	—	892	535	1,427	—	—	—	6	—	1,433	6 1,
- utilities	—	1,569	530	2,099	124	3	127	85	—	2,311	— 2,
- other	—	2,966	1,555	4,521	131	70	201	34	—	4,756	25 4,
Agriculture, forestry and fishing	—	699	53	752	—	1	1	1	—	754	31
Finance lease and instalment credit	—	260	435	695	—	—	—	—	—	695	—
Interest accruals	7	101	71	172	437	—	437	—	—	616	—

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Group	254	59,005	23,651	82,656	29,814	351	30,165	724	6,819	120,618	143	120,
RoW												
Central and local government	117	54	629	683	11,414		—11,414	190	92	12,496		— 12,
Finance - banks	6,605	4,767	147	4,914	2,886		— 2,886		2,777	17,182	25	17,
- other (3)	1,956	4,051	53	4,104	268	235	503	30,700	592	37,855	27,872	9,
Residential mortgages		502	200	702						702		
Personal lending		1,510	1	1,511				1		1,512		— 1,
Property Construction		304	546	850	269	15	284	61	1	1,196		— 1,
Manufacturing		59	10	69	9	2	11	22		102		
Service industries and business activities		2,395	322	2,717	7	13	20	1,052	306	4,095		— 4,
- retail, wholesale and repairs		1,276	28	1,304	3	34	37	96		1,437		— 1,
- transport and storage		366	239	605	225	6	231	443		1,279	35	1,
- health, education and recreation		358	225	583		4	4	34		621		
- hotels and restaurants		25		25		2	2			27		
- utilities		1,479	369	1,848	13	22	35	94		1,977		— 1,
- other		2,372	179	2,551	78	259	337	857	2	3,747		— 3,
Agriculture, forestry and fishing		85		85				3		88		
Finance lease and instalment credit		91	26	117	127		127	2		246		
Interest accruals	12	18		18	49		49			79		
Group	8,690	19,712	2,974	22,686	15,348	592	15,940	33,555	3,770	84,641	27,932	56,

For notes relating to this table refer to page 128.

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	Reverse repos £m	Loans and advances			Securities			Derivatives £m	Other (1) £m	Total £m	Netting and offset (£ m)
		Core £m	Non-Core £m	Total £m	Debt £m	Equity £m	Total £m				
2010											
UK											
Central and local government Finance - banks	611	5,728	173	5,901	72,427	1	72,428	7,300	173	86,413	3,911
- other (3)	28,370	41,541	481	42,022	5,381	—	5,381	—	28,097	103,870	24,481
Residential mortgages	33,186	27,995	6,023	34,018	27,737	18,645	46,382	249,324	5,390	368,300	232,461
Personal lending	—	99,928	1,665	101,593	—	—	—	6	—	101,599	1,665
Property Construction	—	23,035	585	23,620	1	—	1	9	23	23,653	1,665
Manufacturing Service industries and business activities	—	34,970	30,492	65,462	2,302	175	2,477	3,739	28	71,706	1,041
- retail, wholesale and repairs	—	7,041	2,310	9,351	39	—	39	741	—	10,131	1,391
- transport and storage	389	12,300	1,510	13,810	354	—	354	2,159	—	16,712	2,159
- health, education and recreation	—	12,554	1,853	14,407	343	11	354	874	—	15,635	2,451
- hotels and restaurants	—	8,105	5,015	13,120	241	3	244	1,573	—	14,937	211
- utilities	—	13,502	1,039	14,541	160	22	182	877	—	15,600	1,041
- other	—	6,558	808	7,366	172	—	172	518	—	8,056	241
Agriculture, forestry and fishing	—	3,101	1,035	4,136	1,040	5	1,045	2,112	2	7,295	981
Finance lease and instalment credit	1	14,445	1,991	16,436	549	447	996	1,986	335	19,754	1,351
Interest accruals	—	2,872	67	2,939	—	—	—	35	—	2,974	91
Group	—	5,589	7,785	13,374	13	2	15	14	—	13,403	131
US	56	415	98	513	501	—	501	—	—	1,070	513
Central and local government	62,613	319,679	62,930	382,609	111,260	19,311	130,571	271,267	34,048	881,108	272,001

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Finance - banks	8,978	820	12	832	1,951	—	1,951	—	19,455	31,216	18
- other (3)	16,023	9,522	587	10,109	21,958	126	22,084	121,717	4,950	174,883	123,67
Residential mortgages	—	20,548	3,653	24,201	—	—	—	—	—	24,201	
Personal lending	—	6,816	2,704	9,520	—	—	—	—	—	9,520	
Property Construction	—	1,611	3,318	4,929	95	4	99	23	—	5,051	
Manufacturing	—	442	78	520	5	—	5	16	—	541	
Service industries and business activities	—	5,459	143	5,602	412	22	434	583	—	6,619	
- retail, wholesale and repairs	—	4,264	237	4,501	132	—	132	68	—	4,701	
- transport and storage	—	1,786	1,408	3,194	99	2	101	929	—	4,224	
- health, education and recreation	—	2,380	313	2,693	1,308	3	1,311	292	—	4,296	
- hotels and restaurants	—	486	136	622	104	—	104	3	—	729	
- utilities	—	1,117	53	1,170	567	2	569	272	—	2,011	
- other	124	4,042	577	4,619	789	279	1,068	1,200	42	7,053	
Agriculture, forestry and fishing	—	31	—	31	28	—	28	3	—	62	
Finance lease and instalment credit	—	2,315	—	2,315	—	—	—	—	—	2,315	
Interest accruals	7	183	73	256	240	—	240	—	—	503	
Group	25,132	62,085	13,345	75,430	52,663	1,204	53,867	125,111	24,559	304,099	123,86

For notes relating to this table refer to page 128.



Business review [Risk and balance sheet management continued](#)

## Risk management: Credit risk continued

## Balance sheet analysis: Credit concentration: Sector and geographical region continued

	Loans and advances				Securities						Netting and offset	
	Reverse repos £m	Core £m	Non-Core £m	Total £m	Debt £m	Equity £m	Total £m	Derivatives £m	Other (1) £m	Total £m	Netting and offset (2) £m	
2010												
Europe												
Central and local government	—	365	1,017	1,382	18,648	—18,648		66	—	20,096	—	20,096
Finance - banks	94	10,219	313	10,532	11,843	—11,843		—	7,936	30,405	—	30,405
- other (3)	—	2,642	1,019	3,661	4,886	347	5,233	746	53	9,693	1	9,693
Residential mortgages	—19,473		621	20,094	—	—	—	—	—	20,094	5	20,094
Personal lending	—2,270		600	2,870	62	—	62	—	25	2,957	—	2,957
Property	—5,139		12,636	17,775	—	43	43	—	—	17,818	5	17,818
Construction	—1,014		873	1,887	—	27	27	1	—	1,915	14	1,915
Manufacturing	—5,853		4,181	10,034	18	87	105	39	—	10,178	6	10,178
Service industries and business activities												
- retail, wholesale and repairs	—4,126		999	5,125	32	2	34	33	—	5,192	15	5,192
- transport and storage	—5,625		1,369	6,994	141	22	163	2	—	7,159	5	7,159
- health, education and recreation	—1,442		496	1,938	27	9	36	—	—	1,974	—	1,974
- hotels and restaurants	—1,055		535	1,590	—	120	120	—	—	1,710	4	1,710
- utilities	—1,412		623	2,035	74	188	262	10	—	2,307	—	2,307
- other	—3,877		2,050	5,927	109	176	285	54	1	6,267	23	6,267
Agriculture, forestry and fishing	—	849	68	917	—	1	1	—	—	918	21	918
Finance lease and instalment credit	—	370	744	1,114	—	—	—	—	—	1,114	—	1,114
Interest accruals	28	143	101	244	575	—	575	—	—	847	—	847
	122	65,874	28,245	94,119	36,415	1,022	37,437	951	8,015	140,644	99	140,644

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Group before RFS MI													
RFS MI	—	—	—	2	—	—	—	—	—	2	—	—	—
Group	122	65,874	28,245	94,121	36,415	1,022	37,437	951	8,015	140,646	99	140,646	99
RoW													
Central and local government	34	425	428	853	14,073	—	—14,073	189	6	15,155	—	15,155	—
Finance - banks	5,129	4,453	197	4,650	3,299	—	—3,299	—	1,526	14,604	—	14,604	—
other (3)	2,088	6,751	22	6,773	145	444	589	27,531	1,792	38,773	22,575	16,198	16,198
Residential mortgages	—	410	203	613	—	—	—	—	—	613	—	613	—
Personal lending	—	1,460	2	1,462	—	—	—	6	—	1,468	—	1,468	—
Property	—	735	1,205	1,940	303	15	318	68	—	2,326	—	2,326	—
Construction	—	183	91	274	12	4	16	22	—	312	—	312	—
Manufacturing	—	2,185	686	2,871	—	4	4	448	—	3,323	—	3,323	—
Service industries and business activities													
- retail, wholesale and repairs	—	1,030	102	1,132	13	28	41	149	—	1,322	1	1,322	1
- transport and storage	—	430	403	833	398	27	425	199	—	1,457	—	1,457	—
- health, education and recreation	—	132	17	149	—	8	8	29	—	186	—	186	—
- hotels and restaurants	—	90	13	103	—	3	3	4	—	110	—	110	—
- utilities	—	1,468	399	1,867	33	34	67	97	—	2,031	—	2,031	—
- other	1	2,100	912	3,012	85	270	355	1,004	8	4,380	1	4,380	4
Agriculture, forestry and fishing	—	6	—	6	—	—	—	2	—	8	—	8	—
Finance lease and instalment credit	—	47	—	47	—	—	—	—	—	47	—	47	—
Interest accruals	—	90	6	96	82	—	82	—	—	178	—	178	—
Group	7,252	21,995	4,686	26,681	18,443	837	19,280	29,748	3,332	86,293	22,577	63,716	63,716

For notes relating to this table refer to page 128.

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	Reverse repos £m	Loans and advances			Securities			Derivatives £m	Other (1) £m	Total £m	Netting and offset (2) £m
		Core £m	Non-Core £m	Total £m	Debt £m	Equity £m	Total £m				
2009											
UK											
Central and local government	129	4,353	276	4,629	79,662	1	79,663	6,752	4	91,177	1,723
Finance - banks	21,955	36,741	424	37,165	2,355	—	2,355	—	20,693	82,168	2,483
- other (3)	29,240	29,278	6,004	35,282	38,135	5,676	43,811	257,109	5,492	370,934	236,443
Residential mortgages	—	90,688	1,896	92,584	—	—	—	11	—	92,595	7
Personal lending	—	24,613	1,137	25,750	1	—	1	9	22	25,782	2
Property Construction	—	36,407	35,387	71,794	3,303	458	3,761	4,086	104	79,745	1,114
Manufacturing Service industries and business activities	—	6,964	3,640	10,604	48	306	354	849	62	11,869	1,450
- retail, wholesale and repairs	182	14,462	3,255	17,717	640	1,003	1,643	4,222	102	23,866	3,184
- transport and storage	—	13,412	2,672	16,084	445	263	708	819	29	17,640	2,549
- health, education and recreation	—	10,066	5,319	15,385	369	163	532	988	15	16,920	20
- hotels and restaurants	22	15,551	1,225	16,776	303	164	467	1,005	—	18,270	1,051
- utilities	—	7,575	1,033	8,608	320	573	893	824	86	10,411	284
- other	—	2,626	1,652	4,278	1,142	2,308	3,450	2,321	259	10,308	443
Agriculture, forestry and fishing	—	13,516	3,964	17,480	1,608	2,621	4,229	1,892	353	23,954	1,274
Finance lease and instalment credit	—	2,946	138	3,084	43	209	252	39	9	3,384	70
Interest accruals	—	5,343	10,843	16,186	291	3	294	16	—	16,496	39
Group before RFS MI	321	713	178	891	457	—	457	—	—	1,669	—
RFS MI	51,849	315,254	79,043	394,297	129,122	13,748	142,870	280,942	27,230	897,188	252,352
RFS MI	—	—	—	444	49	1	50	494	—	988	—
Group	51,849	315,254	79,043	394,741	129,171	13,749	142,920	281,436	27,230	898,176	252,352

US

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Central and local government	—	196	64	260	23,841	779	24,620	9	141	25,030	
Finance - banks	7,466	982	76	1,058	1,473	—	1,473	—	7,533	17,530	63
- other (3)	9,912	9,524	1,771	11,295	25,592	85	25,677	125,599	5,779	178,262	113,607
Residential mortgages	—	21,842	4,317	26,159	—	—	—	—	—	26,159	
Personal lending	—	7,373	3,599	10,972	—	—	—	—	—	10,972	
Property Construction	—	1,498	3,788	5,286	56	—	56	30	—	5,372	
Manufacturing Service industries and business activities	—	490	132	622	71	1	72	50	—	744	
- retail, wholesale and repairs	—	5,895	1,200	7,095	218	25	243	580	—	7,918	
- transport and storage	—	3,897	422	4,319	142	—	142	108	—	4,569	
- health, education and recreation	—	1,679	1,525	3,204	108	1	109	738	—	4,051	
- hotels and restaurants	—	1,595	1,356	2,951	1,698	—	1,698	272	—	4,921	
- utilities	—	772	88	860	98	—	98	7	—	965	
- other	—	1,178	46	1,224	113	—	113	204	—	1,541	
Agriculture, forestry and fishing	280	4,957	1,068	6,025	944	216	1,160	1,157	—	8,622	
Finance lease and instalment credit	—	27	—	27	1	—	1	2	—	30	
Interest accruals	—	2,417	—	2,417	—	—	—	—	—	2,417	
Group before RFS MI	16	204	94	298	334	—	334	—	—	648	
RFS MI	17,674	64,526	19,546	84,072	54,689	1,107	55,796	128,756	13,453	299,751	113,670
RFS MI	—	—	—	360	—	—	—	—	—	360	
Group	17,674	64,526	19,546	84,432	54,689	1,107	55,796	128,756	13,453	300,111	113,670

For notes relating to this table refer to page 128.

Business review [Risk and balance sheet management continued](#)

## Risk management: Credit risk continued

## Balance sheet analysis: Credit concentration: Sector and geographical region continued

	Loans and advances				Securities					Netting and offset (2) £m	
	Reverse repos £m	Core £m	Non-Core £m	Total £m	Debt £m	Equity £m	Total £m	Derivatives £m	Other (1) £m		
2009											
Europe											
Central and local government	—	334	1,164	1,498	25,328	—25,328		68	24	26,918	—
Finance - banks	—	4,905	529	5,434	17,390	—17,390		—	22,792	45,616	—
- other (3)	189	4,095	905	5,000	5,097	426	5,523	1,699	43	12,454	—
Residential mortgages	—15,055		6,718	21,773	—	—	—	—	—	21,773	—
Personal lending	—	1,877	1,009	2,886	—	—	—	—	17	2,903	—
Property Construction	—10,812		9,417	20,229	—	1	1	17	4	20,251	—
Manufacturing	—1,946		1,167	3,113	—	1	1	1	1	3,116	—
Service industries and business activities	—7,311		8,609	15,920	19	23	42	123	—	16,085	—
- retail, wholesale and repairs	—	5,464	1,661	7,125	15	1	16	7	—	7,148	—
- transport and storage	—	4,385	1,463	5,848	15	4	19	—	2	5,869	—
- health, education and recreation	—	1,419	1,121	2,540	54	9	63	—	—	2,603	—
- hotels and restaurants	—	1,221	568	1,789	—	19	19	—	4	1,812	—
- utilities	—	1,816	786	2,602	4	30	34	6	37	2,679	—
- other	12	4,783	4,284	9,067	156	24	180	75	8	9,342	—
Agriculture, forestry and fishing	—	737	356	1,093	—	1	1	—	—	1,094	—
Finance lease and instalment credit	—	379	1,094	1,473	—	12	12	—	—	1,485	—
Interest accruals	102	168	245	413	706	—	706	—	—	1,221	—
	303	66,707	41,096	107,803	48,784	551	49,335	1,996	22,932	182,369	—

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Group before RFS MI											
RFS MI	—	—	—140,098	21,681	3,232	24,913	165,020	—330,031	—	3	
Group	303	66,707	41,096	247,901	70,465	3,783	74,248	167,016	22,932	512,400	— 5
RoW											
Central and local government	131	1,245	28	1,273	13,201	—13,201	169	36	14,810	—	
Finance - banks	5,277	4,946	331	5,277	3,332	—3,332	—	1,243	15,129	—	
other (3)	847	7,776	1,033	8,809	—	440	440	25,045	796	35,937	19,747
Residential mortgages	—	390	1	391	—	—	—	—	—	391	—
Personal lending	—1,450	613	2,063	—	—	—	29	1	2,093	—	
Property Construction	— 337	1,780	2,117	669	10	679	51	—	2,847	—	
Manufacturing Service industries and business activities	— 102	319	421	176	12	188	23	—	632	—	
- retail, wholesale and repairs	—2,604	1,338	3,942	1	25	26	428	14	4,410	—	
- transport and storage	—	612	327	939	—	19	19	62	—	1,020	1
- health, education and recreation	—	563	505	1,068	115	30	145	94	—	1,307	—
- hotels and restaurants	—	232	41	273	—	15	15	23	—	311	—
- utilities	—	131	21	152	—	3	3	1	—	156	—
- other	—1,152	622	1,774	39	41	80	82	—	1,936	—	
Agriculture, forestry and fishing	1	1,836	1,869	3,705	106	221	327	495	1	4,529	—
Finance lease and instalment credit	—	16	59	75	—	—	—	3	—	78	—
Interest accruals	—	8	19	27	—	—	—	—	—	27	—
Group before RFS MI	55	94	32	126	74	—	74	—	—	255	—
RFS MI	6,311	23,494	8,938	32,432	17,713	816	18,529	26,505	2,091	85,868	19,748
RFS MI	—	—	—	1,786	—	22	22	1,808	—	3,616	—
Group	6,311	23,494	8,938	34,218	17,713	838	18,551	28,313	2,091	89,484	19,748

Notes:  
(1)

Includes cash and balances at central banks of £79,269 million (2010 - £57,014 million; 2009 - £52,261 million) and settlement balances of £7,771 million (2010 - £11,605 million; 2009 - £12,033 million).

- (2) This shows the amount by which the Group's credit risk exposure is reduced through arrangements, such as master netting agreements, which give the Group a legal right to set off the financial asset against a financial liability due to the same counterparty. In addition, the Group holds collateral in respect of individual loans and advances to banks and customers. This collateral includes mortgages over property (both personal and commercial); charges over business assets such as plant, inventories and trade debtors; and guarantees of lending from parties other than the borrower. The Group obtains collateral in the form of securities in reverse repurchase agreements. Cash and securities are received as collateral in respect of derivative transactions.
- (3) Loans made by the Group's consolidated conduits to asset owning companies are included within Finance.

## Cross border exposures

Cross border exposures are loans and advances including finance leases and instalment credit receivables and other monetary assets, such as debt securities, including non-local currency claims of overseas offices on local residents.

The Group monitors the geographical breakdown of these exposures based on the country of domicile of the borrower or guarantor of ultimate risk. Cross border exposures exclude exposures to local residents in local currencies.

The table below sets out the Group's cross border exposures greater than 0.5% of the Group's total assets. None of these countries have experienced repayment difficulties that have required restructuring of outstanding debt.

	Government	Banks	Other	Total	Short positions	Net of short positions
	£m	£m	£m	£m	£m	£m
2011						
United States	20,932	7,300	38,721	66,953	13,329	53,624
Germany	34,615	5,952	9,787	50,354	2,946	47,408
France	11,633	14,800	8,189	34,622	5,903	28,719
Japan	8,350	7,505	3,375	19,230	3,141	16,089
Netherlands	4,466	2,210	10,711	17,387	982	16,405
Spain	340	3,656	10,282	14,278	973	13,305
Italy	5,190	548	1,489	7,227	4,826	2,401
Republic of Ireland	665	3,287	2,759	6,711	68	6,643
Switzerland	1,335	3,282	1,492	6,109	25	6,084
China	1,589	2,669	1,849	6,107	—	6,107
Cayman Islands	—	15	4,194	4,209	2	4,207
Belgium	1,662	1,285	1,222	4,169	726	3,443
2010						
United States	21,201	14,382	36,813	72,396	14,240	58,156
Germany	22,962	6,276	10,467	39,705	4,685	35,020
France	17,293	16,007	6,756	40,056	4,285	35,771
Japan	7,983	6,962	7,542	22,487	409	22,078
Netherlands	2,900	3,055	10,824	16,779	951	15,828
Spain	1,401	4,248	11,589	17,238	1,357	15,881
Italy	6,409	1,083	2,188	9,680	3,183	6,497
Republic of Ireland	199	3,789	3,101	7,089	131	6,958
Switzerland	4	1,714	2,944	4,662	12	4,650
China	553	1,775	1,561	3,889	5	3,884
Cayman Islands	2	94	7,330	7,426	44	7,382
Belgium	1,461	752	2,806	5,019	606	4,413



Business review [Risk and balance sheet management continued](#)

## Risk management: Credit risk continued

## Balance sheet analysis continued

## Asset quality

The asset quality analysis presented below is based on the Group's internal asset quality ratings which have ranges for the probability of default as set out below. Customers are assigned credit grades, based on various credit grading models that reflect the key drivers of default for the customer type. All credit grades across the Group map to both a Group level asset quality scale, used for external financial reporting, and a master grading scale for wholesale exposures used for internal management reporting across portfolios. Debt securities are analysed by external ratings and are therefore excluded from the table below and are set out on pages 133 and 134.

Asset quality band	Probability of default range
AQ1	0% - 0.034%
AQ2	0.034% - 0.048%
AQ3	0.048% - 0.095%
AQ4	0.095% - 0.381%
AQ5	0.381% - 1.076%
AQ6	1.076% - 2.153%
AQ7	2.153% - 6.089%
AQ8	6.089% - 17.222%
AQ9	17.222% - 100%
AQ10	100%

	Cash and balances central banks	Loans and advances to banks (1)	Loans and advances to customers	Settlement balances	Derivatives	Other financial instruments	Commitments	Contingent liabilities	Total
2011	£m	£m	£m	£m	£m	£m	£m	£m	£m
Total	78,592	74,192	113,437	4,582	481,622	556	75,356	14,076	842,413
AQ1	342	1,881	15,622	93	8,177	—	24,269	3,154	53,538
AQ2	196	1,981	32,830	546	10,819	—	23,471	4,427	74,270
AQ3	19	1,612	103,617	760	14,421	—	40,071	5,847	166,347

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AQ5	90	1,261	112,537	79	6,516	45	34,593	4,301	159,422
AQ6	9	188	47,892	46	2,221	—	17,153	1,662	69,171
AQ7	8	432	31,379	13	2,393	—	19,163	1,037	54,425
AQ8	7	30	11,871	19	1,252	—	4,159	276	17,614
AQ9	5	83	16,006	4	1,150	320	2,286	943	20,797
AQ10	1	164	570	6	1,047	—	2,354	221	4,363
Past due	—	2	10,995	1,623	—	—	—	—	12,620
Impaired	—	137	38,610	—	—	414	—	—	39,161
Impairment provision	—	(123)	(19,760)	—	—	(26)	—	—	(19,909)
Group	79,269	81,840	515,606	7,771	529,618	1,309	242,875	35,944	1,494,232
2010									
AQ1	56,655	91,952	126,444	6,815	408,489	658	78,728	9,745	779,486
AQ2	14	598	13,282	1,271	2,659	3	26,128	1,980	45,935
AQ3	48	2,197	25,981	156	3,317	—	25,731	4,337	61,767
AQ4	188	639	95,777	571	3,391	6	41,027	6,522	148,121
AQ5	99	2,322	114,796	64	4,860	144	38,612	5,169	166,066
AQ6	3	159	65,497	34	1,070	—	25,991	2,230	94,984
AQ7	2	178	46,072	1	857	69	18,752	2,456	68,387
AQ8	—	15	16,573	14	403	—	9,289	9,545	35,839
AQ9	—	115	14,263	2	450	80	3,889	932	19,731
AQ10	5	355	5,644	2	1,581	—	2,829	407	10,823
Accruing past due	—	10	13,430	2,675	—	—	—	—	16,115
Impaired	—	145	35,556	—	—	375	—	—	36,076
Impairment provision	—	—	(127)	(18,055)	—	—	—	—	(18,211)
Group before RFS	—	—	—	—	—	(29)	—	—	—
MI	57,014	98,558	555,260	11,605	427,077	1,306	270,976	43,323	1,465,119
RFS MI	—	2	—	—	—	—	—	32	34
Group	57,014	98,560	555,260	11,605	427,077	1,306	270,976	43,355	1,465,153

For the note relating to this table refer to page 132.

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	Cash and balances at central banks	Loans and advances to banks (1)	Loans and advances to customers	Settlement balances	Derivatives	Other financial instruments	Commitments	Contingent liabilities	Total
	£m	£m	£m	£m	£m	£m	£m	£m	£m
2009									
AQ1	51,521	72,384	106,062	6,582	389,019	754	62,085	9,446	697,853
AQ2	—	1,725	10,780	306	11,550	9	27,598	4,526	56,494
AQ3	1	2,175	29,958	199	10,791	—	28,364	6,088	77,576
AQ4	23	1,357	102,922	605	8,296	—	52,496	14,948	180,647
AQ5	2	2,497	124,724	149	8,270	37	43,239	7,387	186,305
AQ6	1	424	94,513	40	2,548	—	30,847	2,448	130,821
AQ7	—	110	46,928	33	2,181	98	26,724	2,352	78,426
AQ8	—	137	23,593	—	1,448	—	12,507	1,008	38,693
AQ9	—	184	16,025	—	2,030	—	5,141	1,279	24,659
AQ10	—	277	9,142	3	2,026	—	3,618	507	15,573
Accruing past due	—	36	14,475	3,910	40	—	—	—	18,461
Impaired	—	206	31,588	197	—	—	—	—	31,991
Impairment provision	—	(157)	(15,016)	—	—	—	—	—	(15,173)
Group before RFS									
MI	51,548	81,355	595,694	12,024	438,199	898	292,619	49,989	1,522,326
RFS MI	713	7,865	132,699	9	3,255	—	5,022	4,031	153,594
Group	52,261	89,220	728,393	12,033	441,454	898	297,641	54,020	1,675,920
2011									
Core									
AQ1	78,534	73,689	94,704	4,566	477,746	468	69,220	13,247	812,174
AQ2	342	1,877	13,970	91	7,500	—	23,404	3,122	50,306
AQ3	56	1,967	30,082	546	10,360	—	22,319	4,354	69,684
AQ4	18	1,557	97,001	759	13,475	—	38,808	5,655	157,273
AQ5	90	1,256	105,392	79	5,087	45	33,226	4,092	149,267
AQ6	9	140	41,476	46	1,987	—	16,118	1,634	61,410
AQ7	8	432	27,114	13	796	—	17,514	949	46,826
AQ8	7	20	9,857	19	666	—	4,068	236	14,873
AQ9	5	83	11,515	4	592	272	1,769	898	15,138
AQ10	1	164	264	6	339	—	1,274	180	2,228
Past due	—	2	9,451	1,623	—	—	—	—	11,076
Impaired	—	136	15,170	—	—	413	—	—	15,719
Impairment provision	—	(122)	(8,292)	—	—	(25)	—	—	(8,439)
Group	79,070	81,201	447,704	7,752	518,548	1,173	227,720	34,367	1,397,535
2010									
AQ1	56,637	91,298	103,645	6,814	396,419	366	71,091	9,651	735,921
AQ2	14	550	10,534	1,271	2,243	3	24,923	1,728	41,266

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AQ3	48	2,165	22,851	155	3,132	—	23,546	4,268	56,165
AQ4	10	539	85,779	571	3,017	6	36,909	5,070	131,901
AQ5	99	2,247	100,051	64	3,988	15	35,302	4,924	146,690
AQ6	3	138	53,498	34	805	—	24,050	2,140	80,668
AQ7	2	154	38,438	1	595	69	17,605	2,309	59,173
AQ8	—	15	13,290	14	257	—	8,617	9,434	31,627
AQ9	—	107	9,898	2	237	50	3,442	886	14,622
AQ10	5	300	2,777	2	368	—	1,500	250	5,202
Past due	—	3	10,744	2,629	—	—	—	—	13,376
Impaired	—	144	13,367	—	—	375	—	—	13,886
Impairment	—	(126)	(7,740)	—	—	(29)	—	—	(7,895)
provision									
Group	56,818	97,534	457,132	11,557	411,061	855	246,985	40,660	1,322,602

For the note relating to this table refer to page 132.

Business review [Risk and balance sheet management continued](#)

Risk management: Credit risk continued

Balance sheet analysis: Asset quality continued

	Cash and balances central banks £m	Loans and advances to banks (1) £m	Loans and advances to customers £m	Settlement balances £m	Derivatives £m	Other financial instruments £m	Commitments £m	Contingent liabilities £m	Total £m	
2011										
Non-Core										
AQ1	58	503	18,733	16	3,876	88	6,136	829	30,239	
AQ2	—	4	1,652	2	677	—	865	32	3,232	
AQ3	140	14	2,748	—	459	—	1,152	73	4,586	
AQ4	1	55	6,616	1	946	—	1,263	192	9,074	
AQ5	—	5	7,145	—	1,429	—	1,367	209	10,155	
AQ6	—	48	6,416	—	234	—	1,035	28	7,761	
AQ7	—	—	4,265	—	1,597	—	1,649	88	7,599	
AQ8	—	10	2,014	—	586	—	91	40	2,741	
AQ9	—	—	4,491	—	558	48	517	45	5,659	
AQ10	—	—	306	—	708	—	1,080	41	2,135	
Accruing past due	—	—	1,544	—	—	—	—	—	1,544	
Impaired	—	1	23,440	—	—	1	—	—	—23,442	
Impairment provision	—	(1)	(11,468)	—	—	(1)	—	—	—(11,470)	
Group	199	639	67,902	19	11,070	136	15,155	1,577	96,697	
2010										
AQ1		18	654	22,799	1	12,070	292	7,637	94	43,565
AQ2		—	48	2,748	—	416	—	1,205	252	4,669
AQ3		—	32	3,130	1	185	—	2,185	69	5,602
AQ4		178	100	9,998	—	374	—	4,118	1,452	16,220
AQ5		—	75	14,745	—	872	129	3,310	245	19,376
AQ6		—	21	11,999	—	265	—	1,941	90	14,316
AQ7		—	24	7,634	—	262	—	1,147	147	9,214
AQ8		—	—	3,283	—	146	—	672	111	4,212
AQ9		—	8	4,365	—	213	30	447	46	5,109
AQ10		—	55	2,867	—	1,213	—	1,329	157	5,621
Accruing past due		—	7	2,686	46	—	—	—	—	2,739
Impaired		—	1	22,189	—	—	—	—	—	—22,190
Impairment provision		—	(1)	(10,315)	—	—	—	—	—	—(10,316)
Group before RFS MI		196	1,024	98,128	48	16,016	451	23,991	2,663	142,517

Note:

(1)

Excluding items in the course of collection from other banks of £1,470 million (2010 - £1,958 million; 2009 - £2,533 million).

## Debt securities

The table below analyses debt securities by issuer and external ratings. Ratings are based on the lower of S&P, Moody's and Fitch.

	Central and local government			Banks	Other financial institutions	Corporate	Total	Total	Of which ABS (1)
	UK	US	Other						
2011									
Total									
AAA	22,451	45	32,522	5,155	15,908	452	76,533	37	17,156
AA to AA+	—	40,435	2,000	2,497	30,403	639	75,974	36	33,615
A to AA-	—	1	24,966	6,387	4,979	1,746	38,079	18	6,331
BBB- to A-	—	—	2,194	2,287	2,916	1,446	8,843	4	4,480
Non-investment grade	—	—	924	575	5,042	1,275	7,816	4	4,492
Unrated	—	3	2	39	1,380	411	1,835	1	1,235
	22,451	40,484	62,608	16,940	60,628	5,969	209,080	100	67,309
Core									
AAA	22,112	45	32,489	4,601	13,245	448	72,940	37	14,534
AA to AA+	—	40,435	1,995	2,434	28,125	565	73,554	38	31,323
A to AA-	—	1	24,964	6,302	3,348	1,614	36,229	18	4,731
BBB- to A-	—	—	2,194	2,272	1,727	1,232	7,425	4	3,188
Non-investment grade	—	—	723	559	2,542	1,048	4,872	2	2,552
Unrated	—	3	1	25	821	260	1,110	1	785
	22,112	40,484	62,366	16,193	49,808	5,167	196,130	100	57,113
Non-Core									
AAA	339	—	33	554	2,663	4	3,593	28	2,622
AA to AA+	—	—	5	63	2,278	74	2,420	19	2,292
A to AA-	—	—	2	85	1,631	132	1,850	14	1,600
BBB- to A-	—	—	—	15	1,189	214	1,418	11	1,292
Non-investment grade	—	—	201	16	2,500	227	2,944	23	1,940
Unrated	—	—	1	14	559	151	725	5	450
	339	—	242	747	10,820	802	12,950	100	10,196

For notes relating to this table refer to page 134.

Business review [Risk and balance sheet management continued](#)

## Risk management: Credit risk continued

## Balance sheet analysis: Debt securities continued

	Central and local government			Banks	Other financial institutions		Corporate	Total	Total	Of which
	UK	US	Other		Corporate	Total			(2) ABS	(1)
2010	£m	£m	£m	£m	£m	£m	£m	£m	%	£m
<b>Total</b>										
AAA	13,486	38,009	44,123	10,704	39,388	878	146,588	67	51,235	
AA to AA+	—	—	—18,025	3,511	6,023	616	28,175	13	6,335	
A to AA-	—	—	—9,138	4,926	2,656	1,155	17,875	8	3,244	
BBB- to A-	—	—	—2,845	1,324	3,412	2,005	9,586	5	3,385	
Non-investment grade	—	—	—1,770	1,528	5,522	2,425	11,245	5	4,923	
Unrated	—	—	54	480	2,552	925	4,011	2	1,703	
	13,486	38,009	75,955	22,473	59,553	8,004	217,480	100	70,825	
<b>Core</b>										
AAA	13,110	37,698	44,101	10,532	35,595	839	141,875	70	47,441	
AA to AA+	—	—	—18,025	3,485	3,242	612	25,364	13	3,656	
A to AA-	—	—	—9,138	4,420	1,605	1,089	16,252	8	1,879	
BBB- to A-	—	—	—2,845	1,050	1,412	1,903	7,210	4	1,108	
Non-investment grade	—	—	—1,464	1,444	3,658	2,014	8,580	4	3,052	
Unrated	—	—	53	420	1,375	768	2,616	1	978	
	13,110	37,698	75,626	21,351	46,887	7,225	201,897	100	58,114	
<b>Non-Core</b>										
AAA	376	311	22	172	3,793	39	4,713	30	3,794	
AA to AA+	—	—	—	26	2,781	4	2,811	18	2,679	
A to AA-	—	—	—	506	1,051	66	1,623	11	1,365	
BBB- to A-	—	—	—	274	2,000	102	2,376	15	2,277	
Non-investment grade	—	—	306	84	1,864	411	2,665	17	1,871	
Unrated	—	—	1	60	1,177	157	1,395	9	725	
	376	311	329	1,122	12,666	779	15,583	100	12,711	
<b>2009</b>										
AAA	26,601	28,210	44,155	13,208	49,363	4,021	165,558	66	65,067	
AA to AA+	—	—	—22,003	4,225	9,602	1,474	37,304	15	8,942	
A to AA-	—	—	—13,161	3,425	4,563	1,526	22,675	9	3,886	
BBB- to A-	—	—	—3,847	788	4,727	1,738	11,100	5	4,243	
Non-investment grade	—	—	353	159	3,937	1,630	6,079	2	3,515	
Unrated	—	—	509	232	3,586	2,052	6,379	3	1,949	
Group before RFS MI	26,601	28,210	84,028	22,037	75,778	12,441	249,095	100	87,602	
RFS MI	721	183	11,871	3,803	675	906	18,159		580	
Group	27,322	28,393	95,899	25,840	76,453	13,347	267,254		88,182	

## Notes:

- (1) Asset-backed securities.  
(2) Percentage calculated on Group before RFS MI.



Key points

- The decrease in AAA rated debt securities relates to the downgrading of US government and agencies to AA+ by S&P during the year.
- The proportion of debt securities rated A to AA- increased to 18%, principally reflecting the Japanese government downgrade in 2011.
- Non-investment grade and unrated debt securities accounted for 5% of the debt securities portfolio at 31 December 2011, down from 7% in the prior year.

The table below analyses debt securities by issuer and measurement classification. The categorisation of debt securities has been revised to include asset-backed securities (ABS) by class of issuer. The main changes are to US central and local government which includes US federal agencies, and financial institutions which now includes US government sponsored agencies and securitisation entities. 2010 data are presented on the revised basis.

	Central and local government			Banks	Other financial institutions		Corporate	Total	Of which ABS
	UK	US	Other						
2011	£m	£m	£m	£m	£m	£m	£m	£m	£m
Held-for-trading (HFT)	9,004	19,636	36,928	3,400	23,160	2,948	95,076	20,816	
Designated as at fair value through profit or loss	1	—	127	53	457	9	647	558	
Available-for-sale	13,436	20,848	25,552	13,175	31,752	2,535	107,298	40,735	
Loans and receivables	10	—	1	312	5,259	477	6,059	5,200	
	22,451	40,484	62,608	16,940	60,628	5,969	209,080	67,309	
Total of which US agencies	—	4,896	—	—	25,924	—	30,820	28,558	
Short positions (HFT)	(3,098)	(10,661)	(19,136)	(2,556)	(2,854)	(754)	(39,059)	(352)	
Available-for-sale									
Gross unrealised gains	1,428	1,311	1,180	52	913	94	4,978	1,001	
Gross unrealised losses	—	—	(171)	(838)	(2,386)	(13)	(3,408)	(3,158)	
2010									
Held-for-trading	5,097	15,648	42,828	5,486	23,711	6,099	98,869	21,988	
Designated as at fair value through profit or loss	1	117	262	4	8	10	402	119	
Available-for-sale	8,377	22,244	32,865	16,982	29,148	1,514	111,130	42,515	
Loans and receivables	11	—	—	1	6,686	381	7,079	6,203	
	13,486	38,009	75,955	22,473	59,553	8,004	217,480	70,825	
Total of which US agencies	—	6,811	—	—	21,686	—	28,497	25,375	
Short positions (HFT)	(4,200)	(10,943)	(18,913)	(1,844)	(3,356)	(1,761)	(41,017)	(1,335)	
Available-for-sale									
Gross unrealised gains	349	525	700	143	827	51	2,595	1,057	
Gross unrealised losses	(10)	(2)	(618)	(786)	(2,626)	(55)	(4,097)	(3,396)	

#### Key points

- Held-for-trading debt securities decreased by £3.8 billion during the year due to a reduction in trading volumes. The reduction in sovereign exposures in the eurozone and other countries, in response to the current economic environment, was offset by an increase in US and UK government bonds.
- The Group's AFS portfolio decreased by £3.8 billion. UK government bonds increased by £5.1 billion, principally in the Group Treasury portfolio.



Business review [Risk and balance sheet management continued](#)

Risk management: Credit risk continued

Balance sheet analysis continued

## Asset-backed securities

The Group structures, originates, distributes and trades debt in the form of loan, bond and derivative instruments in all major currencies and debt capital markets in North America, Western Europe, Asia and major emerging markets. The carrying value of the Group's debt securities is detailed below.

	2011	2010	2009	
	Group	Group	Group	Group
	£bn	£bn	RFS MI £bn	£bn
Securities issued by central and local governments	125.5	127.5	138.8	151.6
Securities issued by corporates	6.0	8.0	12.5	13.3
Securities issued by banks and other financial institutions	77.6	82.0	97.8	102.4
	209.1	217.5	249.1	267.3
Asset-backed securities	67.3	70.8	87.6	88.2

The Group's credit market activities gave rise to risk concentrations in asset-backed securities (ABS). The Group has exposures to ABS, which are predominantly debt securities, but can also be held in derivative form. ABS have an interest in an underlying pool of referenced assets. The risks and rewards of the referenced pool are passed onto investors by the issue of securities with varying seniority by a special purpose entity.

Debt securities include residential mortgage-backed securities (RMBS), commercial mortgage-backed securities (CMBS), collateralised debt obligations (CDOs), collateralised loan obligations (CLOs) and other ABS. In many cases, the risk associated with these assets is hedged by credit derivatives. The counterparties to some of these hedge transactions are monoline insurers.

The following tables summarise the gross and net exposures and carrying values of these securities by the location of the underlying assets at 31 December 2011, 2010 and 2009. Gross exposures represent the principal amounts relating to ABS. Government sponsored or similar RMBS comprises securities that are: (a) guaranteed or effectively guaranteed by the US government, by way of its support for US federal agencies and government sponsored enterprises or (b) guaranteed by the Dutch government. Net exposures represent the carrying value after taking account of protection purchased from monoline insurers and other counterparties, but exclude the effect of counterparty credit valuation adjustments. The hedge provides credit protection of both principal and interest cash flows in the event of default by the counterparty. The value of this protection is based on the underlying instrument being protected.

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Asset-backed securities by product, geography and measurement classification

	US £m	UK £m	Europe £m	RoW £m	Total £m	FVTPL (1)				
						HFT (2) £m	DFV (3) £m	AFS (4) £m	LAR (5) £m	
2011										
Gross exposure										
RMBS: government sponsored or similar	27,549	—	5,884	2	33,435	15,031	—	18,404	—	
RMBS: prime	1,201	3,487	1,541	484	6,713	1,090	567	4,977	79	
RMBS: non-conforming	1,220	2,197	74	—	3,491	717	—	1,402	1,372	
RMBS: sub-prime	1,847	427	94	2	2,370	2,183	—	22	165	
MBS: covered bond	133	203	8,256	—	8,592	—	—	8,592	—	
CMBS	1,623	1,562	883	1	4,069	2,001	—	862	1,206	
CDOs	7,889	72	469	—	8,430	4,455	—	3,885	90	
CLOs	5,019	156	1,055	—	6,230	1,294	—	4,734	202	
ABS covered bond	21	71	948	4	1,044	—	—	1,044	—	
Other ABS	2,085	1,844	1,746	992	6,667	1,965	17	2,389	2,296	
	48,587	10,019	20,950	1,485	81,041	28,736	584	46,311	5,410	
Carrying value										
RMBS: government sponsored or similar	28,022	—	5,549	2	33,573	15,132	—	18,441	—	
RMBS: prime	1,035	3,038	1,206	466	5,745	872	558	4,243	72	
RMBS: non-conforming	708	1,897	74	—	2,679	327	—	980	1,372	
RMBS: sub-prime	686	144	72	2	904	737	—	9	158	
MBS: covered bond	136	209	7,175	—	7,520	—	—	7,520	—	
CMBS	1,502	1,253	635	1	3,391	1,513	—	716	1,162	
CDOs	1,632	31	294	—	1,957	315	—	1,555	87	
CLOs	4,524	98	719	—	5,341	882	—	4,280	179	
ABS covered bond	19	70	953	4	1,046	—	—	1,046	—	
Other ABS	1,715	947	1,525	966	5,153	1,038	—	1,945	2,170	
	39,979	7,687	18,202	1,441	67,309	20,816	558	40,735	5,200	
Net exposure										
RMBS: government sponsored or similar	28,022	—	5,549	2	33,573	15,132	—	18,441	—	
RMBS: prime	825	3,456	1,005	458	5,744	447	557	4,668	72	
RMBS: non-conforming	677	2,225	74	—	2,976	284	—	1,320	1,372	
RMBS: sub-prime	385	138	67	2	592	434	—	—	158	
MBS: covered bond	136	209	7,175	—	7,520	—	—	7,520	—	
CMBS	860	1,253	543	1	2,657	777	—	718	1,162	
CDOs	1,030	31	294	—	1,355	304	—	964	87	
CLOs	1,367	98	712	—	2,177	827	—	1,171	179	
ABS covered bond	19	70	952	4	1,045	—	—	1,045	—	
Other ABS	1,456	843	1,527	804	4,630	617	—	1,941	2,071	
	34,777	8,323	17,898	1,271	62,269	18,822	557	37,788	5,101	

For notes relating to this table refer to page 139.

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Business review [Risk and balance sheet management continued](#)

## Risk management: Credit risk continued

## Balance sheet analysis: Asset-backed securities by product, geography and measurement classification continued

2010	FVTPL (1)								
	US £m	UK £m	Europe £m	RoW £m	Total £m	HFT (2) £m	DFV (3) £m	AFS (4) £m	LAR (5) £m
Gross exposure									
RMBS: government sponsored or similar	24,207	16	6,422	—	30,645	13,840	—	16,805	—
RMBS: prime	1,784	3,385	1,118	192	6,479	1,605	1	4,749	124
RMBS: non-conforming	1,249	2,107	92	—	3,448	708	—	1,313	1,427
RMBS: sub-prime	792	365	139	221	1,517	819	—	496	202
MBS: covered bond	138	208	8,525	—	8,871	—	—	8,871	—
CMBS	3,086	1,451	912	45	5,494	2,646	120	1,409	1,319
CDOs	12,156	128	453	—	12,737	7,951	—	4,687	99
CLOs	6,038	134	879	9	7,060	1,062	—	5,572	426
ABS covered bond	—	—	1,908	—	1,908	—	—	1,908	—
Other ABS	3,104	1,144	963	1,705	6,916	1,533	—	2,615	2,768
	52,554	8,938	21,411	2,172	85,075	30,164	121	48,425	6,365
Carrying value									
RMBS: government sponsored or similar	24,390	16	5,958	—	30,364	13,765	—	16,599	—
RMBS: prime	1,624	3,000	931	192	5,747	1,384	1	4,249	113
RMBS: non-conforming	1,084	1,959	92	—	3,135	605	—	1,102	1,428
RMBS: sub-prime	638	255	120	205	1,218	681	—	344	193
MBS: covered bond	142	208	7,522	—	7,872	—	—	7,872	—
CMBS	2,936	1,338	638	38	4,950	2,262	118	1,281	1,289
CDOs	3,135	69	254	—	3,458	1,341	—	2,021	96
CLOs	5,334	102	635	3	6,074	691	—	4,958	425
ABS covered bond	—	—	1,861	—	1,861	—	—	1,861	—
Other ABS	2,780	945	754	1,667	6,146	1,259	—	2,228	2,659
	42,063	7,892	18,765	2,105	70,825	21,988	119	42,515	6,203
Net exposure									
RMBS: government sponsored or similar	24,390	16	5,958	—	30,364	13,765	—	16,599	—
RMBS: prime	1,523	2,948	596	192	5,259	897	1	4,248	113
RMBS: non-conforming	1,081	1,959	92	—	3,132	602	—	1,102	1,428
RMBS: sub-prime	289	253	112	176	830	305	—	332	193
MBS: covered bond	142	208	7,522	—	7,872	—	—	7,872	—
CMBS	1,823	1,336	458	38	3,655	1,188	10	1,230	1,227
CDOs	1,085	39	245	—	1,369	743	—	530	96
CLOs	1,387	102	629	1	2,119	673	—	1,021	425
ABS covered bond	—	—	1,861	—	1,861	—	—	1,861	—

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Other ABS	2,293	748	748	1,659	5,448	690	—	2,220	2,538
	34,013	7,609	18,221	2,066	61,909	18,863	11	37,015	6,020

For notes relating to this table refer to page 139.

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2009	FVTPL (1)									
	US £m	UK £m	Europe £m	RoW £m	Total £m	HFT (2) £m	DFV (3) £m	AFS (4) £m	LAR (5) £m	
Gross exposure										
RMBS: government sponsored or similar										
	26,644	17	7,016	94	33,771	13,536		—	20,235	—
RMBS: prime										
	2,965	5,276	4,567	222	13,030	6,274	147	5,761	848	
RMBS: non-conforming										
	1,341	2,138	128	—	3,607	635	—	1,498	1,474	
RMBS: sub-prime										
	1,668	724	195	561	3,148	1,632	17	1,020	479	
MBS: covered bond										
	49	297	9,019	—	9,365	—	—	9,365	—	
CMBS										
	3,422	1,781	1,420	75	6,698	2,936	209	1,842	1,711	
CDOs										
	12,382	329	571	27	13,309	9,080	1	3,923	305	
CLOs										
	9,092	166	2,169	1,173	12,600	5,346	—	6,581	673	
ABS covered bond										
	—	—	2,206	—	2,206	—	—	2,206	—	
Other ABS										
	3,587	1,980	2,825	1,569	9,961	2,912	18	3,046	3,985	
	61,150	12,708	30,116	3,721	107,695	42,351	392	55,477	9,475	
Carrying value										
RMBS: government sponsored or similar										
	26,984	17	6,870	33	33,904	13,397		—	20,507	—
RMBS: prime										
	2,696	4,583	4,009	212	11,500	5,133	141	5,643	583	
RMBS: non-conforming										
	958	1,957	128	—	3,043	389	—	1,180	1,474	
RMBS: sub-prime										
	977	314	146	387	1,824	779	17	704	324	
MBS: covered bond										
	50	288	8,734	—	9,072	—	—	9,072	—	
CMBS										
	3,237	1,305	924	43	5,509	2,279	216	1,637	1,377	
CDOs										
	3,275	166	400	27	3,868	2,064	1	1,600	203	
CLOs										
	6,736	112	1,469	999	9,316	3,296	—	5,500	520	
ABS covered bond										
	—	—	2,200	—	2,200	—	—	2,200	—	
Other ABS										
	2,886	1,124	2,169	1,187	7,366	1,483	19	2,421	3,443	
	47,799	9,866	27,049	2,888	87,602	28,820	394	50,464	7,924	
Net exposure										
RMBS: government sponsored or similar										
	26,984	17	6,870	33	33,904	13,397		—	20,507	—
RMBS: prime										
	2,436	3,747	3,018	172	9,373	3,167	142	5,480	584	
RMBS: non-conforming										
	948	1,957	128	—	3,033	379	—	1,180	1,474	
RMBS: sub-prime										
	565	305	137	290	1,297	529	17	427	324	
MBS: covered bond										
	50	288	8,734	—	9,072	—	—	9,072	—	
CMBS										
	2,245	1,228	595	399	4,467	1,331	203	1,556	1,377	
CDOs										
	743	124	382	26	1,275	521	1	550	203	
CLOs										
	1,636	86	1,104	39	2,865	673	—	1,672	520	
ABS covered bond										
	—	—	2,200	—	2,200	—	—	2,200	—	
Other ABS										
	2,117	839	2,131	1,145	6,232	483	19	2,421	3,309	
	37,724	8,591	25,299	2,104	73,718	20,480	382	45,065	7,791	

Notes:

- (1) Fair value through profit or loss.
- (2) Held-for-trading.
- (3) Designated as at fair value.
- (4) Available-for-sale.
- (5) Loans and receivables.

Business review [Risk and balance sheet management continued](#)

Risk management: Credit risk continued

Balance sheet analysis: Asset-backed securities continued

The table below summarises the rating levels of ABS carrying values. Credit ratings are based on those from rating agencies Standard & Poor's (S&P), Moody's and Fitch and have been mapped onto the S&P scale.

	RMBS (1)											
	Government sponsored or similar (2)		Non-Prime conforming		MBS covered CMBS CDOs CLOs				ABS covered		Other ABS	Total
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m		
2011												
AAA	4,169	3,599	1,488	105	2,595	647	135	2,171	625	1,622	17,156	
AA to AA+	29,252	669	106	60	379	710	35	1,533	321	550	33,615	
A to AA-	131	506	110	104	2,567	1,230	161	697	100	725	6,331	
BBB- to A-	—	39	288	93	1,979	333	86	341	—	1,321	4,480	
Non-investment grade	21	784	658	396	—	415	1,370	176	—	672	4,492	
Unrated	—	148	29	146	—	56	170	423	—	263	1,235	
	33,573	5,745	2,679	904	7,520	3,391	1,957	5,341	1,046	5,153	67,309	
2010												
AAA	28,835	4,355	1,754	317	7,107	2,789	444	2,490	988	2,156	51,235	
AA to AA+	1,529	147	144	116	357	392	567	1,786	681	616	6,335	
A to AA-	—	67	60	212	408	973	296	343	192	693	3,244	
BBB- to A-	—	82	316	39	—	500	203	527	—	1,718	3,385	
Non-investment grade	—	900	809	458	—	296	1,863	332	—	265	4,923	
Unrated	—	196	52	76	—	—	85	596	—	698	1,703	
	30,364	5,747	3,135	1,218	7,872	4,950	3,458	6,074	1,861	6,146	70,825	
2009												
AAA	33,779	9,211	1,981	578	8,645	3,441	615	2,718	1,933	2,166	65,067	
AA to AA+	125	676	197	121	360	599	944	4,365	267	1,288	8,942	
A to AA-	—	507	109	306	67	1,022	254	607	—	1,014	3,886	
BBB- to A-	—	547	160	87	—	298	944	260	—	1,947	4,243	
Non-investment grade	—	558	594	579	—	147	849	636	—	152	3,515	
Unrated	—	1	2	153	—	2	262	730	—	799	1,949	
	33,904	11,500	3,043	1,824	9,072	5,509	3,868	9,316	2,200	7,366	87,602	

Notes:

- (1) Residential mortgage-backed securities.
- (2) Includes US agency and Dutch government guaranteed securities.
- (3) Commercial mortgage-backed securities.
- (4) Collateralised debt obligations.
- (5) Collateralised loan obligations.

Key points

- Carrying value of total ABS decreased by £3.5 billion during 2011. US government sponsored RMBS increased by £3.6 billion, reflecting a move towards G10 governments generally, partially off-set by decrease in European exposure. There were reductions across all other portfolios.
- The decrease in AAA rated debt securities mainly relates to the downgrading of US government and agencies to AA+ by S&P during the year.
- CDOs and CLOs decreased by £2.2 billion principally reflecting asset reductions in Non-Core.
- The decrease in CMBS of £1.6 billion, primarily reflecting restructuring of certain monoline exposures.
- The average mark of total ABS was 83%, broadly the same as 2010 and 2009.

## Non-investment grade and unrated ABS

The table below summarises the carrying values by accounting classification of non-investment grade or not publicly rated ABS.

	Non-investment grade				Unrated			
	HFT	AFS	LAR	Total	HFT	AFS	LAR	Total
	£m	£m	£m	£m	£m	£m	£m	£m
2011								
RMBS: G10 governments	—	21	—	21	—	—	—	—
RMBS: prime	312	417	54	783	148	—	—	148
RMBS: non-conforming	279	372	7	658	28	—	—	28
RMBS: sub-prime	387	9	—	396	146	—	—	146
CMBS	307	10	98	415	56	—	—	56
CDOs	116	1,215	40	1,371	130	40	—	170
CLOs	131	—	44	175	284	139	—	423
Other ABS	150	12	511	673	12	70	182	264
	1,682	2,056	754	4,492	804	249	182	1,235
2010								
RMBS: prime	354	535	11	900	196	—	—	196
RMBS: non-conforming	389	414	6	809	52	—	—	52
RMBS: sub-prime	437	21	—	458	76	—	—	76
CMBS	198	17	81	296	—	—	—	—
CDOs	691	1,151	21	1,863	85	—	—	85
CLOs	239	5	88	332	267	329	—	596
Other ABS	148	17	100	265	191	162	345	698
	2,456	2,160	307	4,923	867	491	345	1,703
2009								
RMBS: prime	120	430	8	558	—	1	—	1
RMBS: non-conforming	253	341	—	594	—	2	—	2
RMBS: sub-prime	339	240	—	579	153	—	—	153
CMBS	89	3	55	147	1	—	1	2
CDOs	487	300	62	849	143	119	—	262
CLOs	269	359	8	636	207	523	—	730
Other ABS	78	63	11	152	270	134	395	799
	1,635	1,736	144	3,515	774	779	396	1,949

Business review [Risk and balance sheet management continued](#)

Risk management: Credit risk continued

Balance sheet analysis continued

## Residential mortgage-backed securities

RMBS are securities that represent an interest in a portfolio of residential mortgages. Repayments made on the underlying mortgages are used to make payments to holders of the RMBS. The risk of the RMBS will vary primarily depending on the quality and geographic region in which the underlying mortgage assets are located and the credit enhancement of the securitisation structure. Several tranches of notes are issued, each secured against the same portfolio of mortgages, but providing differing levels of seniority to match the risk appetite of investors. The most junior (or equity) notes will suffer early capital and interest losses experienced by the referenced mortgage collateral, with each more senior note benefiting from the protection provided by the subordinated notes below. Additional credit enhancements may be provided to the holder of senior RMBS notes, including provided by monoline insurers.

The main categories of mortgages that serve as collateral to RMBS held by the Group with related vintages are set out below and described in the Glossary on pages 440 to 447. The US market has more established definitions of differing underlying mortgage quality and these are used as the basis for the Group's RMBS categorisation.

The Group classifies RMBS as sub-prime or Alt-A based on industry standard criteria, including Fair Isaac Corporation scores (FICO), level of documentation and loan-to-value (LTV) ratios of the underlying mortgage loans. RMBS are classified as sub-prime if the mortgage portfolio comprises loans with FICO scores between 500 and 650 with full or limited documentation. Mortgages in Alt-A RMBS portfolios have FICO scores of 640 to 720, limited documentation and an original LTV of 70% to 95%. The FICO score is the determining factor in the classification of the Group's RMBS as sub-prime or Alt-A.

The table below analyses the vintage of the Group's carrying value of RMBS portfolios by geography and classification.

	By geography				Total	By classification				
	US	UK	Other	RoW		Government sponsored	Covered bond	Prime	conforming	Non-Sub-prime
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
2011										
2004 and earlier	2,435	56	1,054	42	3,587	2,344	622	428	80	113
2005	1,661	161	3,262	26	5,110	1,652	2,333	539	382	204
2006	575	1,407	4,944	97	7,023	1,681	3,272	1,224	628	218
2007	1,540	2,689	3,874	36	8,139	3,588	1,293	1,560	1,482	216
2008	1,154	24	373	127	1,678	1,428	—	173	75	2
2009	1,364	58	7	1	1,430	1,209	—	163	7	51
2010 and later	21,858	893	562	141	23,454	21,671	—	1,658	25	100
	30,587	5,288	14,076	470	50,421	33,573	7,520	5,745	2,679	904
2010										
2004 and earlier	4,405	175	1,057	50	5,687	4,148	641	678	90	130
2005	2,579	176	3,435	28	6,218	2,379	2,410	634	567	228
2006	1,082	2,249	5,460	121	8,912	2,106	3,451	2,129	736	490
2007	2,576	2,370	4,135	33	9,114	4,774	1,352	1,280	1,477	231

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2008	2,314	58	420	155	2,947	2,598	18	223	104	4
2009 and later	14,922	410	116	10	15,458	14,359	—	803	161	135
	27,878	5,438	14,623	397	48,336	30,364	7,872	5,747	3,135	1,218
2009										
2004 and earlier	8,504	293	1,760	33	10,590	7,951	752	1,460	99	328
2005	4,221	783	4,252	74	9,330	3,801	2,582	2,173	510	264
2006	1,847	3,116	7,449	216	12,628	2,691	4,135	4,514	690	598
2007	1,844	2,957	5,916	60	10,777	4,394	1,585	2,842	1,529	427
2008 and later	15,249	10	510	249	16,018	15,067	18	511	215	207
	31,665	7,159	19,887	632	59,343	33,904	9,072	11,500	3,043	1,824

## Derivatives

The Group's derivative assets by internal asset quality rating and residual maturity are analysed below. Master netting arrangements in respect of mark-to-market (mtm) positions and collateral shown below do not result in a net presentation on the Group's balance sheet under IFRS.

	2011						2010						2009
	0-3	3-6	6-12	1-5	Over 5	Total	0-3	3-6	6-12	1-5	Over 5	Total	
	months	months	months	years	years		months	months	months	years	years		
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
AQ1	24,580	10,957	17,180	126,105	302,800	481,622	30,840	10,755	17,554	135,311	214,029	408,489	389,019
AQ2	326	236	431	2,046	5,138	8,177	319	105	212	1,561	462	2,659	11,550
AQ3	975	390	459	2,811	6,184	10,819	1,284	391	626	610	406	3,317	10,791
AQ4	1,465	782	713	4,093	7,368	14,421	989	155	240	1,726	281	3,391	8,290
AQ5	890	93	219	1,787	3,527	6,516	1,016	81	201	1,447	2,115	4,860	8,270
AQ6	121	30	81	803	1,186	2,221	134	46	71	653	166	1,070	2,548
AQ7	101	29	56	1,674	533	2,393	150	29	44	375	259	857	2,181
AQ8	16	21	11	143	1,061	1,252	2	1	10	118	272	403	1,448
AQ9	5	8	7	254	876	1,150	104	8	39	110	189	450	2,030
AQ10	13	20	35	658	321	1,047	170	11	52	353	995	1,581	2,020
Accruing past due	—	—	—	—	—	—	—	—	—	—	—	—	40
	28,492	12,566	19,192	140,374	328,994	529,618	35,008	11,582	19,049	142,264	219,174	427,077	438,199
RFS MI						—							3,255
Group						529,618						427,077	441,454
Counterparty mtm netting						(441,626)						(330,397)	(358,917)
Cash collateral held against derivative exposures (1)						(37,222)						(31,096)	(33,667)
Net exposure						50,770						65,584	48,870

At 31 December 2011 the Group also held collateral in the form of securities of £5.3 billion (2010 - £2.9 billion; 2009 - £3.6 billion).

Contract type	2011			2010			2009		
	Notional £bn	Assets £m	Liabilities £m	Notional £bn	Assets £m	Liabilities £m	Notional £bn	Assets £m	Liabilities £m
Interest rate	38,722	422,156	406,709	39,760	311,731	299,209	43,230	323,592	311,415
Exchange rate	4,479	74,492	80,980	4,854	83,253	89,375	3,842	69,283	63,919
Credit derivatives	1,054	26,836	26,743	1,357	26,872	25,344	1,621	41,748	39,127
Equity and commodity	123	6,134	9,551	179	5,221	10,039	188	6,831	9,680
		529,618	523,983		427,077	423,967		441,454	424,141

## Key points

- Net exposure, after taking account of position and collateral netting arrangements, declined by 23% despite an increase in derivative carrying values, primarily due to the increased use of netting arrangements.

-



Interest rate contracts increased due to continued reductions in interest rate yields and the depreciation of sterling against the US dollar. This was partially offset by the appreciation of sterling against the euro.

- Exchange rate contracts decreased due to a reduction in trade volumes and the appreciation of sterling against the euro. This was partially offset by the depreciation of sterling against the US dollar.
- Credit derivatives remained flat as the increase from the widening of credit spreads and the depreciation of sterling against the US dollar was offset by a reduction in trade volume.

Business review [Risk and balance sheet management continued](#)

## Risk management: Credit risk continued

## Balance sheet analysis: Derivatives continued

The tables below analyse the Group's derivative assets by contract type and residual maturity and the effect of position netting and collateral.

	0-3 months	3-6 months	6-12 months	1-5 years	Over 5 years	Total	Counterparty mtm netting	Net exposure
	£m	£m	£m	£m	£m	£m	£m	£m
2011								
Exchange rate	23,838	8,434	9,766	19,176	13,278	74,492	(57,511)	16,981
Interest rate	3,977	3,197	7,672	102,163	305,147	422,156	(356,325)	65,831
Credit derivatives	135	332	626	15,675	10,068	26,836	(23,980)	2,856
Equity and commodity	542	603	1,128	3,360	501	6,134	(3,810)	2,324
	28,492	12,566	19,192	140,374	328,994	529,618	(441,626)	87,992
Cash collateral held against derivative exposures (1)								(37,222)
Net exposure								50,770
2010								
Exchange rate	28,938	7,820	9,360	23,174	13,961	83,253	(69,509)	13,744
Interest rate	4,822	3,533	7,927	104,026	191,423	311,731	(236,513)	75,218
Credit derivatives	497	99	313	12,374	13,589	26,872	(22,728)	4,144
Equity and commodity	751	130	1,449	2,690	201	5,221	(1,647)	3,574
	35,008	11,582	19,049	142,264	219,174	427,077	(330,397)	96,680
Cash collateral held against derivative exposures (1)								(31,096)
Net exposure								65,584
2009								
Exchange rate	19,127	5,824	7,603	23,831	11,967	68,352	(47,885)	20,467
Interest rate	8,415	8,380	16,723	111,144	176,799	321,461	(270,791)	50,670
Credit derivatives	201	112	390	19,859	21,186	41,748	(36,411)	5,337
Equity and commodity	1,562	436	1,109	3,057	474	6,638	(3,830)	2,808
	29,305	14,752	25,825	157,891	210,426	438,199	(358,917)	79,282
RFS MI						3,255	—	3,255
Group						441,454	(358,917)	82,537
Cash collateral held against derivative exposures (1)								(33,667)
Net exposure								48,870

## Note:

(1) At 31 December 2011, in addition to cash collateral the Group holds collateral in the form of securities of £5.3 billion (2010 - £2.9 billion; 2009 - £3.6 billion) against derivative positions.



## Credit derivatives

The Group trades credit derivatives as part of its client led business and to mitigate credit risk. The Group's credit derivative exposures relating to proprietary trading are minimal. The table below analyses the Group's bought and sold protection.

	2011				2010			
	Notional		Fair value		Notional		Fair value	
	Bought £bn	Sold £bn	Bought £bn	Sold £bn	Bought £bn	Sold £bn	Bought £bn	Sold £bn
Client-led trading and residual risk	401.0	390.5	17.0	16.5	386.7	362.5	8.4	6.7
Credit hedging - banking book (1)	15.6	4.7	0.1	0.1	16.3	21.8	—	0.1
Credit hedging - trading book								
- Rates	21.2	17.1	0.9	1.7	21.9	10.4	(0.9)	0.2
- Credit and mortgage markets	42.9	28.4	2.3	1.7	168.1	172.7	3.5	3.1
- Other	0.9	0.1	—	—	0.7	0.1	—	—
Total excluding APS	481.6	440.8	20.3	20.0	593.7	567.5	11.0	10.1
APS	131.8	—	(0.2)	—	195.8	—	0.6	—
	613.4	440.8	20.1	20.0	789.5	567.5	11.6	10.1
Core								
Client-led trading	371.0	369.4	14.6	14.0	347.5	343.0	5.2	4.4
Credit hedging - banking book	2.2	1.0	—	0.1	1.1	1.0	(0.2)	—
Credit hedging - trading book								
- Rates	19.9	16.2	0.9	1.7	21.7	10.3	(0.8)	0.2
- Credit and mortgage markets	4.6	4.0	0.3	0.2	4.4	4.3	0.2	0.3
- Other	0.7	0.1	—	—	0.6	0.1	—	—
	398.4	390.7	15.8	16.0	375.3	358.7	4.4	4.9
Non-Core								
Residual risk	30.0	21.1	2.4	2.5	39.2	19.5	3.2	2.3
Credit hedging - banking book	13.4	3.7	0.1	—	15.2	20.8	0.2	0.1
Credit hedging - trading book								
- Rates	1.3	0.9	—	—	0.2	0.1	(0.1)	—
- Credit and mortgage markets	38.3	24.4	2.0	1.5	163.7	168.4	3.3	2.8
- Other	0.2	—	—	—	0.1	—	—	—
	83.2	50.1	4.5	4.0	218.4	208.8	6.6	5.2

The table below analyses the Group's credit derivative bought and sold, by counterparty

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Counterparty								
Central and local government - APS	131.8	—	(0.2)	—	195.8	—	0.6	—
Monoline insurers	8.6	—	0.6	—	14.9	—	1.5	—
CDPCs	24.5	—	0.9	—	25.0	—	0.8	—
Banks	204.1	202.1	8.5	10.2	370.7	370.6	5.0	5.7
Other financial institutions	234.8	231.6	10.5	9.5	176.6	195.0	4.4	4.3
Corporates	9.6	7.1	(0.2)	0.3	6.5	1.9	(0.7)	0.1
	613.4	440.8	20.1	20.0	789.5	567.5	11.6	10.1

Note:

(1) Credit hedging in the banking book principally relates to portfolio management in Non-Core.

Business review [Risk and balance sheet management continued](#)

Risk management: Credit risk continued

Balance sheet analysis continued

## Monoline insurers

The table below summarises the Group's exposure to monolines, all of which are in Non-Core.

	2011	2010	2009
	£m	£m	£m
Gross exposure to monolines	1,888	4,023	6,170
Hedges with financial institutions	(71)	(71)	(531)
Credit valuation adjustment	(1,198)	(2,443)	(3,796)
Net exposure to monolines	619	1,509	1,843
Credit valuation adjustment as a % of gross exposure	63%	61%	62%
Counterparty and credit risk RWAs*	£3.6bn	£17.8bn	£13.7bn

The net income statement effect relating to monoline exposures is detailed below.

	2011	2010	2009
	£m	£m	£m
Credit valuation adjustment at 1 January	(2,443)	(3,796)	(5,988)
Credit valuation adjustment at 31 December	(1,198)	(2,443)	(3,796)
Decrease in credit valuation adjustment	1,245	1,353	2,192
Net debit relating to realisations, hedges, foreign exchange and other movements	(1,878)	(844)	(3,290)
Net credit/(debit) relating to reclassified debt securities	197	(305)	(1,468)
Net (debit)/credit to income statement (1)	(436)	204	(2,566)

Note:

- (1) Comprises the following elements:
- a loss of £670 million (2010 - £5 million; 2009 - £2,387 million) in income from trading activities;
  - impairment (losses)/reversals of £(1) million (2010 - £71 million; 2009 - £(239) million); and
  - other income of £235 million (2010 - £138 million; 2009 - £60 million) relating to reclassified debt securities.

The table below summarises monoline exposures by rating. Credit ratings are based on those from rating agencies S&P and Moody's. Where the ratings differ, the lower of the two is taken.

	Fair value:		Credit		Net	
	Notional: reference protected assets	protected assets	Gross exposure	valuation adjustment	Hedges exposure	exposure
	£m	£m	£m	£m	£m	£m
2011	4,939	4,243	696	252	—	444
A to AA-						

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Non-investment grade	3,623	2,431	1,192	946	71	175
	8,562	6,674	1,888	1,198	71	619
Of which:						
CMBS	946	674	272	247		
CDOs	500	57	443	351		
CLOs	4,616	4,166	450	177		
Other ABS	1,998	1,455	543	334		
Other	502	322	180	89		
	8,562	6,674	1,888	1,198		

\* unaudited

	Fair value:		Gross exposure	Credit valuation adjustment	Hedges	Net exposure
	Notional: reference protected assets	protected assets				
	£m	£m	£m	£m	£m	£m
2010						
A to AA- Non-investment grade	6,336	5,503	833	272	—	561
	8,555	5,365	3,190	2,171	71	948
	14,891	10,868	4,023	2,443	71	1,509
Of which:						
CMBS	4,149	2,424	1,725	1,253		
CDOs	1,133	256	877	593		
CLOs	6,724	6,121	603	210		
Other ABS	2,393	1,779	614	294		
Other	492	288	204	93		
	14,891	10,868	4,023	2,443		
2009						
A to AA- Non-investment grade	7,143	5,875	1,268	378	—	890
	12,598	7,696	4,902	3,418	531	953
	19,741	13,571	6,170	3,796	531	1,843
Of which:						
CMBS	4,253	2,034	2,219	1,562		
CDOs	2,284	797	1,487	1,059		
CLOs	10,007	8,584	1,423	641		
Other ABS	2,688	1,861	827	412		
Other	509	295	214	122		
	19,741	13,571	6,170	3,796		

#### Key points

- The exposure to monolines declined during the year, primarily due to the restructuring of some exposures, partially offset by lower prices of underlying reference instruments.
- The CVA decreased in line with the reduction in exposure partially offset by the impact of wider credit spreads.
- The reduction in the Group's RWA requirements was driven by the decrease in exposure to monolines.\*

A number of debt instruments with monoline protection were reclassified from HFT to AFS in 2008. Changes in the fair value of these securities since the reclassification are recognised in the income statement to the extent that they are considered to be impaired. Changes in the fair value of the related monoline CDSs continue to be recorded in the income statement.

The fair value of these reclassified debt securities at 31 December 2011 was £4,453 million (1 July 2008 - £5,071 million after adjusting for both principal based cash flows and foreign exchange effects between 1 July 2008 and 31 December 2011). As a result of these reclassifications, total cumulative losses of £254 million have not been recognised in the income statement.





Business review [Risk and balance sheet management continued](#)

## Risk management: Credit risk continued

## Balance sheet analysis continued

The Group also has indirect exposures to monoline insurers through wrapped securities and other assets with credit enhancement from monoline insurers. These securities are traded with the benefit of this credit enhancement. Any deterioration in the credit rating of the monoline is reflected in the fair value of these assets.

## Credit derivative product companies (CDPCs)

A summary of the Group's exposure to CDPCs, all of which are in Non-Core, is detailed below.

	2011	2010	2009
	£m	£m	£m
Gross exposure to CDPCs	1,896	1,244	1,275
Credit valuation adjustment	(1,034)	(490)	(499)
Net exposure to CDPCs	862	754	776
Credit valuation adjustment as a % of gross exposure	55%	39%	39%
Counterparty and credit risk RWAs*	£8.4bn	£7.2bn	£7.5bn
Capital deductions	£245m	£280m	£347m

The table below details CDPC exposures by rating.

	Fair value:				
	Notional: protected assets	reference protected assets	Gross exposure	Credit valuation adjustment	Net exposure
	£m	£m	£m	£m	£m
2011					
AAA	213	212	1	—	1
A to AA-	646	632	14	3	11
Non-investment grade	19,671	18,151	1,520	788	732
Unrated	3,974	3,613	361	243	118
	24,504	22,608	1,896	1,034	862
2010					
AAA	213	212	1	—	1
A to AA-	644	629	15	4	11
Non-investment grade	20,066	19,050	1,016	401	615
Unrated	4,165	3,953	212	85	127
	25,088	23,844	1,244	490	754
2009					
AAA	1,658	1,637	21	5	16
BBB- to A-	1,070	1,043	27	9	18
Non-investment grade	17,696	16,742	954	377	577
Unrated	3,926	3,653	273	108	165
	24,350	23,075	1,275	499	776

The table below details the net income statement effect arising from CDPC exposures.

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	2011	2010	2009
	£m	£m	£m
Credit valuation adjustment at 1 January	(490)	(499)	(1,311)
Credit valuation adjustment at 31 December	(1,034)	(490)	(499)
(Increase)/decrease in credit valuation adjustment	(544)	9	812
Net credit/(debit) relating to realisations, hedges, foreign exchange and other movements	459	(150)	(1,769)
Loss from trading activities	(85)	(141)	(957)

Key points

- The exposure to CDPCs has increased during the year. This was primarily driven by wider credit spreads of the underlying reference loans and bonds.
- The CVA increased in line with the increase in exposure.
- Counterparty and credit RWAs increased in line with the increase in the exposure.\*

\* unaudited

## Other counterparties

The net income statement effect arising from the change in the level of credit valuation adjustments (CVA) for all other counterparties and related trades is shown in the table below.

	2011	2010	2009
	£m	£m	£m
Credit valuation adjustment at 1 January	(1,714)	(1,588)	(1,738)
Credit valuation adjustment at 31 December	(2,254)	(1,714)	(1,588)
(Increase)/decrease in credit valuation adjustment	(540)	(126)	150
Net credit/(debit) relating to realisations, hedges, foreign exchange and other movements	244	(19)	(841)
Loss from trading activities	(296)	(145)	(691)

## Key point

- The CVA held against exposures to other counterparties increased during the year, primarily due to wider credit spreads.

## Risk elements in lending, provisions and reserves

Risk elements in lending (REIL) comprises impaired loans and accruing loans past due 90 days or more as to principal or interest.

Impaired loans are all loans for which an impairment provision has been established; for collectively assessed loans, impairment loss provisions are not allocated to individual loans and the entire portfolio is included in impaired loans.

Loans are classified as accruing loans past due 90 days or more where they are past due 90 days but where no impairment provision is recognised. This category is used for fully collateralised non revolving credit facilities.

	2011			2010			2009	
	Core £m	Non-Core £m	Total £m	Core £m	Non-Core £m	Total £m	Group before RFS MI £m	Total £m
Impaired loans								
- UK	8,291	7,284	15,575	8,575	7,835	16,410	13,869	13,872
- overseas	7,015	16,157	23,172	4,936	14,355	19,291	17,942	21,153
	15,306	23,441	38,747	13,511	22,190	35,701	31,811	35,025
Accruing loans past due 90 days or more								
- UK	1,192	508	1,700	1,434	939	2,373	2,235	2,235
- overseas	364	34	398	262	262	524	943	989
	1,556	542	2,098	1,696	1,201	2,897	3,178	3,224
Total REIL	16,862	23,983	40,845	15,207	23,391	38,598	34,989	38,249
REIL as a % of gross loans and advances (1)	4.4%	30.1%	8.6%	3.7%	20.8%	7.3%	6.1%	5.4%
	50%	48%	49%	52%	44%	47%	44%	46%

Closing provision for  
impairment as a  
% of total REIL (1)

Note:

(1) Includes assets of disposal groups and loans excluding reverse repos.

Potential problem loans

Potential problem loans (PPL) are loans for which an impairment event has taken place but no impairment provision is required. This category is used for fully collateralised advances which are not past due 90 days or revolving credit facilities where identification as 90 days overdue is not feasible.

	2011	2010	2009
	£m	£m	£m
Potential problem loans	739	633	1,009

Both REIL and PPL are reported gross and take no account of the value of any security held which could reduce the eventual loss should it occur, nor of any provision marked. Therefore impaired assets which are highly collateralised, such as mortgages, will have a low coverage ratio of provisions held against the reported impaired balance.

Business review [Risk and balance sheet management continued](#)

Risk management: Credit risk continued

Balance sheet analysis: REIL, provisions and reserves continued

## REIL by division

The tables below analyse loans and advances (excluding reverse repos and disposal groups) and related REIL, provisions, impairments, amounts written-off and coverage ratios by division.

	Gross loans to banks	Gross loans to customer	REIL	Provisions	REIL as a % of gross customer loans	Provisions as a % of REIL	Impairment charge	Amounts written-off
	£m	£m	£m	£m	%	%	£m	£m
2011								
UK Retail	628	103,377	4,087	2,344	4.0	57	788	823
UK Corporate	806	98,563	3,988	1,623	4.0	41	790	658
Wealth	2,422	16,913	211	81	1.2	38	25	11
International Banking	3,411	57,728	1,632	851	2.8	52	168	125
Ulster Bank	2,079	34,052	5,523	2,749	16.2	50	1,384	124
US Retail & Commercial	208	51,562	1,007	455	2.0	45	248	373
Retail & Commercial	9,554	362,195	16,448	8,103	4.5	49	3,403	2,114
Markets	29,991	31,490	414	311	1.3	75	—	23
Direct Line Group	3,829	929	—	—	—	—	—	—
Core	43,374	394,614	16,862	8,414	4.3	50	3,403	2,137
Non-Core	619	79,258	23,983	11,469	30.3	48	3,838	2,390
Group before RFS MI	43,993	473,872	40,845	19,883	8.6	49	7,241	4,527
RFS MI	—	—	—	—	—	—	(8)	—
Group	43,993	473,872	40,845	19,883	8.6	49	7,233	4,527
2010								
UK Retail	408	108,405	4,620	2,741	4.3	59	1,160	1,135
UK Corporate	126	113,782	3,981	1,746	3.5	44	768	357
Wealth	2,220	16,130	223	66	1.4	30	18	9
International Banking	3,982	62,922	1,484	855	2.4	58	125	92
Ulster Bank	2,928	36,858	3,619	1,633	9.8	45	1,161	48
US Retail & Commercial	145	48,602	914	509	1.9	56	485	550
Retail & Commercial	9,809	386,699	14,841	7,550	3.8	51	3,717	2,191
Markets	45,084	25,300	366	316	1.4	86	20	33
Direct Line Group	2,140	601	—	—	—	—	—	—
Core	57,033	412,600	15,207	7,866	3.7	52	3,737	2,224
Non-Core	1,003	108,203	23,391	10,316	21.6	44	5,407	3,818
Group before RFS MI	58,036	520,803	38,598	18,182	7.4	47	9,144	6,042
RFS MI	2	—	—	—	—	—	42	—
Group	58,038	520,803	38,598	18,182	7.4	47	9,186	6,042
2009								
UK Retail	818	102,994	4,641	2,677	4.5	58	1,679	1,150

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UK Corporate Wealth	131	112,995	2,345	1,287	2.1	55	931	358
International Banking	1,738	66,250	995	1,139	1.5	114	417	92
Ulster Bank	2,637	39,707	2,260	962	5.7	43	649	34
US Retail & Commercial	30	48,974	644	482	1.3	75	705	550
Retail & Commercial Markets	7,195	384,604	11,103	6,602	2.9	59	4,414	2,196
Markets	38,487	37,048	986	319	2.7	32	153	90
Direct Line Group	1,892	755	—	—	—	—	—	—
Core	47,574	422,407	12,089	6,921	2.9	57	4,567	2,286
Non-Core	1,360	147,263	22,900	8,252	15.6	36	8,523	4,192
Group before RFS MI	48,934	569,670	34,989	15,173	6.1	43	13,090	6,478
RFS MI	7,879	134,809	3,260	2,110	2.4	65	1,044	461
Group	56,813	704,479	38,249	17,283	5.4	45	14,134	6,939

## Movement in REIL

The table below details the movement in REIL during the year ended 31 December 2011.

	Impaired loans			Other loans (1)			REIL		
	Core £m	Non-Core £m	Total £m	Core £m	Non-Core £m	Total £m	Core £m	Non-Core £m	Total £m
At 1 January 2011	13,511	22,190	35,701	1,696	1,201	2,897	15,207	23,391	38,598
Transfers to disposal groups	(1,287)	—	(1,287)	(238)	—	(238)	(1,525)	—	(1,525)
Intra-group transfers	300	(300)	—	149	(149)	—	449	(449)	—
Currency translation and other adjustments	(158)	(496)	(654)	(14)	—	(14)	(172)	(496)	(668)
Additions	8,379	8,698	17,077	2,585	1,059	3,644	10,964	9,757	20,721
Transfers	645	381	1,026	(362)	(352)	(714)	283	29	312
Disposals and restructurings	(407)	(1,470)	(1,877)	(9)	(97)	(106)	(416)	(1,567)	(1,983)
Repayments	(3,540)	(3,172)	(6,712)	(2,251)	(1,120)	(3,371)	(5,791)	(4,292)	(10,083)
Amounts written-off	(2,137)	(2,390)	(4,527)	—	—	—	(2,137)	(2,390)	(4,527)
At 31 December 2011	15,306	23,441	38,747	1,556	542	2,098	16,862	23,983	40,845

Note:

(1) Accruing loans past due 90 days or more (also see table below).

## Key points

- REIL increased by £2.2 billion in the year. REIL at 31 December 2011 excludes £1.5 billion (impaired loans £1.3 billion; accruing loans £0.2 billion) in relation to the UK branch-based businesses being sold to Santander UK plc, of which £1.0 billion was in UK Corporate and £0.5 billion in UK Retail.
- Ulster Bank Group's non-performing loans increased significantly by £3.5 billion (Core - £1.9 billion; Non-Core - £1.6 billion). This principally related to residential mortgages (£0.6 billion, 39% increase) and commercial real estate (£2.4 billion, 25% increase), reflecting the continued deterioration in the property sectors in Ireland. The Non-Core REIL increase related to Ulster Bank was partially offset by run off in other Non-Core donating divisions in the year.

## Past due analysis

The table below shows loans and advances to customers that were past due at the balance sheet date but are not considered impaired.

	2011			2010			2009 Group before	
	Core £m	Non-Core £m	Total £m	Core £m	Non-Core £m	Total £m	RFS £m	MI £m
Past due 1-29 days	5,518	724	6,242	6,401	822	7,223	6,587	7,796



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Past due 30-59 days	1,472	171	1,643	1,725	392	2,117	2,300	2,724
Past due 60-89 days	907	107	1,014	922	271	1,193	2,410	2,587
Past due 90 days or more	1,556	542	2,098	1,696	1,201	2,897	3,178	3,224
	9,453	1,544	10,997	10,744	2,686	13,430	14,475	16,331

Business review [Risk and balance sheet management continued](#)

Risk management: Credit risk continued

Balance sheet analysis: REIL, provisions and reserves continued

Loans, REIL and impairments by sector and geographical region

The tables below analyse gross loans and advances (excluding reverse repos and disposal groups), and related REIL, provisions, impairment charges and amounts written-off, by sector and geographical region (by location of lending office).

	Gross loans £m	REIL £m	Provisions £m	Total REIL		Provisions		Impairment charge £m	Amounts written-off £m
				as a % of gross loans %	as a % of Provisions of REIL %	as a % of gross loans %			
2011									
Central and local government	9,742	—	—	—	—	—	—	—	—
Finance									
- banks	43,993	137	123	0.3	90	0.3	—	—	—
- other	49,681	1,049	719	2.1	69	1.4	89	87	
Residential mortgages	143,611	5,084	1,362	3.5	27	0.9	1,076	516	
Personal lending	32,623	2,737	2,172	8.4	79	6.7	782	1,286	
Property	76,768	21,655	8,862	28.2	41	11.5	3,670	1,171	
Construction	9,453	1,762	703	18.6	40	7.4	139	244	
Manufacturing	28,132	881	504	3.1	57	1.8	227	215	
Service industries and business activities									
- retail, wholesale and repairs	23,653	1,007	516	4.3	51	2.2	180	172	
- transport and storage	21,931	589	146	2.7	25	0.7	78	43	
- health, education and recreation	14,692	1,077	458	7.3	43	3.1	304	98	
- hotels and restaurants	8,304	1,437	643	17.3	45	7.7	334	131	
- utilities	8,392	88	23	1.0	26	0.3	3	3	
- other	28,000	2,403	1,095	8.6	46	3.9	799	373	
Agriculture, forestry and fishing	3,600	145	63	4.0	43	1.8	(7)	18	
Finance leases and instalment credit	14,499	794	508	5.5	64	3.5	112	170	
Interest accruals	791	—	—	—	—	—	—	—	
Latent	—	—	1,986	—	—	—	(545)	—	
	517,865	40,845	19,883	7.9	49	3.8	7,241	4,527	
of which:									
UK									
- residential mortgages	100,726	2,076	397	2.1	19	0.4	180	25	
- personal lending	20,207	2,384	1,925	11.8	81	9.5	645	1,007	
- property	55,751	7,880	2,859	14.1	36	5.1	1,413	490	
- other	162,220	4,935	3,040	3.0	62	1.9	699	886	
Europe									

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- residential mortgages	18,946	2,205	713	11.6	32	3.8	467	10
- personal lending	2,464	209	180	8.5	86	7.3	25	126
- property	16,384	13,073	5,751	79.8	44	35.1	2,296	508
- other	44,862	5,192	3,206	11.6	62	7.1	1,205	289
US								
- residential mortgages	23,237	770	240	3.3	31	1.0	426	481
- personal lending	8,441	143	66	1.7	46	0.8	112	153
- property	3,783	329	92	8.7	28	2.4	(2)	138
- other	38,158	656	913	1.7	139	2.4	(166)	197
RoW								
- residential mortgages	702	33	12	4.7	36	1.7	3	—
- personal lending	1,511	1	1	0.1	100	0.1	—	—
- property	850	373	160	43.9	43	18.8	(37)	35
- other	19,623	586	328	3.0	56	1.7	(25)	182
Group before RFS MI	517,865	40,845	19,883	7.9	49	3.8	7,241	4,527
RFS MI							(8)	—
Group	517,865	40,845	19,883	7.9	49	3.8	7,233	4,527

	Gross loans £m	REIL £m	Provisions £m	Total REIL as a % of Provisions		Provisions as a % of gross Impairment		Amounts written-off £m
				gross loans %	as a % of REIL %	gross loans %	charge £m	
2010								
Central and local government Finance	8,452	—	—	—	—	—	—	—
- banks	58,036	145	127	0.2	88	0.2	(13)	12
- other	54,561	1,129	595	2.1	53	1.1	198	141
Residential mortgages	146,501	4,276	877	2.9	21	0.6	1,014	669
Personal lending	37,472	3,544	2,894	9.5	82	7.7	1,370	1,577
Property	90,106	19,584	6,736	21.7	34	7.5	4,682	1,009
Construction	12,032	2,464	875	20.5	36	7.3	530	146
Manufacturing	32,317	1,199	503	3.7	42	1.6	(92)	1,547
Service industries and business activities								
- retail, wholesale and repairs	25,165	1,157	572	4.6	49	2.3	334	161
- transport and storage	24,141	248	118	1.0	48	0.5	87	39
- health, education and recreation	19,321	1,055	319	5.5	30	1.7	159	199
- hotels and restaurants	9,681	1,269	504	13.1	40	5.2	321	106
- utilities	9,208	91	23	1.0	25	0.2	14	7
- other	29,994	1,438	749	4.8	52	2.5	378	310
Agriculture, forestry and fishing	3,893	152	86	3.9	57	2.2	31	6
Finance leases and instalment credit	16,850	847	554	5.0	65	3.3	252	113
Interest accruals	1,109	—	—	—	—	—	—	—
Latent	—	—	2,650	—	—	—	(121)	—
	578,839	38,598	18,182	6.7	47	3.1	9,144	6,042
of which:								
UK								
- residential mortgages	101,593	2,062	314	2.0	15	0.3	169	17
- personal lending	23,620	3,083	2,518	13.1	82	10.7	1,046	1,153
- property	65,462	7,986	2,219	12.2	28	3.4	1,546	397
- other	191,934	5,652	3,580	2.9	63	1.9	1,197	704
Europe								
- residential mortgages	20,094	1,551	301	7.7	19	1.5	221	6
- personal lending	2,870	401	316	14.0	79	11.0	66	24
- property	17,775	10,534	4,199	59.3	40	23.6	2,828	210
- other	53,380	3,950	2,454	7.4	62	4.6	763	1,423
US								
- residential mortgages	24,201	640	253	2.6	40	1.0	615	645
- personal lending	9,520	55	55	0.6	100	0.6	160	271
- property	4,929	765	202	15.5	26	4.1	321	220

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- other	36,780	870	1,133	2.4	130	3.1	(76)	524
RoW								
- residential mortgages	613	23	9	3.8	39	1.5	9	1
- personal lending	1,462	5	5	0.3	100	0.3	98	129
- property	1,940	299	116	15.4	39	6.0	(13)	182
- other	22,666	722	508	3.2	70	2.2	194	136
Group before RFS MI	578,839	38,598	18,182	6.7	47	3.1	9,144	6,042
RFS MI	2	—	—	—	—	—	42	—
Group	578,841	38,598	18,182	6.7	47	3.1	9,186	6,042

Business review [Risk and balance sheet management continued](#)

Risk management: Credit risk continued

Balance sheet analysis: REIL, provisions and reserves continued

	Gross loans £m	REIL £m	Provisions £m	Total REIL as a % of Provisions		Provisions as a % of gross Impairment		Amounts written-off £m
				gross loans %	as a % of REIL %	gross loans %	charge £m	
2009								
Central and local government	7,660	—	—	—	—	—	—	—
Finance								
- banks	48,934	206	157	0.4	76	0.3	34	—
- other	60,386	1,539	419	2.5	27	0.7	886	692
Residential mortgages	140,907	3,284	551	2.3	17	0.4	909	642
Personal lending	41,671	3,940	2,926	9.5	74	7.0	2,517	2,002
Property	99,426	14,318	3,422	14.4	24	3.4	3,296	650
Construction	14,760	2,232	519	15.1	23	3.5	479	287
Manufacturing	44,674	3,131	2,088	7.0	67	4.7	1,520	784
Service industries and business activities	134,076	5,308	1,860	4.0	35	1.4	1,964	1,281
Agriculture, forestry and fishing	4,279	137	73	3.2	53	1.7	30	5
Finance leases and instalment credit	20,103	894	418	4.4	47	2.1	271	135
Interest accruals	1,728	—	—	—	—	—	—	—
Latent	—	—	2,740	—	—	—	1,184	—
	618,604	34,989	15,173	5.7	43	2.5	13,090	6,478
of which:								
UK	394,297	16,104	6,922	4.1	43	1.8	5,593	2,924
Europe	107,803	13,390	5,449	12.4	41	5.1	3,270	427
US	84,072	4,115	2,020	4.9	49	2.4	3,273	2,656
RoW	32,432	1,380	782	4.3	57	2.4	954	471
Group before RFS MI	618,604	34,989	15,173	5.7	43	2.5	13,090	6,478
RFS MI	142,688	3,260	2,110	2.3	65	1.5	1,044	461
Group	761,292	38,249	17,283	5.0	45	2.3	14,134	6,939

	Core							
			REIL		Provisions			
	Gross	REIL	Provisions	as a %	as a %	Provisions	Impairment	Amounts
	loans	Provisions	of	of	of	of	charge	written-off
	£m	£m	£m	gross	REIL	gross	£m	£m
2011				loans	as a %	loans		
				%	%	%		
Central and local government	8,359	—	—	—	—	—	—	—
Finance								
- banks	43,374	136	122	0.3	90	0.3	—	—
- other	46,452	732	572	1.6	78	1.2	207	44
Residential mortgages	138,509	4,704	1,182	3.4	25	0.9	776	198
Personal lending	31,067	2,627	2,080	8.5	79	6.7	715	935
Property	38,704	3,686	1,001	9.5	27	2.6	470	167
Construction	6,781	660	228	9.7	35	3.4	178	143
Manufacturing	23,201	458	221	2.0	48	1.0	106	125
Service industries and business activities								
- retail, wholesale and repairs	21,314	619	312	2.9	50	1.5	208	119
- transport and storage	16,454	325	52	2.0	16	0.3	47	29
- health, education and recreation	13,273	576	213	4.3	37	1.6	170	55
- hotels and restaurants	7,143	952	354	13.3	37	5.0	209	60
- utilities	6,543	22	1	0.3	5	—	—	—
- other	24,228	1,095	591	4.5	54	2.4	553	189
Agriculture, forestry and fishing	3,471	98	36	2.8	37	1.0	(15)	5
Finance leases and instalment credit	8,440	172	110	2.0	64	1.3	31	68
Interest accruals	675	—	—	—	—	—	—	—
Latent	—	—	1,339	—	—	—	(252)	—
	437,988	16,862	8,414	3.8	50	1.9	3,403	2,137
of which:								
UK								
- residential mortgages	99,303	2,024	386	2.0	19	0.4	174	24
- personal lending	20,080	2,347	1,895	11.7	81	9.4	657	828
- property	31,141	2,475	568	7.9	23	1.8	379	113
- other	142,464	2,637	1,536	1.9	58	1.1	525	537
Europe								
- residential mortgages	18,393	2,121	664	11.5	31	3.6	437	10
- personal lending	1,972	143	125	7.3	87	6.3	(8)	22
- property	4,846	1,038	367	21.4	35	7.6	162	11
- other	33,794	2,551	1,891	7.6	74	5.6	928	182
US								
- residential mortgages	20,311	526	120	2.6	23	0.6	162	164
- personal lending	7,505	136	59	1.8	43	0.8	66	85

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- property	2,413	111	24	4.6	22	1.0	16	43
- other	36,054	443	584	1.2	132	1.6	26	101
RoW								
- residential mortgages	502	33	12	6.6	36	2.4	3	—
- personal lending	1,510	1	1	0.1	100	0.1	—	—
- property	304	62	42	20.4	68	13.8	(87)	—
- other	17,396	214	140	1.2	65	0.8	(37)	17
Group before RFS MI	437,988	16,862	8,414	3.8	50	1.9	3,403	2,137



Business review [Risk and balance sheet management continued](#)

Risk management: Credit risk continued

Balance sheet analysis: REIL, provisions and reserves continued

	Gross loans £m	REIL £m	Provisions £m	Core		Impairment charge £m	Amounts written-off £m
				REIL as a % of gross loans %	Provisions as a % of REIL %		
2010							
Central and local government	6,781	—	—	—	—	—	—
Finance							
- banks	57,033	144	126	0.3	88	0.2	1
- other	46,910	567	402	1.2	71	0.9	53
Residential mortgages	140,359	3,999	693	2.8	17	0.5	243
Personal lending	33,581	3,131	2,545	9.3	81	7.6	1,271
Property	42,455	3,287	818	7.7	25	1.9	98
Construction	8,680	610	222	7.0	36	2.6	38
Manufacturing	25,797	555	266	2.2	48	1.0	124
Service industries and business activities							
- retail, wholesale and repairs	21,974	611	259	2.8	42	1.2	103
- transport and storage	15,946	112	40	0.7	36	0.3	35
- health, education and recreation	17,456	507	134	2.9	26	0.8	64
- hotels and restaurants	8,189	741	236	9.0	32	2.9	49
- utilities	7,098	22	3	0.3	14	—	—
- other	24,464	583	276	2.4	47	1.1	98
Agriculture, forestry and fishing	3,758	94	57	2.5	61	1.5	5
Finance leases and instalment credit	8,321	244	140	2.9	57	1.7	42
Interest accruals	831	—	—	—	—	—	—
Latent	—	—	1,649	—	—	—	—
	469,633	15,207	7,866	3.2	52	1.7	2,224
of which:							
UK							
- residential mortgages	99,928	2,010	307	2.0	15	0.3	16
- personal lending	23,035	2,888	2,341	12.5	81	10.2	1,142
- property	34,970	2,454	500	7.0	20	1.4	43
- other	161,746	2,657	1,743	1.6	66	1.1	318
Europe							
- residential mortgages	19,473	1,506	280	7.7	19	1.4	6
- personal lending	2,270	203	164	8.9	81	7.2	19
- property	5,139	631	240	12.3	38	4.7	1
- other	38,992	1,565	1,343	4.0	86	3.4	85

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US								
- residential mortgages	20,548	460	97	2.2	21	0.5	225	221
- personal lending	6,816	35	35	0.5	100	0.5	81	110
- property	1,611	144	43	8.9	30	2.7	84	54
- other	33,110	388	649	1.2	167	2.0	35	171
RoW								
- residential mortgages	410	23	9	5.6	39	2.2	5	—
- personal lending	1,460	5	5	0.3	100	0.3	—	—
- property	735	58	35	7.9	60	4.8	20	—
- other	19,390	180	75	0.9	42	0.4	71	38
Group before RFS MI	469,633	15,207	7,866	3.2	52	1.7	3,737	2,224

	Gross loans £m	REIL £m	Provisions £m	Core		Provisions as a % of gross loans %	Impairment charge £m	Amounts written-off £m
				REIL as a % of gross loans %	Provisions as a % of REIL %			
2009								
Central and local government	6,128	—	—	—	—	—	—	—
Finance								
- banks	47,574	168	135	0.4	80	0.3	12	—
- other	50,673	1,038	259	2.0	25	0.5	256	113
Residential mortgages	127,975	2,670	341	2.1	13	0.3	305	146
Personal lending	35,313	3,344	2,560	9.5	77	7.2	1,816	1,398
Property	49,054	1,766	468	3.6	27	1.0	417	37
Construction	9,502	457	131	4.8	29	1.4	58	30
Manufacturing	30,272	491	191	1.6	39	0.6	136	93
Service industries and business activities	100,438	1,762	669	1.8	38	0.7	500	365
Agriculture, forestry and fishing	3,726	90	46	2.4	51	1.2	24	4
Finance leases and instalment credit	8,147	303	116	3.7	38	1.4	52	100
Interest accruals	1,179	—	—	—	—	—	—	—
Latent	—	—	2,005	—	—	—	991	—
	469,981	12,089	6,921	2.6	57	1.5	4,567	2,286
of which:								
UK	315,254	7,704	4,209	2.4	55	1.3	2,884	1,645
Europe	66,707	2,607	1,709	3.9	66	2.6	750	46
US	64,526	1,497	876	2.3	59	1.4	813	576
RoW	23,494	281	127	1.2	45	0.5	120	19
Group before RFS MI	469,981	12,089	6,921	2.6	57	1.5	4,567	2,286

Business review [Risk and balance sheet management continued](#)

Risk management: Credit risk continued

Balance sheet analysis: REIL, provisions and reserves continued

	Gross loans £m	REIL £m	Provisions £m	Non-Core REIL		Provisions as a % of gross loans %	Impairment charge £m	Amounts written-off £m
				as a % of gross loans %	Provisions as a % of gross loans %			
2011								
Central and local government	1,383	—	—	—	—	—	—	—
Finance								
- banks	619	1	1	0.2	100	0.2	—	—
- other	3,229	317	147	9.8	46	4.6	(118)	43
Residential mortgages	5,102	380	180	7.4	47	3.5	300	318
Personal lending	1,556	110	92	7.1	84	5.9	67	351
Property	38,064	17,969	7,861	47.2	44	20.7	3,200	1,004
Construction	2,672	1,102	475	41.2	43	17.8	(39)	101
Manufacturing	4,931	423	283	8.6	67	5.7	121	90
Service industries and business activities								
- retail, wholesale and repairs	2,339	388	204	16.6	53	8.7	(28)	53
- transport and storage	5,477	264	94	4.8	36	1.7	31	14
- health, education and recreation	1,419	501	245	35.3	49	17.3	134	43
- hotels and restaurants	1,161	485	289	41.8	60	24.9	125	71
- utilities	1,849	66	22	3.6	33	1.2	3	3
- other	3,772	1,308	504	34.7	39	13.4	246	184
Agriculture, forestry and fishing	129	47	27	36.4	57	20.9	8	13
Finance leases and instalment credit	6,059	622	398	10.3	64	6.6	81	102
Interest accruals	116	—	—	—	—	—	—	—
Latent	—	—	647	—	—	—	(293)	—
	79,877	23,983	11,469	30.0	48	14.4	3,838	2,390
of which:								
UK								
- residential mortgages	1,423	52	11	3.7	21	0.8	6	1
- personal lending	127	37	30	29.1	81	23.6	(12)	179
- property	24,610	5,405	2,291	22.0	42	9.3	1,034	377
- other	19,756	2,298	1,504	11.6	65	7.6	174	349
Europe								
- residential mortgages	553	84	49	15.2	58	8.9	30	—
- personal lending	492	66	55	13.4	83	11.2	33	104
- property	11,538	12,035	5,384	104.3	45	46.7	2,134	497
- other	11,068	2,641	1,315	23.9	50	11.9	277	107

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US								
- residential mortgages	2,926	244	120	8.3	49	4.1	264	317
- personal lending	936	7	7	0.7	100	0.7	46	68
- property	1,370	218	68	15.9	31	5.0	(18)	95
- other	2,104	213	329	10.1	154	15.6	(192)	96
RoW								
- residential mortgages	200	—	—	—	—	—	—	—
- personal lending	1	—	—	—	—	—	—	—
- property	546	311	118	57.0	38	21.6	50	35
- other	2,227	372	188	16.7	51	8.4	12	165
Group before RFS MI	79,877	23,983	11,469	30.0	48	14.4	3,838	2,390

	Non-Core							
	REIL				Provisions			
	as a %		of Provisions		as a % of		Impairment	
	Gross	REIL	Provisions	gross	as a %	gross	charge	Amounts
	loans	Provisions	of Provisions	loans	of REIL	loans	written-off	written-off
	£m	£m	£m	%	%	%	£m	£m
2010								
Central and local government	1,671	—	—	—	—	—	—	—
Finance								
- banks	1,003	1	1	0.1	100	0.1	(8)	11
- other	7,651	562	193	7.3	34	2.5	7	88
Residential mortgages	6,142	277	184	4.5	66	3.0	436	426
Personal lending	3,891	413	349	10.6	85	9.0	213	306
Property	47,651	16,297	5,918	34.2	36	12.4	3,943	911
Construction	3,352	1,854	653	55.3	35	19.5	341	108
Manufacturing	6,520	644	237	9.9	37	3.6	(211)	1,423
Service industries and business activities								
- retail, wholesale and repairs	3,191	546	313	17.1	57	9.8	135	58
- transport and storage	8,195	136	78	1.7	57	1.0	47	4
- health, education and recreation	1,865	548	185	29.4	34	9.9	14	135
- hotels and restaurants	1,492	528	268	35.4	51	18.0	156	57
- utilities	2,110	69	20	3.3	29	0.9	13	7
- other	5,530	855	473	15.5	55	8.6	241	212
Agriculture, forestry and fishing	135	58	29	43.0	50	21.5	7	1
Finance leases and instalment credit	8,529	603	414	7.1	69	4.9	189	71
Interest accruals	278	—	—	—	—	—	—	—
Latent	—	—	1,001	—	—	—	(116)	—
	109,206	23,391	10,316	21.4	44	9.4	5,407	3,818
of which:								
UK								
- residential mortgages	1,665	52	7	3.1	13	0.4	5	1
- personal lending	585	195	177	33.3	91	30.3	13	11
- property	30,492	5,532	1,719	18.1	31	5.6	1,152	354
- other	30,188	2,995	1,837	9.9	61	6.1	508	386
Europe								
- residential mortgages	621	45	21	7.2	47	3.4	37	—
- personal lending	600	198	152	33.0	77	25.3	23	5
- property	12,636	9,903	3,959	78.4	40	31.3	2,587	209
- other	14,388	2,385	1,111	16.6	47	7.7	295	1,338
US								
- residential mortgages	3,653	180	156	4.9	87	4.3	390	424
- personal lending	2,704	20	20	0.7	100	0.7	79	161
- property	3,318	621	159	18.7	26	4.8	237	166

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- other	3,670	482	484	13.1	100	13.2	(111)	353
RoW								
- residential mortgages	203	—	—	—	—	—	4	1
- personal lending	2	—	—	—	—	—	98	129
- property	1,205	241	81	20.0	34	6.7	(33)	182
- other	3,276	542	433	16.5	80	13.2	123	98
Group before RFS MI	109,206	23,391	10,316	21.4	44	9.4	5,407	3,818

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Business review [Risk and balance sheet management continued](#)

Risk management: Credit risk continued

Balance sheet analysis: REIL, provisions and reserves continued

	Gross loans £m	REIL £m	Provisions £m	Non-Core REIL		Provisions		Impairment charge £m	Amounts written-off £m
				as a % of gross loans %	as a % of REIL %	as a % of gross loans %	as a % of gross loans %		
2009									
Central and local government	1,532	—	—	—	—	—	—	—	—
Finance									
- banks	1,360	38	22	2.8	58	1.6	22	—	—
- other	9,713	501	160	5.2	32	1.6	630	579	—
Residential mortgages	12,932	614	210	4.7	34	1.6	604	496	—
Personal lending	6,358	596	366	9.4	61	5.8	701	604	—
Property	50,372	12,552	2,954	24.9	24	5.9	2,879	613	—
Construction	5,258	1,775	388	33.8	22	7.4	421	257	—
Manufacturing	14,402	2,640	1,897	18.3	72	13.2	1,384	691	—
Service industries and business activities	33,638	3,546	1,191	10.5	34	3.5	1,464	916	—
Agriculture, forestry and fishing	553	47	27	8.5	57	4.9	6	1	—
Finance leases and instalment credit	11,956	591	302	4.9	51	2.5	219	35	—
Interest accruals	549	—	—	—	—	—	—	—	—
Latent	—	—	735	—	—	—	193	—	—
	148,623	22,900	8,252	15.4	36	5.6	8,523	4,192	—
of which:									
UK	79,043	8,400	2,713	10.6	32	3.4	2,709	1,279	—
Europe	41,096	10,783	3,740	26.2	35	9.1	2,520	381	—
US	19,546	2,618	1,144	13.4	44	5.9	2,460	2,080	—
RoW	8,938	1,099	655	12.3	60	7.3	834	452	—
Group before RFS MI	148,623	22,900	8,252	15.4	36	5.6	8,523	4,192	—

## Impairment loss provision methodology

A financial asset or portfolio of financial assets is impaired and an impairment loss incurred if there is objective evidence that an event or events since initial recognition of the asset have adversely affected the amount or timing of future cash flows from the asset.

For retail loans, which are segmented into collective, homogenous portfolios, time-based measures, such as days past due, are typically used as evidence of impairment. For these portfolios, the Group recognises an impairment at 90 days past due.



For corporate portfolios, given their complexity and nature, the Group relies not only on time-based measures but also on management judgement to identify evidence of impairment. Other factors considered may include: significant financial difficulty of the borrower; a breach of contract; a loan restructuring; a probable bankruptcy; and any observable data indicating a measurable decrease in estimated future cash flows.

Depending on various factors as explained below, the Group uses one of the following three different methods to assess the amount of provision required: individual; collective; and latent.

- Individually assessed provisions: provisions required for individually significant impaired assets are assessed on a case-by-case basis. If there is objective evidence that an impairment loss has been incurred, the amount of the loss is measured as the difference between the assets carrying amount and the present value of the estimated future cash flows discounted at the financial asset's original effective interest rate. Future cash flows are estimated through a case-by-case analysis of individually assessed assets.

This assessment takes into account the benefit of any guarantee or other collateral held. The value and timing of cash flow receipts are based on available estimates in conjunction with facts available at that time. Timings and amounts of cash flows are reviewed on subsequent assessment dates, as new information becomes available. The asset continues to be assessed on an individual basis until it is repaid in full, transferred to the performing portfolio or written-off.

- Collectively assessed provisions: provisions on impaired credits below an agreed threshold are assessed on a portfolio basis to reflect the homogeneous nature of the assets. The Group segments impaired credits in its collectively assessed portfolios according to asset type, such as credit cards, personal loans, mortgages and smaller homogenous wholesale portfolios, such as business or commercial banking. A further distinction is made between those impaired assets in collections and those in recoveries (refer to Problem debt management on page 97 for a discussion of the collections and recoveries functions).

The provision is determined based on a quantitative review of the relevant portfolio, taking account of the level of arrears, the value of any security, historical and projected cash recovery trends over the recovery period. The provision also incorporates any adjustments that may be deemed appropriate given current economic and credit conditions. Such adjustments may be determined based on: a review of the current cash collections profile performance against historical trends; updates to metric inputs - including model recalibrations; and monitoring of operational processes used in managing exposures - including the time taken to process non-performing exposures.

- Latent loss provisions: a separate approach is taken for provisions held against impairments in the performing portfolio that have been incurred as a result of events occurring before the balance sheet date but which have not been identified at the balance sheet date.

The Group's methodologies to estimate latent loss provisions reflect:

- the probability that the performing customer will default;
- historical loss experience, adjusted, where appropriate, given current economic and credit conditions; and
- the emergence period, defined as the period between an impairment event occurring and a loan being identified and reported as impaired.

Emergence periods are estimated at a portfolio level and reflect the portfolio product characteristics such as the repayment terms and the duration of the loss mitigation and recovery processes. They are based on internal systems and processes within the particular portfolio and are reviewed regularly.

As with collectively assessed impaired portfolios, the Group segments its performing portfolio according to asset type.

#### Provisions and AFS reserves

The Group's consumer portfolios, which consist of high volume, small value credits, have highly efficient largely automated processes for identifying problem credits and very short timescales, typically three months, before resolution or adoption of various recovery methods. Corporate portfolios consist of higher value, lower volume credits, which tend to be structured to meet individual customer requirements.

Provisions are assessed on a case by case basis by experienced specialists with input from professional valuers and accountants. The Group operates a transparent provisions governance framework, setting thresholds to trigger enhanced oversight and challenge.

Analyses of provisions are set out on page 162 and 163.

Available-for-sale financial assets are initially recognised at fair value plus directly related transaction costs and are subsequently measured at fair value with changes in fair value reported in owners' equity until disposal, at which stage the cumulative gain or loss is recognised in profit or loss. When there is objective evidence that an available-for-sale financial asset is impaired, any decline in its fair value below original cost is removed from equity and recognised in profit or loss.

The Group reviews its portfolios of available-for-sale financial assets for evidence of impairment, which includes: default or delinquency in interest or principal payments; significant financial difficulty of the issuer or obligor; and it becoming probable that the issuer will enter bankruptcy or other financial reorganisation. However, the disappearance of an active market because an entity's financial instruments are no longer publicly traded is not evidence of impairment. Furthermore, a downgrade of an entity's credit rating is not, of itself, evidence of impairment, although it may be evidence of impairment when considered with other available information. A decline in the fair value of a financial asset below its cost or amortised cost is not necessarily evidence of impairment. Determining whether objective evidence of impairment exists requires the exercise of management judgment. The unrecognised losses on the Group's available-for-sale debt securities are concentrated in its portfolios of mortgage-backed securities. The losses reflect the widening of credit spreads as a result of the reduced market liquidity in these securities and the current uncertain macroeconomic outlook in the US and Europe. The underlying securities remain unimpaired.

Analyses of AFS debt securities and related AFS reserves are set out on page 164.

Business review [Risk and balance sheet management continued](#)

Risk management: Credit risk continued

Balance sheet analysis: REIL, provisions and reserves continued

## Movement in loan impairment provisions

The movement in impairment provisions by division is shown in the table below.

	UK Retail	UK Corporate	UK Wealth	IB (1)	Ulster Bank	US R&C (2)	Total R&C (2)	Markets	Total Core	Non-Core	RFS MI	Group £m
2011	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
At 1 January	2,741	1,746	66	855	1,633	509	7,550	316	7,866	10,316		-48,182
Intra-group transfers	—	177	—	—	—	—	177	—	177	(177)	—	—
Transfers to disposal groups	(335)	(436)	—	(2)	—	—	(773)	—	(773)	—	—	(773)
Currency translation and other adjustments	—	23	3	(35)	(79)	(5)	(93)	17	(76)	(207)	—	(283)
Disposal of subsidiaries	—	—	—	—	—	—	—	—	—	—	8	8
Amounts written-off	(823)	(658)	(11)	(125)	(124)	(373)	(2,114)	(23)	(2,137)	(2,390)	—	(4,527)
Recoveries of amounts previously written-off	69	17	—	3	1	76	166	1	167	360	—	527
Charged to income statement - continuing operations	788	790	25	168	1,384	248	3,403	—	3,403	3,838	—	-7,241
- discontinued operations	—	—	—	—	—	—	—	—	—	—	(8)	(8)
Unwind of discount (3)	(96)	(36)	(2)	(13)	(66)	—	(213)	—	(213)	(271)	—	(484)
At 31 December	2,344	1,623	81	851	2,749	455	8,103	311	8,414	11,469		-49,883
Individually assessed												
- banks	—	—	2	44	—	—	46	76	122	1	—	123
- customers	—	679	70	637	991	73	2,450	224	2,674	9,960	—	-12,634
Collectively assessed	2,157	676	—	2	1,282	162	4,279	—	4,279	861	—	-5,140
Latent	187	268	9	168	476	220	1,328	11	1,339	647	—	-1,986
	2,344	1,623	81	851	2,749	455	8,103	311	8,414	11,469		-49,883

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2010												
At 1 January	2,677	1,287	55	1,139	962	482	6,602	319	6,921	8,252	2,110	17,283
Intra-group transfers	—	—	—	(217)	(351)	—	(568)	—	(568)	568	—	—
Transfers to disposal groups	—	—	—	—	—	—	—	—	—	(72)	—	(72)
Currency translation and other adjustments	—	71	4	(98)	(22)	20	(25)	9	(16)	59	—	43
Disposal of subsidiaries	—	—	—	—	—	—	—	—	—	(20)	(2,152)	(2,172)
Amounts written-off	(1,135)	(357)	(9)	(92)	(48)	(550)	(2,191)	(33)	(2,224)	(3,818)	—	(6,042)
Recoveries of amounts previously written-off	128	8	—	2	1	72	211	2	213	198	—	411
Charged to income statement - continuing operations	1,160	768	18	125	1,161	485	3,717	20	3,737	5,407	—	9,144
- discontinued operations	—	—	—	—	—	—	—	—	—	—	42	42
Unwind of discount (3)	(89)	(31)	(2)	(4)	(70)	—	(196)	(1)	(197)	(258)	—	(455)
At 31 December	2,741	1,746	66	855	1,633	509	7,550	316	7,866	10,316	—	48,182
Individually assessed												
- banks	—	—	2	46	—	—	48	78	126	1	—	127
- customers	—	546	57	572	502	56	1,733	215	1,948	8,161	—	40,109
Collectively assessed	2,526	703	—	—	733	177	4,139	—	4,139	1,157	—	5,296
Latent	215	497	7	237	398	276	1,630	23	1,653	997	—	2,650
	2,741	1,746	66	855	1,633	509	7,550	316	7,866	10,316	—	48,182

For the notes relating to this table refer to page 163.

	UK Retail £m	UK Corporate £m	Wealth £m	IB (1) £m	Ulster Bank £m	US R&C (2) £m	Total R&C (2) £m	Markets £m	Total Core £m	Non-Core £m	RFS MI £m	Group £m
2009												
At 1 January	2,086	710	34	569	491	298	4,188	81	4,269	5,182	1,565	11,016
Transfers to disposal groups	—	—	—	—	—	—	—	(16)	(16)	(305)	(3)	(324)
Currency translation and other adjustments	67	5	1	241	(109)	(29)	176	247	423	(851)	(102)	(530)
Disposal of subsidiaries	—	—	—	—	—	—	—	(62)	(62)	(3)	—	(65)
Amounts written-off	(1,150)	(358)	(12)	(92)	(34)	(550)	(2,196)	(90)	(2,286)	(4,192)	(461)	(6,939)
Recoveries of amounts previously written-off	97	20	—	5	1	58	181	8	189	136	74	399
Charged to income statement - continuing operations	1,679	931	33	417	649	705	4,414	153	4,567	8,523	—	—13,090
- discontinued operations	—	—	—	—	—	—	—	—	—	—	—1,044	1,044
Unwind of discount (3)	(102)	(21)	(1)	(1)	(36)	—	(161)	(2)	(163)	(238)	(7)	(408)
At 31 December	2,677	1,287	55	1,139	962	482	6,602	319	6,921	8,252	2,110	17,283
Individually assessed												
- banks	—	—	2	52	—	—	54	81	135	22	—	157
- customers	—	205	44	526	280	14	1,069	203	1,272	6,229	1,295	8,796
Collectively assessed	2,475	492	—	—	412	130	3,509	—	3,509	1,266	479	5,254
Latent	202	590	9	561	270	338	1,970	35	2,005	735	336	3,076
	2,677	1,287	55	1,139	962	482	6,602	319	6,921	8,252	2,110	17,283

## Notes:

- (1) International Banking.  
(2) Retail & Commercial.  
(3) Recognised in interest income.

## Analysis of loan impairment charge

The following table analyses impairment losses.

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	2011	2010	2009
	£m	£m	£m
Latent loss	(545)	(121)	1,184
Collectively assessed	2,591	3,070	3,994
Individually assessed	5,195	6,208	7,878
Customer loans	7,241	9,157	13,056
Bank loans	—	(13)	34
Securities	1,468	112	809
Charge to income statement	8,709	9,256	13,899
Charge relating to customer loans as a % of gross customer loans (1)	1.5%	1.7%	2.3%

Note:

(1) Customer loan impairment charge as a percentage of gross loans and advances to customers including assets of disposal groups and excluding reverse repos.

Key points

- Impairment provisions, net of £0.8 billion relating to disposal groups, increased by £1.7 billion during 2011.
- Ulster Bank Group's provisions increased by £3.1 billion during the year (Core - £1.1 billion; Non-Core - £2.0 billion), with provision coverage increasing to 53% (Core - 50%; Non-Core - 54%) from 44% at the end of 2010, predominantly reflecting the deterioration in the value of the commercial real estate development portfolio.

Business review [Risk and balance sheet management continued](#)

Risk management: Credit risk continued

Balance sheet analysis: REIL, provisions and reserves continued

	2011			2010			2009			
	Core £m	Non-Core £m	RFS MI £m	Total £m	Core £m	Non-Core £m	Total £m	Core £m	Non-Core £m	Total £m
Loan impairment losses										
- customers	3,403	3,838	—	7,241	3,742	5,415	9,157	4,555	8,501	13,056
- banks	—	—	—	—	(5)	(8)	(13)	12	22	34
	3,403	3,838	—	7,241	3,737	5,407	9,144	4,567	8,523	13,090
Impairment losses on securities										
- debt securities	1,381	50	2	1,433	40	41	81	98	503	601
- equity securities	4	31	—	35	4	27	31	13	195	208
	1,385	81	2	1,468	44	68	112	111	698	809
Charge to income statement	4,788	3,919	2	8,709	3,781	5,475	9,256	4,678	9,221	13,899

## Key points

- The impairment charge, excluding securities, decreased by £1.9 billion or 21% compared with 2010, driven largely by a £1.6 billion reduction in Non-Core, despite continuing challenges in Ulster Bank and corporate real estate portfolios.
- The Group's customer loan impairment charge as a percentage of loans and advances was 1.5% compared with 1.7% for 2010.
- The securities impairment in 2011 primarily reflects an impairment charge of £1.3 billion in respect of the Group's holdings of Greek sovereign bonds and related interest rate hedges.

## Available-for-sale debt securities and reserves

The table below analyses available-for-sale debt securities and related reserves, gross of tax.

	2011				2010			
	US £m	UK £m	Other (1) £m	Total £m	US £m	UK £m	Other (1) £m	Total £m
Central and local government	20,848	13,436	25,552	59,836	22,244	8,377	32,865	63,486
Banks	376	1,391	11,408	13,175	704	4,297	11,981	16,982
Other financial institutions	17,453	3,100	11,199	31,752	15,973	1,662	11,513	29,148
Corporate	131	1,105	1,299	2,535	65	438	1,011	1,514
Total	38,808	19,032	49,458	107,298	38,986	14,774	57,370	111,130



Of which ABS	20,256	3,659	16,820	40,735	20,872	4,002	17,641	42,515
AFS reserves (gross)	486	845	(1,815)	(484)	(304)	158	(2,559)	(2,705)

Note:

(1)

Includes eurozone countries as detailed on pages 169 to 186.

## Available-for-sale debt securities: gross unrealised losses

The table below shows the fair value of available-for-sale debt securities that were in an unrealised loss position at 31 December and the related gross unrealised losses.

	Less than 12 months		More than 12 months		Total	
	Fair value	Gross unrealised losses	Fair value	Gross unrealised losses	Fair value	Gross unrealised losses
	£m	£m	£m	£m	£m	£m
2011						
Central and local government - Other	2,878	65	778	106	3,656	171
Banks	3,924	49	5,676	789	9,600	838
Other financial institutions	472	41	6,504	2,345	6,976	2,386
Corporate	204	11	78	2	282	13
Total	7,478	166	13,036	3,242	20,514	3,408
Of which ABS	878	54	11,908	3,104	12,786	3,158
2010						
Central and local government						
- UK	716	10	—	—	716	10
- US	74	1	163	1	237	2
- Other	4,328	6	1,738	612	6,066	618
Banks	1,655	16	6,202	770	7,857	786
Other financial institutions	2,993	73	6,972	2,553	9,965	2,626
Corporate	163	32	114	23	277	55
Total	9,929	138	15,189	3,959	25,118	4,097
Of which ABS	2,519	101	12,867	3,296	15,386	3,397

Business review [Risk and balance sheet management continued](#)

Risk management: Country risk

Introduction\*

Country risk is the risk of material losses arising from significant country-specific events such as sovereign events (default or restructuring); economic events (contagion of sovereign default to other parts of the economy, cyclical economic shock); political events (transfer or convertibility restrictions and expropriation or nationalisation); and natural disaster or conflict. Such events have the potential to affect elements of the Group's credit portfolio that are directly or indirectly linked to the country in question and can also give rise to market, liquidity, operational and franchise risk related losses.

External risk environment\*

2011 was another year of heightened country risks. However, trends were divergent, with conditions deteriorating among vulnerable eurozone countries facing growth impediments and higher public debt burdens, while many emerging markets continued to enjoy relative stability, seeing net inflows of capital for the full year and lower spreads despite some risk aversion in the second half. In the US, notwithstanding a more challenging political environment and a sovereign downgrade from a rating agency, a deal was secured to increase the sovereign debt ceiling, and yields on government debt remain low.

Eurozone risks

Europe was at the centre of rising global risks, owing to a combination of slower growth among some of its major economies and a further deepening of the ongoing sovereign crisis, which in turn harmed financial sector health. Risks in Greece rose as a deeper than expected contraction in GDP impacted the fiscal adjustment programme and hit debt sustainability. Negotiations on a voluntary restructuring of public debt held by the private sector commenced in the first half and a deal was eventually reached in February 2012, with more punitive write-offs for private investors than previously envisaged. This in turn led to an agreement by eurozone leaders on a further borrowing programme for the Greek government.

In May 2011, Portugal's new government agreed a borrowing programme with the European Union and International Monetary Fund (EU-IMF) after a sharp deterioration in sovereign liquidity. Ireland's performance under its EU-IMF programme was good and the announcement of a bank restructuring deal without defaults on senior debt obligations helped improve market confidence. This was reflected in a compression in bond spreads in the second half of the year.

Despite the announcement of significant new support proposals by eurozone leaders in July 2011, investor worries over risks to their implementation rose and market conditions worsened markedly as a result. Risk aversion towards Spanish and Italian assets picked up and despite a policy response by both countries, yields remained elevated, prompting the ECB to intervene to support their bonds in secondary markets for the first time. Contagion affected bank stocks and asset prices.

Eurozone leaders responded by stepping up anti-crisis efforts, focusing largely on agreeing fiscal reform, bolstering bank capital and strengthening capacity to offer financing support to sovereigns losing market access. The ECB continued to buy sovereign debt in the secondary market and increased liquidity support to banks with the introduction of an emergency three-year long-term refinancing operation in December. This helped ease interbank funding tensions somewhat and may have contributed to some relief in sovereign debt markets late in the year, as yields on new issuance by Spain and Italy dropped.

Emerging markets

Emerging markets continued to perform relatively well. In Asia, despite slowing growth, China and India continued to post strong overall expansion, while generally large external savings levels reinforced balance of payments stability. In China specifically, measures to curb house price growth began to have a more noticeable impact, with real estate

prices falling in many cities. Efforts are underway to address some bank asset quality concerns linked to rapid lending growth in 2009.

In emerging Europe, Russia experienced some contagion into asset markets from weaker commodity prospects and a challenging investment climate, but the sovereign balance sheet remained quite robust. Foreign exchange debts remained a risk factor in a number of Eastern European economies. Elsewhere, Turkey's economy cooled in the second half of 2011, helping to narrow the current account deficit sharply, though external vulnerabilities persisted.

The Middle East and North Africa witnessed political instability in a number of the relatively lower-income countries. The path of any transition has yet to become fully clear in most cases. Excluding Bahrain, pressures for change were more contained in the Gulf Co-Operation Council countries.

Latin America remained characterised by relative stability owing to balance sheet repair by a number of countries following crises in previous decades. Capital inflows contributed to currency appreciation, but overheating pressures have so far proven contained, including in Brazil where credit growth slowed from high levels.

#### Outlook

Overall, the outlook for 2012 remains challenging with risks likely to remain elevated but divergent. Much will depend on the success of EU efforts to contain contagion from the sovereign crisis (where downside risks are high) and whether growth headwinds in larger advanced economies persist. Emerging market balance sheet risks remain lower, despite ongoing structural and political constraints, but these economies will continue to be affected by events elsewhere through financial markets and trade channels.

\* unaudited

#### Governance\*

All country exposures are covered by the Group's country risk framework. In this framework, a limited number of advanced countries are under risk-based monitoring, with all other countries placed under limit control using the Group's country risk watchlist process either when these have been identified as exhibiting signs of stress, or when it is considered appropriate. Detailed portfolio reviews are undertaken to align country risk profiles to the Group's country risk appetite in light of evolving economic and political developments.

The framework for the Group's appetite for country risk is set by the Executive Risk Forum (ERF) in the form of country risk appetite ceilings by sovereign risk grade for both total and medium-term exposure. Authority is delegated to the Group Country Risk Committee to manage exposures within the framework, with escalation where needed to ERF.

Total and medium-term exposure limits are set for individual countries based on a risk assessment taking into account the country's economic situation and outlook as well as the Group's franchise and business mix in that country. Additional limitations (for example, on foreign-currency exposure and product types with higher potential for loss in case of country events) may be established to address specific vulnerabilities in the context of a country's outlook and/or the Group's business strategy in a particular country.

#### Monitoring, management and mitigation\*

A country watchlist framework is in place to proactively monitor emerging issues and facilitate the development of mitigation strategies.

Management of country risk was further strengthened in 2011 with intensified stress testing, portfolio actions on a number of countries and enhancements to risk appetite setting and management systems, contributing inter alia to a reduction in exposures to a range of countries.

During 2011, the Group conducted an analysis of its country risk profile. The outcome of this analysis was used to define more specific scenarios to be used as trigger events in stress testing - on an ongoing basis - at both Group and divisional levels. Such risk scenarios include a major balance sheet deleveraging across Europe, a default of a eurozone sovereign, or one or more stressed member states exiting the eurozone and undergoing currency redenomination, with subsequent contagion effects.

The situation remains very uncertain and the results of stress tests are sensitive to input assumptions. As a result, estimates of the potential impact on the Group of various developments are wide-ranging. If a single country exits the eurozone, the impact could be limited. If several do, the impact is likely to be significant. Depending on the circumstances, the generally negative effect on the Group of devaluations could be offset by the impact of revaluations. Nonetheless, the extent of market disruption is very difficult to predict and could be substantial.

From mid-2011, the Group intensified its risk-mitigating actions at divisional level aimed at preparing the Group for a wide variety of potential eurozone stress scenarios, with a particular focus on counterparty credit risk, settlement risk and funding risk. It also carried out a detailed assessment of the potential impact of such scenarios on Group systems to ensure broad readiness.

In a few specific cases, management of the Group's exposure was temporarily handed over to a cross-divisional country crisis team. Risk mitigation actions typically included taking guarantees or insurance, updating collateral agreements, credit documentation reviews and specified credit referral processes.

Risk appetite setting was strengthened by various measures. In addition to Greece, Ireland and Portugal, the Group brought Italy and Spain under country limit control. Belgium and Japan followed in January 2012, with other advanced countries scheduled for review in this process throughout 2012. Benchmark ratios systematically guide the

setting of medium-term country exposure limits.

The Group's regular, comprehensive and detailed country exposure reviews were further enhanced by intensified counterparty monitoring. Refer to pages 105 to 107 for discussion on banks, financial institutions and other sectors.

All of this, in combination with customers' own efforts to reduce their debt levels, contributed to reductions in exposure to a range of countries including the vulnerable eurozone countries, Japan and countries in political transition in North Africa and the Middle East. Exposure reductions were implemented selectively, often retaining some credit lines for strategic clients and in cases of sufficient risk mitigation. Due to their nature, medium-term exposures cannot be adjusted as rapidly as short-term exposure.

Further strategic enhancements to portfolio management systems included the introduction of a comprehensive country risk management and reporting application, comprising banking and trading book exposures across the Group on a consistent basis, and taking account of country risk transfers given guarantees, insurance and collateral taken. This system supports analysing and managing the exposures to countries in the eurozone and elsewhere, by tenor bucket, currency type, sector and product type, as well as by individual counterparty names and facilities. In addition, developments in trading book management systems played a role in actual exposure reductions in trading on a number of countries.

Internal rating systems were also further developed, contributing to more accurate calculations of country-specific default probabilities and expected loss given default rates which are determinants in the calculation of risk-weighted assets and economic capital.

Other developments in country risk management in 2011 included the development of the regional and country risk view in the Group's economic capital model and in integrated stress testing.

\* unaudited

Business review [Risk and balance sheet management continued](#)

Risk management: Country risk continued

Monitoring, management and mitigation\* continued

Going forward, the Group continues to extend country limit control to other countries within and outside the eurozone and will continue to manage medium-term exposure closer to its medium-term benchmark ratios. In addition, work is continuing on the determination of actual appetite per country, on the country risk reporting systems and their integration with credit, treasury and finance systems, on the representation of country risk aspects in rating models, economic capital models and integrated stress testing, and on the combination with actual and expected returns. All of this should help RBS determine and steer its risk profile and further optimise the Group's global portfolio management.

Credit default swap (CDS) contracts are used for a number of purposes such as hedging of the credit trading portfolio, management of counterparty credit exposure and the mitigation of wrong-way risk. The Group generally uses CDS contracts to manage exposure on a portfolio rather than specific exposures. This may give rise to maturity mismatches between the underlying exposure and the CDS contract as well as between bought and sold CDS contracts on the same reference entity.

The terms of the Group's CDS contracts are covered by standard ISDA documentation, which determines if a contract is triggered due to a credit event. Such events may include bankruptcy or restructuring of the reference entity or a failure of the reference entity to repay its debt or interest. Under the terms of a CDS contract, one of the regional ISDA Credit Derivatives Determinations Committees is empowered to decide whether or not a credit event has occurred.

Country risk analysis

All the data tables and related definitions in this section are audited.

The following tables show the Group's exposure by country of incorporation of the counterparty at 31 December 2011. Countries shown are those where the Group's balance sheet exposure to counterparties incorporated in the country exceeded £1 billion and the country had an external rating of A+ or below from S&P, Moody's or Fitch at 31 December 2011, as well as selected eurozone countries. The numbers are stated before taking into account the impact of mitigating action, such as collateral, insurance or guarantees that may have been taken to reduce or eliminate exposure to country risk events. Exposures relating to ocean-going vessels are not included due to their multinational nature.

The following definitions apply to the tables and key points on pages 169 to 186:

Lending comprises gross loans and advances to: central and local governments; central banks, including cash balances; other banks and financial institutions, incorporating overdraft and other short-term credit lines; corporations, in large part loans and leases; and individuals, comprising mortgages, personal loans and credit card balances. Lending includes impaired loans and loans where an impairment event has taken place, but no impairment provision is recognised.

Debt securities comprise securities classified as available-for-sale (AFS), loans and receivables (LAR), held-for-trading (HFT) and designated as at fair value through profit or loss (DFV). All debt securities other than LAR securities are carried at fair value with LAR debt securities are carried at amortised cost less impairment. HFT debt securities are presented as gross long positions (including DFV securities) and short positions per country. Impairment losses and exchange differences relating to AFS debt securities, together with interest, are recognised in the income statement; other changes in the fair value of AFS securities are reported within AFS reserves, which are presented gross of tax.

Derivatives comprise the mark-to-market (mtm) value of such contracts after the effect of enforceable netting agreements, but gross of collateral. Reverse repurchase agreements (repos) comprise the mtm value of counterparty exposure arising from repo transactions net of collateral.

Balance sheet exposures comprise lending exposures, debt securities and derivatives, and repo exposures.

Contingent liabilities and commitments comprise contingent liabilities, including guarantees and committed undrawn facilities.

Credit default swap (CDS) under CDS contract the credit risk on the reference entity is transferred from the buyer to the seller. The fair value, or mtm, represents the balance sheet carrying value. The mtm value of CDSs is included within derivatives against the counterparty of the trade, as opposed to the reference entity. The notional is the par amount of the credit protection bought or sold and is included against the reference entity of the CDS contract.

The column CDS notional less fair value represents the notional less fair value amounts arising from sold positions netted against those arising from bought positions, and represents the net change in exposure for a given reference entity should the CDS contract be triggered by a credit event, assuming there is a zero recovery rate. However, in most cases, the Group expects the recovery rate to be greater than zero and the exposure change to be less than this amount.

The Group primarily transacts CDS contracts with investment-grade global financial institutions who are active participants in the CDS market. These transactions are subject to regular margining. For European peripheral sovereigns, credit protection has been purchased from a number of major European banks, predominantly outside the country of the reference entity. In a few cases where protection was bought from banks in the country of the reference entity, giving rise to wrong-way risk, this risk is mitigated through specific collateralisation. Due to their bespoke nature, exposures relating to CDPCs and related hedges have not been included, as they cannot be meaningfully attributed to a particular country or a reference entity. Exposures to CDPCs are disclosed on page 148.

The Group used CDS contracts throughout 2011 to manage both eurozone country and counterparty exposures. As shown in the individual country tables, this resulted in increases in both gross notional bought and sold eurozone CDS contracts, mainly on Italy, France and the Netherlands. The magnitude of the fair value of bought and sold CDS contracts increased over 2011 in line with the widening of eurozone CDS spreads.

‘Other eurozone’ comprises Austria, Cyprus, Estonia, Finland, Malta, Slovakia and Slovenia.

\* unaudited



	Lending							Total lending £m	Of which Non-Core £m	Debt securities £m	Derivatives (gross of collateral) and repos £m	Balanc s expos
	Central and local government £m	Central banks £m	Other banks £m	Other financial institutions £m	Corporate £m	Personal £m	£m					
2011												
Eurozone												
Ireland	45	1,467	136	333	18,994	18,858	39,833	10,156	886	2,824	43	
Spain	9	3	130	154	5,775	362	6,433	3,735	6,155	2,393	14	
Italy	—	73	233	299	2,444	23	3,072	1,155	1,258	2,314	6	
Greece	7	6	—	31	427	14	485	94	409	355	1	
Portugal	—	—	10	—	495	5	510	341	113	519	1	
Germany	—18,068	653	305	6,608	155	25,789	5,402	15,767	10,335	51		
Netherlands	8	7,654	623	1,557	4,827	20	14,689	2,498	9,893	10,285	34	
France	481	3	1,273	282	3,761	79	5,879	2,317	7,794	9,046	22	
Luxembourg	—	—	101	925	2,228	2	3,256	1,497	130	3,689	7	
Belgium	—	8	287	354	588	20	1,257	480	652	3,010	4	
Other	121	—	28	115	1,375	26	1,665	324	710	1,950	4	
Total	671	27,282	3,474	4,355	47,522	19,564	102,868	27,999	43,767	46,720	193	
Other countries												
India	—	275	610	35	2,949	127	3,996	350	1,530	218	5	
China	9	178	1,237	16	654	30	2,124	50	597	413	3	
South Korea	—	5	812	2	576	1	1,396	3	845	404	2	
Turkey	215	193	252	66	1,072	16	1,814	423	361	94	2	
Russia	—	36	970	8	659	62	1,735	76	186	47	1	
Brazil	—	—	936	—	227	4	1,167	70	790	24	1	
Romania	66	145	30	8	413	392	1,054	1,054	220	6	1	
Mexico	—	7	233	—	683	1	924	39	83	131	1	
Poland	35	208	3	9	624	6	885	45	116	56	1	

\* unaudited

Business review [Risk and balance sheet management continued](#)

## Risk management: Country risk continued

2010	Lending							Total lending	Of which Non-Core	Debt securities	Derivatives (gross of collateral) and repos	Balances exposed
	Central and local government	Central banks	Other banks	Other financial institutions	Corporate	Personal	£m					
<b>Eurozone</b>												
Ireland	61	2,119	87	813	19,886	20,228	43,194	10,758	1,323	2,940	47	
Spain	19	5	166	92	6,991	407	7,680	4,538	7,107	2,047	16	
Italy	45	78	668	418	2,483	27	3,719	1,901	3,836	2,032	9	
Greece	14	36	18	31	191	16	306	130	974	227	1	
Portugal	86	—	63	—	611	6	766	316	242	394	1	
Germany	—	10,894	1,060	422	7,519	162	20,057	6,471	14,747	15,266	50	
Netherlands	914	6,484	554	1,801	6,170	81	16,004	3,205	12,523	9,058	37	
France	511	3	1,095	470	4,376	102	6,557	2,787	14,041	8,607	29	
Luxembourg	—	25	26	734	2,503	3	3,291	1,517	378	2,545	6	
Belgium	102	14	441	32	893	327	1,809	501	803	2,238	4	
Other	124	1	142	119	1,505	24	1,915	332	535	1,370	3	
<b>Total</b>	<b>1,876</b>	<b>19,659</b>	<b>4,320</b>	<b>4,932</b>	<b>53,128</b>	<b>21,383</b>	<b>105,298</b>	<b>32,456</b>	<b>56,509</b>	<b>46,724</b>	<b>208</b>	
<b>Other countries</b>												
India	—	—	1,307	307	2,665	273	4,552	653	1,686	178	6	
China	17	298	1,223	16	753	64	2,371	236	573	252	3	
South Korea	—	276	1,033	5	558	2	1,874	53	1,353	493	3	
Turkey	282	68	448	37	1,386	12	2,233	692	550	111	2	
Russia	—	110	244	7	1,181	58	1,600	125	124	51	1	
Brazil	—	—	825	—	315	5	1,145	120	687	15	1	
Romania	36	178	21	21	426	446	1,128	1,123	310	8	1	
Mexico	—	8	149	—	999	1	1,157	303	144	122	1	
Poland	—	168	7	7	655	6	843	108	271	69	1	

\* unaudited

Key points\*

Reported exposures are affected by currency movements. Over the year, sterling fell 0.3% against the US dollar and rose 3.1% against the euro.

- Exposure to most countries shown in the table declined over 2011 as the Group maintained a cautious stance and many bank clients reduced debt levels. Decreases were seen in balance sheet and off-balance sheet exposures in many countries. Increases in derivatives and repos were in line with the Group's strategy, driven partly by customer demand for hedging solutions and partly by market movements; risks are generally mitigated by active collateralisation.
- India - strong economic growth in 2011 resulted in increased exposure across most product types until the fourth quarter, when a decline took place, driven by an International Banking exercise in the region to manage down risk-weighted assets, natural run-offs/maturities and a sharp rupee depreciation. Year-on-year increases in lending to corporate clients (£0.3 billion) and the central bank (£0.3 billion) were offset by reductions in lending to banks (£0.7 billion) and other financial institutions (£0.3 billion).
- China - lending to Chinese banks increased in the first three quarters of the year, supporting trade finance activities and on-shore regulatory needs, but by the end of 2011 exposure had decreased close to December 2010 levels. The Group reduced lending in the interbank money markets over the final quarter. This reduction in lending was offset by significant growth in repo trading with Chinese financial institutions helping to support the Group's funding requirements, with highly liquid US Treasuries being the main underlying security. A reduction in off-balance sheet exposures, including guarantees and undrawn commitments, was in part due to the run-off of performance bonds in respect of shipping deliveries and also due to reduced appetite for trade finance assets.
- South Korea - exposure decreased by £1.6 billion during 2011. This was partly due to a reduction in debt securities as the Group managed its wrong-way risk exposure. The Group maintained a cautious stance given the current global economic downturn.
- Turkey - exposures were managed down in most categories, with the non-strategic (mid-market) portfolio significantly reduced in 2011. Nonetheless, Turkey continues to be one of the Group's key emerging markets. The strategy remains client-centric, with the product offering tailored to selected client segments across large Turkish international corporate clients and financial institutions as well as Turkish subsidiaries of global clients.
- Mexico - asset sales and a number of early repayments in the corporate portfolio led to exposure falling £0.8 billion in the year. This decline also reflects the Group's cautious approach to new business following its decision to close its onshore operation in Mexico.
- Eurozone periphery (Ireland, Spain, Italy, Greece and Portugal) - exposure decreased across most of the periphery, with derivatives (gross of collateral) and repos being the only component that still saw some increases (partly an effect of market movements on existing positions). Most of the Group's country risk exposure to the eurozone periphery countries arises from the activities of Markets, International Banking and Ulster Bank (with respect to Ireland). The Group has some large holdings of Spanish bank and financial institution mortgage-backed security bonds and smaller quantities of Italian bonds and Greek sovereign debt. International Banking provides trade finance facilities to clients across Europe including the eurozone periphery.

## Business review Risk and balance sheet management continued

## Risk management: Country risk continued

## Eurozone

	Lending	REIL	Provisions	AFS and LAR debt	AFS reserves	HFT debt securities		Total debt securities	Derivatives (gross of collateral) and repos	Balance sheet exposures	Credit de Notio Bought
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
2011											
Central and local government	671	—	—	18,406	81	19,597	15,049	22,954	1,924	25,549	37,080
Central banks	27,282	—	—	20	—	6	—	26	35	27,343	—
Other banks	3,474	—	—	8,423	(752)	1,272	1,502	8,193	29,685	41,352	19,736
Other financial Institutions	4,355	—	—	10,494	(1,129)	1,138	471	11,161	10,956	26,472	17,949
Corporate	47,522	14,152	7,267	964	24	528	59	1,433	4,119	53,074	76,966
Personal	19,564	2,280	1,069	—	—	—	—	—	1	19,565	—
	102,868	16,432	8,336	38,307	(1,776)	22,541	17,081	43,767	46,720	193,355	151,731
2010											
Central and local government	1,876	—	—	23,201	(893)	25,041	14,256	33,986	1,537	37,399	28,825
Central banks	19,659	—	—	—	—	7	—	7	6,382	26,048	—
Other banks	4,320	—	—	9,192	(916)	1,719	1,187	9,724	25,639	39,683	16,616
Other financial institutions	4,932	—	—	10,583	(737)	908	83	11,408	9,025	25,365	12,921
Corporate	53,128	12,404	5,393	813	45	831	260	1,384	4,141	58,653	70,354
Personal	21,383	1,642	537	—	—	—	—	—	—	21,383	—
	105,298	14,046	5,930	43,789	(2,501)	28,506	15,786	56,509	46,724	208,531	128,716

## CDS bought protection: counterparty analysis by internal asset quality band

	AQ1		AQ2-AQ3		AQ4-AQ9		AQ10		Total	
	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
2011										
Banks	67,624	5,585	1,085	131	198	23	—	—	68,907	5,739
Other financial institutions	79,824	5,605	759	89	2,094	278	147	14	82,824	5,986
Total	147,448	11,190	1,844	220	2,292	301	147	14	151,731	11,725



Ireland

	Lending £m	REIL £m	Provisions £m	AFS and LAR debt securities £m	AFS reserves £m	HFT debt securities		Total debt securities £m	Derivatives (gross of collateral) and repos £m	Balance sheet exposures £m	Credit default (referen Notional Bought Sold £m £m		
						Long £m	Short £m				£m	£m	
2011													
Central and local government	45	—	—	102	(46)	20	19	103	92	240	2,145	2,222	
Central banks	1,467	—	—	—	—	—	—	—	—	1,467	—	—	
Other banks	136	—	—	177	(39)	195	14	358	1,459	1,953	110	107	
Other financial institutions	333	—	—	61	—	116	35	142	855	1,330	523	630	
Corporate	18,994	10,269	5,689	148	3	135	—	283	417	19,694	425	322	
Personal	18,858	2,258	1,048	—	—	—	—	—	1	18,859	—	—	
	39,833	12,527	6,737	488	(82)	466	68	886	2,824	43,543	3,203	3,282	

2010													
Central and local government	61	—	—	104	(45)	93	88	109	20	190	1,872	2,014	
Central banks	2,119	—	—	—	—	7	—	7	126	2,252	—	—	
Other banks	87	—	—	435	(51)	96	45	486	1,523	2,096	317	312	
Other financial institutions	813	—	—	291	(1)	205	—	496	837	2,146	566	597	
Corporate	19,886	8,291	4,072	91	(2)	140	6	225	434	20,545	483	344	
Personal	20,228	1,638	534	—	—	—	—	—	—	20,228	—	—	
	43,194	9,929	4,606	921	(99)	541	139	1,323	2,940	47,457	3,238	3,266	

CDS bought protection: counterparty analysis by internal asset quality band

	AQ1		AQ2-AQ3		AQ4-AQ9		AQ10		Total	
	Notional £m	Fair value £m	Notional £m	Fair value £m	Notional £m	Fair value £m	Notional £m	Fair value £m	Notional £m	Fair value £m
2011										
Banks	1,586	300	2	—	—	—	—	—	1,588	300
Other financial institutions	1,325	232	161	1	129	7	—	—	1,615	240
Total	2,911	532	163	1	129	7	—	—	3,203	540



Business review [Risk and balance sheet management continued](#)

Risk management: Country risk continued  
Ireland continued

Key points\*

- The Group's exposure to Ireland is driven by Ulster Bank Group (87% of the Group's Irish exposure at 31 December 2011). The portfolio is predominantly personal lending of £18.9 billion (largely mortgages) and corporate lending of £19.0 billion (largely loans to the property sector). In addition, the Group has lending and derivatives exposure to the Central Bank of Ireland, financial institutions and large international clients with funding units based in Ireland.
- Group exposure declined in all categories, with notable reductions in lending of £3.4 billion and in off-balance sheet items of £1.4 billion over the year, as a result of currency movements and de-risking in the portfolio.

Central and local government and central bank

- Exposure to the central bank fluctuates, driven by regulatory requirements and by deposits of excess liquidity as part of the Group's assets and liabilities management. Exposures fell by £0.7 billion over the year, with most of the decline occurring in the fourth quarter.

Financial institutions

- Markets, International Banking and Ulster Bank account for the majority of the Group's exposure to financial institutions. Exposure to the financial sector fell by £1.1 billion during the year, caused by a £0.5 billion reduction in lending, a £0.4 billion reduction in debt securities and smaller reductions in derivatives and repos and in off-balance sheet exposure. The largest category is derivatives and repos where exposure is affected predominantly by market movements and transactions are typically collateralised.

Corporate

- Corporate lending exposure fell approximately £0.9 billion over the year, driven by a combination of exchange rate movements and write-offs. At the end of 2011, lending exposure was highest in the property sector (£11.6 billion), which is also the sector that experienced the largest year-on-year reduction (£0.4 billion). REIL and impairment provisions rose by £2.0 billion and £1.6 billion respectively over the year.

Personal

- The Ulster Bank retail portfolio mainly consists of mortgages (approximately 95% of Ulster Bank personal lending at 31 December 2011), with the remainder comprising credit card and other personal lending. Overall personal lending exposure fell approximately £1.4 billion over the year as a result of exchange rate movements, amortisation, a small amount of write-offs and a lack of demand in the market.

Non-Core (included above)

Refer to tables on pages 169 and 170 for details.

- Ireland Non-Core lending exposure was £10.2 billion at 31 December 2011, down by £0.6 billion or 6% since 31 December 2010. The remaining lending portfolio largely consists of exposures to real estate (79%), retail (7%) and leisure (4%).

\* unaudited



## Spain

	Lending	REIL	Provisions	AFS and LAR debt securities	AFS reserves	HFT debt securities	Long	Short	Total debt securities	Derivatives (gross of collateral) and repos	Balance sheet exposures	Credit de (refer Notional	Sol
2011	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Central and local government	9	—	—	33	(15)	360	751	(358)	35	(314)	5,151	5,151	
Central banks	3	—	—	—	—	—	—	—	—	3	—	—	
Other banks	130	—	—	4,892	(867)	162	214	4,840	1,622	6,592	1,965	1,965	
Other financial institutions	154	—	—	1,580	(639)	65	8	1,637	282	2,073	2,417	2,200	
Corporate	5,775	1,190	442	9	—	27	—	36	454	6,265	4,831	3,950	
Personal	362	—	—	—	—	—	—	—	—	362	—	—	
	6,433	1,190	442	6,514	(1,521)	614	973	6,155	2,393	14,981	14,364	13,250	
2010													
Central and local government	19	—	—	88	(7)	1,172	1,248	12	53	84	3,820	3,920	
Central banks	5	—	—	—	—	—	—	—	—	5	—	—	
Other banks	166	—	—	5,264	(834)	147	118	5,293	1,482	6,941	2,087	2,150	
Other financial institutions	92	—	—	1,724	(474)	34	7	1,751	22	1,865	1,648	1,380	
Corporate	6,991	1,871	572	9	38	50	8	51	490	7,532	5,192	4,220	
Personal	407	1	—	—	—	—	—	—	—	407	—	—	
	7,680	1,872	572	7,085	(1,277)	1,403	1,381	7,107	2,047	16,834	12,747	11,690	

## CDS bought protection: counterparty analysis by internal asset quality band

	AQ1		AQ2-AQ3		AQ4-AQ9		AQ10		Total	
	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value
2011	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Banks	6,595	499	68	5	32	4	—	—	6,695	508
Other financial institutions	7,238	736	162	3	269	50	—	—	7,669	789
Total	13,833	1,235	230	8	301	54	—	—	14,364	1,297

Business review [Risk and balance sheet management continued](#)

Risk management: Country risk continued  
Spain continued

Key points\*

- The Group maintains strong relationships with Spanish government entities, banks, other financial institutions and large corporate clients. The exposure to Spain is driven by corporate lending and a large MBS covered bond portfolio.
- Exposure fell in most categories in 2011, particularly in corporate lending, as a result of steps to de-risk the portfolio.

Central and local government and central bank

- The Group's exposure to the government was negative at 31 December 2011, reflecting net short held-for-trading debt securities.

Financial institutions

- A sizeable covered bond portfolio of £6.5 billion is the Group's largest exposure to the Spanish financial sector. The portfolio continued to perform satisfactorily in 2011. Stress analysis conducted to date on these available-for-sale debt securities indicated that this exposure is unlikely to suffer material credit losses. However, the Group continues to monitor the situation closely.
- A further £1.9 billion of the Group's exposure to financial institutions consists of derivatives exposure to Spanish international banks and a few of the large regional banks, the majority of which is collateralised. This increased £0.4 billion in 2011, due partly to market movements.
- Lending to banks consists mainly of short-term uncommitted credit lines with the top two international Spanish banks.

Corporate

- Exposure to corporate clients declined during 2011, with reductions in lending of £1.2 billion and in off-balance sheet items of £0.4 billion, driven by reductions in exposure to property, transport and technology, media and telecommunications sectors. The majority of REIL relates to commercial real estate lending and decreased over the year, reflecting disposals and restructurings.

Non-Core (included above)

Refer to tables on pages 169 and 170 for details.

- As at 31 December 2011, Non-Core had lending exposure of £3.7 billion to Spain, a reduction of £0.8 billion or 18% since 31 December 2010. The real estate (66%), construction (11%), electricity (7%) and land transport (3%) sectors account for the majority of this lending exposure.

\* unaudited

## Italy

	Lending	REIL	Provisions	AFS and LAR debt securities	AFS reserves	HFT debt securities	Long	Short	Total debt securities	Derivatives (gross of collateral) and repos	Balance sheet exposures	Credit def (refer Notional Bought	Sol £
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
2011													
Central and local government	—	—	—	704	(220)	4,336	4,725		315	90	405	12,125	12,21
Central banks	73	—	—	—	—	—	—	—	—	—	73	—	—
Other banks	233	—	—	119	(14)	67	88		98	1,064	1,395	6,078	5,93
Other financial institutions	299	—	—	685	(15)	40	13		712	686	1,697	872	76
Corporate	2,444	361	113	75	—	58	—		133	474	3,051	4,742	4,29
Personal	23	—	—	—	—	—	—		—	—	23	—	—
	3,072	361	113	1,583	(249)	4,501	4,826		1,258	2,314	6,644	23,817	23,21
2010													
Central and local government	45	—	—	906	(99)	5,113	3,175		2,844	71	2,960	8,998	8,51
Central banks	78	—	—	—	—	—	—		—	—	78	—	—
Other banks	668	—	—	198	(11)	67	16		249	782	1,699	4,417	4,45
Other financial institutions	418	—	—	646	(5)	49	—		695	759	1,872	723	69
Corporate	2,483	314	141	20	—	36	8		48	420	2,951	4,506	3,96
Personal	27	—	—	—	—	—	—		—	—	27	—	—
	3,719	314	141	1,770	(115)	5,265	3,199		3,836	2,032	9,587	18,644	17,64

## CDS bought protection: counterparty analysis by internal asset quality band

	AQ1		AQ2-AQ3		AQ4-AQ9		AQ10		Total	
	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
2011										
Banks	12,904	1,676	487	94	61	10	—	—	13,452	1,780
Other financial institutions	10,138	1,550	8	2	219	43	—	—	10,365	1,595
Total	23,042	3,226	495	96	280	53	—	—	23,817	3,375

## Key points\*

- The Group maintains strong relationships with Italian government entities, banks, other financial institutions and large corporate clients. Since the start of 2011, the Group has taken steps to reduce its risks through strategic exits where appropriate, or to mitigate these risks through increased collateral requirements, in line with its evolving appetite for Italian risk. As a result, the Group reduced lending exposure to Italian counterparties by £0.6 billion

over 2011 to £3.1 billion.

#### Central and local government and central bank

- The Group is an active market-maker in Italian government bonds, resulting in large gross long and short positions in held-for-trading securities. Given this role, the Group left itself in a relatively modest long position at 31 December 2011 to avoid being temporarily over exposed as a result of its expected participation in the purchase of new government bonds being issued in January 2012.
- Over 2011, the total government debt securities position declined by £2.5 billion to £0.3 billion, reflecting a rebalancing of the trading portfolio.

#### Financial institutions

- The majority of the Group's exposure to Italian financial institutions relates to the top five banks. The Group's product offering consists largely of collateralised trading products and, to a lesser extent, short-term uncommitted lending lines for liquidity purposes.

#### Corporate

- Lending exposure fell slightly during 2011, with reductions in lending to the property industry offset by increased lending to manufacturing companies, particularly in the fourth quarter.

#### Non-Core (included above)

Refer to tables on pages 169 and 170 for details.

- Non-Core lending exposure was £1.2 billion at 31 December 2011, a £0.7 billion (39%) reduction since 31 December 2010. The remaining lending exposure comprises mainly commercial real estate finance (22%), leisure (20%), unleveraged funds (16%), electricity (15%) and industrials (10%).

\* unaudited

## Business review Risk and balance sheet management continued

## Risk management: Country risk continued

## Greece

	Lending	REIL	Provisions	AFS and LAR debt	AFS reserves	HFT debt		Total debt	Derivatives (gross of collateral) and repos	Balance sheet exposures	Credit (re) Notion Bought
	£m	£m	£m	£m	£m	Long	Short	£m	£m	£m	£m
2011											
Central and local government	7	—	—	312	—	102	5	409	—	416	3,158 3
Central banks	6	—	—	—	—	—	—	—	—	6	—
Other banks	—	—	—	—	—	—	—	—	290	290	22
Other financial institutions	31	—	—	—	—	—	—	—	2	33	34
Corporate	427	256	256	—	—	—	—	—	63	490	434
Personal	14	—	—	—	—	—	—	—	—	14	—
	485	256	256	312	—	102	5	409	355	1,249	3,648 3
2010											
Central and local government	14	—	—	895	(694)	118	39	974	7	995	2,960 3
Central banks	36	—	—	—	—	—	—	—	—	36	—
Other banks	18	—	—	—	—	—	—	—	167	185	21
Other financial institutions	31	—	—	—	—	—	—	—	3	34	35
Corporate	191	48	48	—	—	—	—	—	50	241	511
Personal	16	—	—	—	—	—	—	—	—	16	—
	306	48	48	895	(694)	118	39	974	227	1,507	3,527 3

## CDS bought protection: counterparty analysis by internal asset quality band

	AQ1		AQ2-AQ3		AQ4-AQ9		AQ10		Total	
	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
2011										
Banks	2,001	1,345	1	1	—	—	—	—	2,002	1,346
Other financial institutions	1,507	945	63	45	76	47	—	—	1,646	1,037
Total	3,508	2,290	64	46	76	47	—	—	3,648	2,383

## Key points\*

- The Group has reduced its effective exposure to Greece and continues to actively manage its exposure to the country, in line with the de-risking strategy that has been in place since early 2010. Much of the remaining exposure is collateralised or guaranteed.

Central and local government and central bank

- As a result of the continued deterioration in Greece's fiscal position, coupled with the potential for the restructuring of Greek sovereign debt, the Group recognised an impairment charge in respect of available-for-sale Greek government bonds.

Financial institutions

- Activity with Greek financial companies is under close scrutiny; exposure is minimal.
- Due to market movements, the gross derivatives exposure to banks increased by £0.1 billion during the year. The portfolio is largely collateralised.

Corporate

- At the start of 2011, the Group reclassified the domicile of exposures to a number of defaulted clients, resulting in an increase in reported exposure to Greek corporate clients as well as increases in REIL and impairment provisions.
- The Group's focus is now on short-term trade facilities to the domestic subsidiaries of international clients, increasingly supported by parental guarantees.

Non-Core (included above)

Refer to tables on pages 169 and 170 for details.

- The Non-Core division's lending exposure to Greece was £0.1 billion at 31 December 2011, a reduction of 28% since 31 December 2010. The remaining lending portfolio primarily consists of the following sectors: financial intermediaries (33%), construction (20%), other services (16%) and electricity (14%).

\* unaudited

## Portugal

	Lending £m	REIL £m	Provisions £m	AFS and LAR debt		HFT debt		Total debt securities £m	Derivatives (gross of collateral) and repos £m	Balance sheet exposures £m	Credit defa (referen Notional	
				securities £m	reserves £m	Long £m	Short £m				Bought £m	Sold £m
2011												
Central and local government	—	—	—	56	(58)	36	152	(60)	19	(41)	3,304	3,413
Other banks	10	—	—	91	(36)	12	2	101	389	500	1,197	1,155
Other financial institutions	—	—	—	5	—	7	—	12	30	42	8	5
Corporate	495	27	27	42	1	18	—	60	81	636	366	321
Personal	5	—	—	—	—	—	—	—	—	5	—	—
	510	27	27	194	(93)	73	154	113	519	1,142	4,875	4,894
2010												
Central and local government	86	—	—	92	(26)	68	122	38	29	153	2,844	2,923
Other banks	63	—	—	106	(24)	46	2	150	307	520	1,085	1,107
Other financial institutions	—	—	—	47	—	7	—	54	7	61	9	6
Corporate	611	27	21	—	1	—	—	—	51	662	581	507
Personal	6	—	—	—	—	—	—	—	—	6	—	—
	766	27	21	245	(49)	121	124	242	394	1,402	4,519	4,543

## CDS bought protection: counterparty analysis by internal asset quality band

	AQ1		AQ2-AQ3		AQ4-AQ9		AQ10		Total	
	Notional £m	Fair value £m	Notional £m	Fair value £m	Notional £m	Fair value £m	Notional £m	Fair value £m	Notional £m	Fair value £m
2011										
Banks	2,922	786	46	12	—	—	—	—	2,968	798
Other financial institutions	1,874	517	—	—	33	15	—	—	1,907	532
Total	4,796	1,303	46	12	33	15	—	—	4,875	1,330

## Key points\*

- In early 2011, RBS closed its local operations in Portugal, leaving the Group with modest overall exposure of £1.4 billion by year-end. The portfolio, now managed out of Spain, is focused on corporate lending and derivatives trading with the largest local banks. Medium-term activity has ceased with the exception of that carried out under a Credit Support Annex.

## Central and local government and central bank

- During 2011, the Group's exposure to the Portuguese government was reduced to a very small derivatives position, the result of decreases in contingent and lending exposures to public sector entities by way of facility maturities. The Group's exposure to the government was negative at 31 December 2011, reflecting net short held-for-trading debt securities.

Financial institutions

- A major proportion of the remaining exposures is focused on the top four systemically important financial groups. Exposures generally consist of collateralised trading products.

Corporate

- The largest non-financial corporate exposure is to the energy and transport sectors. The Group's exposure is concentrated on a few large, highly creditworthy clients.

Non-Core (included above)

Refer to tables on pages 169 and 170 for details.

- The Non-Core division's lending exposure to Portugal was £0.3 billion at 31 December 2011, an increase of 8% in the portfolio since 31 December 2010, due to an infrastructure project drawing committed facilities. The portfolio comprises lending exposure to the land transport and logistics (52%), electricity (30%) and commercial real estate (14%) sectors. There is no exposure to central or local government.

\* unaudited



## Business review Risk and balance sheet management continued

## Risk management: Country risk continued

## Germany

	Lending	REIL	Provisions	AFS and LAR debt	AFS reserves	HFT debt securities		Total debt securities	Derivatives (gross of collateral) and repos	Balance sheet exposures	
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
2011											
Central and local government	—	—	—	12,035	523	4,136	2,084	14,087	423	14,510	2,600
Central banks	18,068	—	—	—	—	—	—	—	2	18,070	—
Other banks	653	—	—	1,376	5	294	761	909	6,003	7,565	4,700
Other financial institutions	305	—	—	563	(33)	187	95	655	3,321	4,281	3,600
Corporate	6,608	191	80	109	9	14	7	116	586	7,310	20,400
Personal	155	19	19	—	—	—	—	—	—	155	—
	25,789	210	99	14,083	504	4,631	2,947	15,767	10,335	51,891	31,400
2010											
Central and local government	—	—	—	10,648	1	5,964	4,124	12,488	160	12,648	2,000
Central banks	10,894	—	—	—	—	—	—	—	6,233	17,127	—
Other banks	1,060	—	—	1,291	3	567	481	1,377	6,289	8,726	3,800
Other financial institutions	422	—	—	494	(47)	195	17	672	1,951	3,045	2,700
Corporate	7,519	163	44	219	4	44	53	210	633	8,362	20,700
Personal	162	—	—	—	—	—	—	—	—	162	—
	20,057	163	44	12,652	(39)	6,770	4,675	14,747	15,266	50,070	29,300

## CDS bought protection: counterparty analysis by internal asset quality band

	AQ1		AQ2-AQ3		AQ4-AQ9		AQ10		Total	
	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
2011										
Banks	14,644	171	163	4	8	—	—	—	14,815	175
Other financial institutions	16,315	357	18	—	334	6	—	—	16,667	363
Total	30,959	528	181	4	342	6	—	—	31,482	538

## Netherlands

	Lending	REIL	Provisions	AFS and LAR debt	AFS reserves	HFT debt securities		Total debt securities	Derivatives (gross of collateral) and repos	Balance sheet exposures	Credit (re) Notio Bought
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
2011											
Central and local government	8	—	—	1,447	74	849	591	1,705	40	1,753	1,206
Central banks	7,654	—	—	—	—	6	—	6	7	7,667	—
Other banks	623	—	—	802	217	365	278	889	7,574	9,086	965
Other financial institutions	1,557	—	—	6,804	(386)	290	108	6,986	1,914	10,475	5,772
Corporate	4,827	621	209	199	6	113	5	307	750	5,884	15,416
Personal	20	3	2	—	—	—	—	—	—	20	—
	14,689	624	211	9,252	(89)	1,623	982	9,893	10,285	34,867	23,359
2010											
Central and local government	914	—	—	3,469	16	1,426	607	4,288	46	5,248	1,195
Central banks	6,484	—	—	—	—	—	—	—	—	6,484	—
Other banks	554	—	—	984	2	223	275	932	5,021	6,507	784
Other financial institutions	1,801	—	—	6,612	(185)	344	12	6,944	3,116	11,861	4,210
Corporate	6,170	388	149	264	3	152	57	359	875	7,404	12,330
Personal	81	3	3	—	—	—	—	—	—	81	—
	16,004	391	152	11,329	(164)	2,145	951	12,523	9,058	37,585	18,519

## CDS bought protection: counterparty analysis by internal asset quality band

	AQ1		AQ2-AQ3		AQ4-AQ9		AQ10		Total	
	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
2011										
Banks	7,605	107	88	1	6	—	—	—	7,699	108
Other financial institutions	14,529	231	308	37	676	81	147	14	15,660	363
Total	22,134	338	396	38	682	81	147	14	23,359	471

## Business review Risk and balance sheet management continued

## Risk management: Country risk continued

## France

	Lending	REIL	Provisions	AFS and LAR debt securities	AFS reserves	HFT debt securities		Total debt securities	Derivatives (gross of collateral) and repos	Balance sheet exposures	Bou
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
2011											
Central and local government	481	—	—	2,648	(14)	8,705	5,669	5,684	357	6,522	3,
Central banks	3	—	—	20	—	—	—	20	—	35	
Other banks	1,273	—	—	889	(17)	157	75	971	7,271	9,515	4,
Other financial Institutions	282	—	—	642	(40)	325	126	841	675	1,798	2,
Corporate	3,761	128	74	240	9	72	34	278	743	4,782	23,
Personal	79	—	—	—	—	—	—	—	—	79	
	5,879	128	74	4,439	(62)	9,259	5,904	7,794	9,046	22,719	33,
2010											
Central and local government	511	—	—	5,912	40	10,266	3,968	12,210	362	13,083	2,
Central banks	3	—	—	—	—	—	—	—	15	18	
Other banks	1,095	—	—	774	—	410	204	980	7,183	9,258	3,
Other financial institutions	470	—	—	666	(22)	42	23	685	375	1,530	1,
Corporate	4,376	230	46	71	1	185	90	166	672	5,214	19,
Personal	102	—	—	—	—	—	—	—	—	102	
	6,557	230	46	7,423	19	10,903	4,285	14,041	8,607	29,205	27,

## CDS bought protection: counterparty analysis by internal asset quality band

	AQ1		AQ2-AQ3		AQ4-AQ9		AQ10		Total	
	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
2011										
Banks	13,353	453	162	13	79	8	—	—	13,594	474
Other financial institutions	19,641	758	24	1	254	22	—	—	19,919	781
Total	32,994	1,211	186	14	333	30	—	—	33,513	1,255

## Luxembourg

	Lending	REIL	Provisions	AFS and LAR debt securities	AFS reserves	HFT debt securities		Total debt securities	Derivatives (gross of collateral) and repos	Balance sheet exposures	Cre No Bough
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
2011											
Other banks	101	—	—	10	—	7	—	17	546	664	
Other financial Institutions	925	—	—	54	(7)	82	80	56	2,963	3,944	2,08
Corporate	2,228	897	301	5	—	58	6	57	180	2,465	2,47
Personal	2	—	—	—	—	—	—	—	—	2	
	3,256	897	301	69	(7)	147	86	130	3,689	7,075	4,55
2010											
Central and local government	—	—	—	—	—	24	—	24	—	24	
Central banks	25	—	—	—	—	—	—	—	—	25	
Other banks	26	—	—	30	(1)	45	—	75	499	600	
Other financial institutions	734	—	—	99	(3)	32	19	112	1,800	2,646	1,29
Corporate	2,503	807	206	5	1	183	21	167	246	2,916	2,36
Personal	3	—	—	—	—	—	—	—	—	3	
	3,291	807	206	134	(3)	284	40	378	2,545	6,214	3,66

## CDS bought protection: counterparty analysis by internal asset quality band

	AQ1		AQ2-AQ3		AQ4-AQ9		AQ10		Total	
	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
2011										
Banks	1,535	93	16	—	—	—	—	—	1,551	93
Other financial institutions	2,927	164	10	—	70	7	—	—	3,007	171
Total	4,462	257	26	—	70	7	—	—	4,558	264

## Business review Risk and balance sheet management continued

## Risk management: Country risk continued

## Belgium

	Lending	REIL	Provisions	AFS and LAR debt securities	AFS reserves	HFT debt securities		Total debt securities	Derivatives (gross of collateral) and repos	Balance sheet exposures	
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
2011											
Central and local government	—	—	—	742	(116)	608	722	628	89	717	1,611
Central banks	8	—	—	—	—	—	—	—	3	11	31
Other banks	287	—	—	4	—	—	—	4	2,450	2,741	56
Other financial institutions	354	—	—	—	—	1	4	(3)	191	542	2,487
Corporate	588	31	21	3	—	20	—	23	277	888	56
Personal	20	—	—	—	—	—	—	—	—	20	2,487
	1,257	31	21	749	(116)	629	726	652	3,010	4,919	2,487
2010											
Central and local government	102	—	—	763	(54)	529	602	690	92	884	884
Central banks	14	—	—	—	—	—	—	—	7	21	27
Other banks	441	—	—	39	1	66	2	103	1,822	2,366	27
Other financial institutions	32	—	—	—	—	—	—	—	126	158	62
Corporate	893	27	27	1	—	11	2	10	191	1,094	62
Personal	327	—	—	—	—	—	—	—	—	327	1,787
	1,809	27	27	803	(53)	606	606	803	2,238	4,850	1,787

## CDS bought protection: counterparty analysis by internal asset quality band

	AQ1		AQ2-AQ3		AQ4-AQ9		AQ10		Total	
	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
2011										
Banks	1,602	97	2	—	12	1	—	—	1,616	98
Other financial institutions	866	48	1	—	4	—	—	—	871	48
Total	2,468	145	3	—	16	1	—	—	2,487	146

## Rest of eurozone (1)

	Lending	REIL	Provisions	AFS and LAR debt securities	AFS reserves	HFT debt securities		Total debt securities	Derivatives (gross of collateral) and repos	Balance sheet exposures	Cre ( Not Bough £m
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
2011											
Central and local government	121	—	—	327	(47)	445	331	441	779	1,341	2,28
Central banks	—	—	—	—	—	—	—	—	23	23	
Other banks	28	—	—	63	(1)	13	70	6	1,017	1,051	9
Other financial institutions	115	—	—	100	(9)	25	2	123	37	275	
Corporate	1,375	181	55	134	(4)	13	7	140	94	1,609	4,05
Personal	26	—	—	—	—	—	—	—	—	26	
	1,665	181	55	624	(61)	496	410	710	1,950	4,325	6,42
2010											
Central and local government	124	—	—	324	(25)	268	283	309	697	1,130	1,97
Central banks	1	—	—	—	—	—	—	—	1	2	
Other banks	142	—	—	71	(1)	52	44	79	564	785	14
Other financial institutions	119	—	—	4	—	—	5	(1)	29	147	
Corporate	1,505	238	67	133	(1)	30	15	148	79	1,732	3,25
Personal	24	—	—	—	—	—	—	—	—	24	
	1,915	238	67	532	(27)	350	347	535	1,370	3,820	5,37

## CDS bought protection: counterparty analysis by internal asset quality band

	AQ1		AQ2-AQ3		AQ4-AQ9		AQ10		Total	
	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
2011										
Banks	2,877	58	50	1	—	—	—	—	2,927	59
Other financial institutions	3,464	67	4	—	30	—	—	—	3,498	67
Total	6,341	125	54	1	30	—	—	—	6,425	126

Note:

(1) Comprises Austria, Cyprus, Estonia, Finland, Malta, Slovakia and Slovenia.

Business review [Risk and balance sheet management continued](#)

Risk management: Country risk continued  
Eurozone non-periphery

Key points\*

- Due to credit risk and capital considerations, the Group increased exposure to central banks (particularly in Germany and the Netherlands) by depositing with them higher levels of surplus liquidity on a short-term basis, given the limited alternative investment opportunities.
- During 2011, in anticipation of widening credit spreads and for reasons of general risk management, the Group reduced its holdings in French and Dutch AFS sovereign bonds. The Group concurrently increased its holdings of German AFS sovereign debt in line with internal liquidity and risk management strategies.

Financial institutions

- France - approximately half of the lending to banks is to the top three banks.
- Luxembourg - lending to non-bank financial institutions increased by £0.2 billion during 2011 reflecting collateral relating to derivatives and repos.

Corporate

- Netherlands - corporate lending fell £1.3 billion over 2011, driven by the manufacturing, natural resources and services sectors. The relatively large contingent liabilities and commitments declined £7.9 billion.

Non-Core

Refer to tables on pages 169 and 170 for details.

- Non-Core lending exposure has been generally reduced in line with the Group's Strategic Plan. Lending exposure in France was £2.3 billion at 31 December 2011, having declined £0.5 billion during 2011. The lending portfolio mainly comprises property (45%) and sovereign and quasi-sovereign (20%) exposures.
- Non-Core lending exposure in Germany was £5.4 billion at 31 December 2011, down £1.1 billion since 31 December 2010. The lending portfolio is mostly in the property (44%) and transport (35%) sectors.
- Non-Core lending exposure in the Netherlands was £2.5 billion at 31 December 2011, down £0.7 billion. The portfolio mainly comprises exposures to the property (66%) and technology, media and telecommunications (19%) sectors.

\* unaudited

## Market risk

All the disclosures in this section (pages 187 to 193) are audited, unless indicated otherwise with an asterisk (\*).

Market risk arises from changes in interest rates, foreign currency, credit spreads, equity prices and risk related factors such as market volatilities. The Group manages market risk centrally within its trading and non-trading portfolios through a comprehensive market risk management framework. This control framework includes qualitative guidance in the form of comprehensive policy statements, dealing authorities, limits based on, but not limited to, value-at-risk (VaR), stress testing, positions and sensitivity analyses.

## Governance

### Business structure

The primary focus of the Group's trading activities is to provide an extensive range of debt and equity financing, risk management and investment services to its customers, including major corporations and financial institutions around the world. The Group undertakes these activities organised within the principal business lines: money markets, rates flow trading, currencies and commodities, equities, credit markets and portfolio management and origination.

Financial instruments held in the Group's trading portfolios include, but are not limited to: debt securities, loans, deposits, equities, securities sale and repurchase agreements and derivative financial instruments.

The Group undertakes transactions in financial instruments that are traded or cleared on an exchange, including interest rate swaps, futures and options. Holders of exchange traded instruments provide margin on a daily basis with cash or other security at the exchange.

The Group also undertakes transactions in financial instruments that are traded over-the-counter (OTC) rather than on a recognised exchange. These instruments range from commoditised transactions in derivative markets, to trades where the specific terms are tailored to meet customer requirements.

Assets and liabilities in the trading book are measured at their fair value. Fair value is the amount at which the instrument could be exchanged in a current transaction. The fair values are determined following IAS 39 guidance, which requires banks to use quoted market prices or, where this is not possible, valuation techniques (models) that make appropriate use of available observable inputs. When marking to market using a model, the valuation methodologies are approved by all stakeholders (trading, finance, market risk, model development and model review) prior to use for profit and loss and risk management purposes. Any profits or losses on the revaluation of positions are recognised in the daily profit and loss.

### Organisation structure

Independent oversight and support is provided to the business by the Global Head of Market & Insurance Risk, assisted by the Group and business Market Risk teams. The head of each business, assisted by a business market risk management team, is accountable for all market risks associated with its activities. The Global Market Risk Committee reviews and makes recommendations concerning the market risk profile across the Group, including risk appetite, risk policy, models, methodology and market risk development issues. The committee meets monthly and is chaired by the Global Head of Market & Insurance Risk. Attendees include respective business market risk managers and Group Market Risk.

## Risk management

### Key principles



The Group's qualitative market risk appetite is set out in policy statements, which outline the governance, responsibilities and requirements surrounding the identification, measurement, analysis, management and communication of market risk arising from the trading and non-trading investment activities of the Group. All teams involved in the management and control of market risk are required to fully comply with the policy statements to ensure the Group is not exposed to market risk beyond the qualitative and quantitative risk appetite. The control framework covers the following principles:

- Clearly defined responsibilities and authorities for the primary groups involved in market risk management in the Group;
- An independent market risk management process;
- A market risk measurement methodology that captures correlation effects and allows aggregation of market risk across risk types, markets and business lines;
- Daily monitoring, analysis and reporting of market risk exposures against market risk limits;
- Clearly defined limit structure and escalation process in the event of a market risk limit excess;
- Use of VaR as a measure of the one-day market risk exposure of all trading positions;
- Use of non-VaR based limits and other controls;
- Use of stress testing and scenario analysis to support the market risk measurement and risk management process by assessing how portfolios and global business lines perform under extreme market conditions;
- Use of back-testing as a diagnostic tool to assess the accuracy of the VaR model and other risk management techniques;
- Adherence to the risks not in VaR (RNIV) framework to identify and quantify risks not captured within the VaR model; and
- A new product approval process that requires market risk teams to assess and quantify market risk associated with proposed new products.

Business review Risk and balance sheet management [continued](#)

Risk management: Market risk continued

Quantitative risk appetite

The Executive Risk Forum (ERF) approves the quantitative market risk appetite for trading and non-trading activities. The Global Head of Market & Insurance Risk, under delegated authority from the ERF, sets and populates a limit framework, which is cascaded down through legal entity, division, business and desk level market risk limits.

At the Group level, the risk appetite is expressed in the form of a combination of VaR, sensitivity and stress testing limits.

A daily report summarises the Group's market risk exposures against the agreed limits. This daily report is sent to the Head of Restructuring & Risk, Global Head of Market & Insurance Risk, business Chief Risk Officers and appropriate business market risk managers.

Legal entities, divisions and lower levels in the business also have an appropriate market risk framework of controls and limits in place to cover all material market risk exposures.

The specific market risk metrics that are appropriate for controlling the positions of a desk will be more granular than the Group level limits and tailored to the particular business.

In line with the overall business strategy to reduce risk exposures, the Group's market risk limits were adjusted down during 2011.

The majority of the Group's market risk exposure is in the Markets and Non-Core divisions and Group Treasury. The Group is also exposed to market risk through interest rate risk on its non-trading activities. There are additional non-trading market risks in the retail and commercial businesses of the Group, principally interest rate risk and foreign exchange risk. These aspects are discussed in more detail in Balance sheet management - Interest rate risk on pages 189 and 190 and structural foreign currency exposures on page 191.

Risk models

VaR is a technique that produces estimates of the potential change in the market value of a portfolio over a specified time horizon at a given confidence level. For internal risk management purposes, the Group's VaR assumes a time horizon of one trading day and a confidence level of 99%. The Group's VaR model is based on a historical simulation model, utilising data from the previous two years.

The VaR model has been approved by the FSA to calculate regulatory capital for the trading book. The approval covers general market risk in interest rate, foreign exchange, equity and specified commodity products and specific risk in interest rate and equity products.

The VaR model is an important market risk measurement and control tool. It is used for determining a significant component of the market risk capital and, as such, it is regularly assessed. The main approach employed is the technique known as back-testing, which counts the number of days when a loss (as defined by the FSA) exceeds the corresponding daily VaR estimate, measured at a 99% confidence level.

The FSA categorises a VaR model as green, amber or red. A green model status is consistent with a good working model and is achieved for models that have four or fewer back-testing exceptions in a 12-month period. For the Group's trading book, a green model status was maintained throughout 2011.

The Group's VaR should be interpreted in light of the limitations of the methodology used, as follows:

- Historical simulation VaR may not provide the best estimate of future market movements. It can only provide a prediction of the future based on events that occurred in the two-year time series. Therefore, events that are more severe than those in the historical data series cannot be predicted.
- The use of a 99% confidence level does not reflect the extent of potential losses beyond that percentile.
- The use of a one-day time horizon will not fully capture the profit and loss implications of positions that cannot be liquidated or hedged within one day.
- The Group computes the VaR of trading portfolios at the close of business. Positions may change substantially during the course of the trading day and, if so, intra-day profit and losses will be incurred.

These limitations mean that the Group cannot guarantee that losses will not exceed the VaR.

The RNIV framework has been developed to quantify those market risks not adequately captured by the market standard VaR methodology. Where risks are not included in the model, various non-VaR controls (for example, portfolio size limits, sensitivity limits, triggers or stress limits) are in place.

Risk models are developed both within business units and by Group functions. Risk models are also subject to independent review and sign-off to the same standard as pricing models. Meetings are held with the FSA every quarter to discuss the traded market risk, including changes in models, management, back-testing results, risks not included in the VaR framework and other model performance statistics.

A number of VaR model and methodology enhancements were introduced during 2011. The quality of the market data time series used in the ABS mortgage trading business was improved, moving from interpolated weekly data to daily observed time series. This change has improved the accuracy of the correlation between the different time series in the daily data. Additionally, the basis modelling between cash and derivatives has been refined by introducing additional time series for the sub-prime and subordinated residential bonds, reducing the over-reliance on the commercial mortgage basis which was used as a conservative proxy.

A more appropriate time series for the Dutch RMBS portfolio was adopted to better reflect the risk in the portfolio as more granular data became available. In addition, collateralised based discounting has been implemented for the vast majority of the collateralised positions in place of the previous LIBOR-based discounting approach.

Following the implementation of CRD III, three new models - for stressed VaR, incremental risk charge and all price risk (see more below) - have been fully approved by the UK regulator and form part of the capital and risk management framework from 31 December 2011 onwards.

#### Basel 2.5 (CRD III)\*

The aim of CRD III is to improve the financial strength of institutions by increasing the financial resources required against certain risks in the trading book.

The Group is required to calculate: (i) an additional capital charge based on a stressed calibration of the VaR model - stressed VaR; (ii) an incremental risk charge to capture the default and migration risk for credit risk positions in the trading book; and (iii) an all price risk measure for correlation trading positions, subject to a capital floor that is based on standardised securitisation charges.

The capital charges associated with these new models at 31 December 2011 are shown in the table below:

	Total £m
Stressed VaR	1,682
Incremental risk	469
All price risk	297

All other aspects of the CRD III rule changes have also been implemented.

#### Pricing models

Pricing models are developed and owned by the front office. Where pricing models are used as the basis of books and records valuations, they are subject to oversight and approval by asset level modelled product review committees (ALMPRCs). These committees prioritise models for independent validation by Group Risk Analytics (GRA) taking into consideration both the materiality of risk booked against the model and an assessment of the degree of model risk (i.e. valuation uncertainty arising from choice of modelling assumptions). The GRA review aims to quantify model risk by comparing model outputs against those of alternative independently developed models, the results of which are used by Market Risk to inform risk limits and by Finance to inform model reserves.

In 2011, updated Group Standards for the development, testing and validation of derivative pricing models were agreed and implemented. Revisions to the model validation framework ensure that all new models and model changes are reviewed by Market Risk and Finance and, subject to materiality, independently validated by GRA. Model governance is through the ALMPRCs, which are newly established sub-committees of the overall Markets and International Banking Modelled Product Review Committee (previously called the Group Model Product Review Committee).

#### Stress testing

The Group undertakes daily stress testing to identify the potential losses in excess of VaR. Stress testing is used to calculate a range of trading book exposures which result from extreme market events. Stress testing measures the impact of exceptional changes in market rates and prices on the fair value of the Group's trading portfolios. The Group calculates sensitivity analysis, historical stress tests and bottom-up stress testing.

Sensitivity analysis measures the sensitivity of the current portfolio of positions to defined market risk factor movements. These stresses are of a smaller magnitude compared to historical or bottom-up stress testing and are subject to the Group Market Risk limit framework.

Historical stress tests calculate the changes in the portfolio valuations that would be generated if the market movements that occurred during historical market events were repeated.

Bottom-up stress testing is based on analysing the market risk exposures by risk factors and stressing each risk factor based on consultation with risk managers, economists and front office. The tests may be based on an economic scenario that is translated into risk factor shocks by an economist or by risk managers and front office as a means of assessing the vulnerabilities of their book.

The Global Market Risk Stress Testing Committee reviews and discusses all matters relating to market risk stress testing. Stress test exposures are discussed with senior management and relevant information is reported to the Group Risk Committee, the ERF and the Board. Breaches in the Group's market risk stress testing limits are monitored and reported.

In 2011, the market risk stress testing framework was further developed and enhanced. Reverse stress testing has been implemented, which is designed to assess the plausibility of stressing market risk factors until the loss reaches a given threshold.

In addition to VaR and stress testing, the Group calculates a wide range of sensitivity and position risk measures, for example interest rate ladders or option revaluation matrices. These measures provide valuable additional controls, often at individual desk or strategy level.

\* unaudited

Business review Risk and balance sheet management [continued](#)

Risk management: Market risk continued

Markets traded revenues\*

Note:

(1) The effect of any month end adjustments, not attributable to a specific daily market move, is spread evenly over the days of the relevant month.

Key points\*

- Markets trading revenue was adversely affected by ongoing concerns around the European sovereign crisis and an overall uncertain macroeconomic environment. High volatility in the markets and increasingly risk-averse sentiment reduced levels of trading activity.
- The average daily revenue earned by Markets' trading activities in 2011 was £19 million, compared with £25 million in 2010. The standard deviation of the daily revenues for 2011 was £21 million, down from £22 million in 2010. The standard deviation measures the variation of daily revenues about the mean value of those revenues.
- The number of days with negative revenue increased from 22 days in 2010 to 42 days in 2011, primarily due to the market and economic conditions referred to above.
- The most frequent result is daily revenue of between £25 million and £30 million with 30 occurrences in 2011, compared with 37 occurrences in 2010.

Daily VaR graph\*

\*unaudited

### Trading VaR

The Group has disclosed separately the Counterparty Exposure Management (CEM) trading book exposure and the exposure of Core excluding CEM. The CEM desk manages the counterparty risk associated with over-the-counter derivatives on behalf of Markets. This risk is centrally controlled and actively managed to reduce excessive concentrations and unwanted counterparty exposures. The hedge positions are reported in the trading books and, thus, included in market risk VaR calculations for the Group, whereas the market value of the counterparty credit risk does not contribute to VaR for regulatory capital. The CEM VaR is disclosed separately, to allow a clear representation of the risk exposure of the trading book including and excluding these hedge activities.

The table below analyses the VaR for the Group's trading portfolios segregated by type of market risk exposure.

	2011				2010				2009			
	Average	end	Maximum	Minimum	Average	end	Maximum	Minimum	Average	end	Maximum	Minimum
Trading VaR	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Interest rate	53.4	68.1	79.2	27.5	51.6	57.0	83.0	32.5	57.0	50.5	112.8	
Credit spread	82.7	74.3	151.1	47.4	166.3	133.4	243.2	110.2	148.3	174.8	231.2	
Currency	10.3	16.2	19.2	5.2	17.9	14.8	28.0	8.4	17.9	20.7	35.8	
Equity	9.4	8.0	17.3	4.6	9.5	10.9	17.9	2.7	13.0	13.1	23.2	
Commodity	1.4	2.3	7.0	—	9.5	0.5	18.1	0.5	14.3	8.9	32.1	
Diversification (1)		(52.3)				(75.6)				(86.1)		
	105.5	116.6	181.3	59.7	168.5	141.0	252.1	103.0	155.2	181.9	229.0	
Core (total)	75.8	89.1	133.9	41.7	103.6	101.2	153.4	58.3	101.5	127.3	137.8	
Core CEM	36.8	52.4	54.1	21.9	53.3	54.6	82.4	30.3	29.7	38.6	41.3	
Core excluding CEM	59.2	42.1	106.2	35.3	82.8	78.7	108.7	53.6	86.7	97.4	128.5	
Non-Core	64.4	34.6	128.6	30.0	105.7	101.4	169.4	63.2	86.3	84.8	162.1	

### Note:

(1) The Group benefits from diversification, which reflects the risk reduction achieved by allocating investments across various financial instrument types, industry counterparties, currencies and regions. The extent of diversification benefit depends on the correlation between the assets and risk factors in the portfolio at a particular time. Diversification has an inverse relationship with correlation. The diversification factor is the sum of the VaR on individual risk types less the total portfolio VaR.

### Key points

- The Group's market risk profile in 2010 was equally split across Non-Core and Core divisions, with a concentrated exposure to credit spread risk factors. The credit spread risk exposure significantly decreased in 2011, primarily due to the reduction in ABS trading inventory in Core and the restructuring of some monoline hedges for banking book exposures in Non-Core, in line with the overall business strategy to reduce risk exposures.
- The credit spread VaR also decreased due to the adoption of a more appropriate daily time series for sub-prime/subordinated RMBS and as the period of high volatility relating to the 2008/2009 financial crisis dropped out of the VaR calculation.

- Overall the average interest rate trading VaR was relatively unchanged between 2011 and 2010.
- At the end of 2010, the commodity VaR was materially lower than the average for that year as a result of the completion of the sale of the Group's interest in the RBS Sempra Commodities joint venture. The commodity VaR increased slightly from mid-September 2011, due to improvements in capturing risk for commodity futures and indices.



Business review Risk and balance sheet management [continued](#)

Risk management: Market risk continued

Non-trading portfolios

The table below analyses the risk for the Group's non-trading portfolios.

VaR is not always the most appropriate measure of risk for assets in the banking book and particularly for those in Non-Core, which will diminish over time as the asset inventory is sold down.

In order to better represent the risk of the non-traded portfolios, the table below analyses the VaR for the non-trading portfolios but excludes the Non-Core structured credit portfolio (SCP). These assets are shown separately on a drawn notional and fair value basis by maturity profile and asset class. The risk in this portfolio is managed on both a third party asset and RWA basis.

Also excluded from the non-traded VaR are the loans and receivable products that are managed within the credit risk management framework.

	2011				2010				2009			
	Average	Period end	Maximum	Minimum	Average	Period end	Maximum	Minimum	Average	Period end	Maximum	Minimum
VaR	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Interest rate	8.8	9.9	11.1	5.7	8.7	10.4	20.5	4.4	13.0	13.9	26.3	
Credit spread	18.2	13.6	39.3	12.1	32.0	16.1	101.2	15.4	81.7	100.3	131.5	
Currency	2.1	4.0	5.9	0.1	2.1	3.0	7.6	0.3	1.4	0.6	7.0	
Equity	2.1	1.9	3.1	1.6	1.2	3.1	4.6	0.2	3.3	2.2	5.8	
Diversification												
(1)		(13.6)				(15.9)				(20.4)		
	19.7	15.8	41.6	13.4	30.9	16.7	98.0	13.7	80.4	96.6	126.9	
Core	19.3	15.1	38.9	13.5	30.5	15.6	98.1	12.8	78.4	95.9	126.9	
Non-Core	3.4	2.5	4.3	2.2	1.3	2.8	4.1	0.2	3.5	1.9	16.9	

Note:

(1) The Group benefits from diversification, which reflects the risk reduction achieved by allocating investments across various financial instrument types, industry counterparties, currencies and regions. The extent of diversification benefit depends on the correlation between the assets and risk factors in the portfolio at a particular time. Diversification has an inverse relationship with correlation. The diversification factor is the sum of the VaR on individual risk types less the total portfolio VaR.

Key points

- The Group's total non-trading VaR at 31 December 2011 was significantly lower than at 31 December 2010, due to the exceptional volatility of the 2008/2009 financial crisis dropping out of the two-year time series data used in the VaR calculation.
- The maximum credit spread VaR was considerably lower in 2011 than in 2010. This was due to the implementation in early 2011 of the relative price-based mapping scheme for the Dutch RMBS portfolio. The availability of more granular data provided a better reflection of the risk in the portfolio.



## Structured credit portfolios

	Drawn notional					Fair value				
	CDOs	CLOs	MBS (1)	Other ABS	Total	CDOs	CLOs	MBS (1)	Other ABS	Total
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
2011										
1-2 years	—	—	—	27	27	—	—	—	22	22
2-3 years	—	—	10	196	206	—	—	9	182	191
4-5 years	—	37	37	95	169	—	34	30	88	152
5-10 years	32	503	270	268	1,073	30	455	184	229	898
>10 years	2,180	442	464	593	3,679	766	371	291	347	1,775
	2,212	982	781	1,179	5,154	796	860	514	868	3,038
2010										
1-2 years	—	—	—	47	47	—	—	—	42	42
2-3 years	85	19	44	98	246	81	18	37	91	227
3-4 years	—	41	20	205	266	—	37	19	191	247
4-5 years	16	—	—	—	16	15	—	—	—	15
5-10 years	98	466	311	437	1,312	87	422	220	384	1,113
>10 years	412	663	584	550	2,209	161	515	397	367	1,440
	611	1,189	959	1,337	4,096	344	992	673	1,075	3,084
2009										
1-2 years	—	—	—	81	81	—	—	—	68	68
2-3 years	40	—	—	19	59	24	—	—	18	42
3-4 years	19	18	42	99	178	16	17	31	76	140
4-5 years	17	47	36	332	432	3	41	29	275	348
5-10 years	107	685	424	521	1,737	90	594	251	394	1,329
>10 years	594	1,114	820	573	3,101	193	896	468	325	1,882
	777	1,864	1,322	1,625	5,588	326	1,548	779	1,156	3,809

## Note:

(1) Mortgage-backed securities (MBS) include sub-prime residential mortgage-backed securities (RMBS) with a drawn notional amount of £401 million (31 December 2010 - £471 million) and a fair value of £252 million (31 December 2010 - £329 million), all with residual maturities of greater than 10 years.

The structured credit portfolio is within Non-Core. The risk on this portfolio is not measured or disclosed using VaR, as the Group believes this is not an appropriate tool for the banking book portfolio, which comprises illiquid debt securities. These assets are reported on a drawn notional and fair value basis, and managed on a third party asset and RWA basis.

## Key Points

- The increase in total and collateralised debt obligation (CDO) drawn notional year-on-year is due to the inclusion of banking book exposures that were previously hedged by monoline protection. As a result of the restructuring of some monoline protection, those previously protected assets are now reported on a drawn notional and fair value basis.
- The overall reduction in collateralised loan obligation (CLO), MBS and other ABS drawn notional is due to the amortisations and pay-downs over the year in line with expected amortisation profiles. In addition to this, fair value

has declined due to falling market prices.

Business review Risk and balance sheet management [continued](#)

Risk management continued

All the disclosures in this section (pages 194 to 204) are unaudited as indicated with an asterisk (\*).

Insurance risk\*

Insurance risk is the largest inherent risk faced by Direct Line Group. It arises through fluctuations in the timing, frequency and/or severity of insured events, relative to the expectations at the time of underwriting. It can be caused by any of the following core activities:

- Pricing and underwriting;
- Claims management;
- Reserving; and
- Reinsurance.

Direct Line Group has continued to develop its approach to risk management, including enhancing its risk function, to help ensure that insurance risks are better identified, controlled, managed, monitored, reported and mitigated. This is being achieved through the embedding of an enterprise-wide risk management framework, with associated risk appetite and policy frameworks. These are expected to have the following benefits:

- a consistent and disciplined approach to risk management;
- a universal view of risk across the business;
- the ability to influence decision-making and shape behaviours;
- a reduction in loss events;
- the improved use and allocation of capital; and
- enhanced return on risk adjusted capital.

Steps taken in 2010 and 2011 to enhance risk management have resulted in Direct Line Group showing improved results in 2011 relative to 2010, although refocusing the division's risk appetite has reduced business volumes.

Governance and culture

Direct Line Group has developed a robust governance structure to control the way it manages insurance risk. This structure includes various forums and committees with associated delegated authorities for the management of insurance risk.

Control and management

The internal economic capital model is rigorously controlled, with robust validation processes applied to the inputs, the model and all outputs to ensure that such data may be used confidently by the business in its decision-making processes.

Stress testing and scenario analysis

Stress testing and scenario analysis take place on a regular basis to support both the division's individual capital assessment and the agreed risk appetite. It is also employed prior to the deployment of new products/lines of business.

#### Monitoring and reporting

A clear framework is in place for the monitoring and reporting of insurance risk within Direct Line Group, with well-defined processes and procedures for the escalation and management of risks and issues.

Key insurance risks are monitored monthly at the Insurance Risk Forum and loss ratio committees, with comprehensive management information being presented regularly (i.e. monthly or quarterly) at the Executive Committee, the Board and the divisional risk and audit committees.

In addition, comprehensive reporting of pricing strength occurs on a monthly basis. Significant enhancements have also been made in the reporting and monitoring of claims management and reserving. Further enhancements are underway, including the launch of a risk management system in late 2011.

#### Mitigation

The business has well-defined procedures in place to address any issues, such as breaches of risk appetite, that are identified through monitoring and reporting activities. In such cases, an action plan to address the issue is developed, implemented and monitored through the appropriate bodies, with a view to ensuring the risk is adequately mitigated or a considered decision at the correct levels is taken to accept it.

#### Operational risk\*

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. It is an integral and unavoidable part of the Group's business as it is inherent in the processes it operates to provide services to customers and meet strategic objectives.

#### Operational risk management

The objective of operational risk management is not to remove operational risk altogether, but to manage it to an acceptable level, taking into account the cost of minimising the risk against the resultant reduction in exposure. Strategies to manage operational risk include avoidance, transfer, acceptance and mitigation by controls.

The Group made significant improvements in its operational risk framework during 2011, enhancing its management of operational risks. This is particularly evident in respect of risk appetite, the Group Policy Framework, risk assessment, scenario analysis and statistical modelling for capital requirements. Further development will continue in 2012.

Details of these, and other elements of operational risk management, including developments undertaken and planned, are set out below along with the key processes through which the Group manages operational risk.

\* unaudited

## Governance, structure and risk appetite

### Governance and structure

Group Operational Risk is an independent function reporting to the Deputy Group Chief Risk Officer. Group Operational Risk is responsible for the design and maintenance of the operational risk policy standards (ORPS).

The ORPS are incorporated in the Group Policy Framework (GPF), they provide the direction for delivering effective operational risk management and are designed to allow the consistent identification, assessment, management, monitoring and reporting of operational risk across the Group.

The Operational Risk Executive Committee which was formed in January 2011, oversees the operational risk framework and profile of the Group in line with the agreed risk appetite. It provides guidance, oversight and advice. It also escalates and reports any issues or areas of concern to the Board Risk Committee and to other senior committees.

### Risk appetite

The Group's operational risk appetite statement is agreed by the Group Board. It comprises a number of specific measures of risk, such as:

- the maximum operational risk losses the Group is prepared to accept. This is expressed as a percentage of the Group's estimated gross income for the year ahead; or
- the value of a single extreme but plausible operational impact. These are identified and assessed through the scenario analysis programme (refer to Scenario analysis below).

To ensure the Group operates within the set risk appetite, the high-level statements are supplemented by specific tolerances for different types of operational risk. The GPF sets out how to manage risk within acceptable limits, which in turn enables the Group to operate within the overall risk appetite and the specific tolerances. The Group has a zero tolerance for risks such as breaches of laws and regulations.

### Operational risk cycle and key management tools

The operational risk cycle comprises four stages:

- Identification of risks;
- Assessment or measurement of the scale of risks;
- Management or control of risks to prevent their recurrence or minimise the potential impact; and
- Monitoring and reporting of risks.

Although the operational risk tools encompass all stages of the risk cycle, they can be broadly categorised as follows:

#### Identification and assessment

##### Risk and control assessments

Controls that are effective without being excessive ensure the Group retains its reputation for efficient customer service and security. Risk and control assessments are used to identify and assess material operational risks and key controls across all business areas. The process is designed to ensure that risks are effectively managed in line with stated risk appetite, prioritised and documented. Controls are tested frequently with a view to ensuring they remain fit for purpose and operate effectively. The Group's risk assessment methodology was enhanced during 2011 to ensure a more consistent approach to identifying risks and their associated controls and measuring expected loss. Risk assessments consider the new firm-wide taxonomy and will soon be captured in the Group-wide repository for

operational risk.

Risk assessments are often conducted in a workshop environment, bringing together subject matter experts from across the division and key functions. By sharing expertise, they can identify improvements to risk identification, measurement and control. Risk governance is reviewed regularly ensuring that there is clarity and ownership of key risk areas.

Through coming together and sharing knowledge, participants gain a broader understanding of how their work fits together.

#### Group new product approval process

The Group's new product approval process ensures there is a consistent process to identify, assess and approve the risks associated with new products.

Following the conclusion of reviews conducted during 2011, enhancements will be made during 2012 to the product governance forums, to provide earlier engagement between the business, Group and divisional risk teams and subject matter experts when assessing whether the risks associated with new products are in line with appetite. The forums will be supported by an upgrade to the Group's key tools used to manage and report on new product approval.

#### Scenario analysis

Scenario analysis is used to assess the possible impact of extreme but plausible operational risk loss events. It provides a forward-looking basis for managing exposures beyond the Group's risk appetite. The methodology provides a structured and consistent approach to scenario scoping and measurement. A significant portfolio of scenarios was developed in 2011 across divisions, covering material risks to which the Group is exposed. Group-wide scenarios are centrally scoped and workshops are facilitated by Group Operational Risk in conjunction with functions and policy owners, before being assessed by divisions to derive specific impact estimates. This also allows the Group to review operational risk impacts as they arise from macroeconomic stresses (e.g. eurozone distress) in a time-efficient and effective manner.

\* unaudited



Business review Risk and balance sheet management [continued](#)

Risk management: Operational risk\* continued

By assessing extreme but plausible events, scenario analysis is an important component in the operational risk framework, providing senior management with valuable insight into systemic risk that could significantly impact its financial performance if these events were to occur. Using its forward-looking nature, senior management cross-examines various risk topics against a range of circumstances and assumptions.

Similar to risk assessments, scenarios are run in a workshop environment, bringing business, risk and control experts together and thereby ensuring that risk management is approached holistically.

Stress testing

During the economic downturn, there has been an increase in large operational risk losses within the banking industry.

Consequently, the Group enhanced its approach to assessing the impact of the economic cycle on its operational risk losses in 2011, by specifically assessing the impact of the FSA's published Anchor II scenario, which describes a series of country-specific shocks around the world on:

- Expected levels of operational risk losses; and
- Unexpected levels of operational risk losses, by stressing its existing portfolio of operational risk scenarios.

The impact of the FSA Anchor II scenario on the Group's operational risk capital, as calculated under the standardised approach, was also projected based on the outputs of the Group's stress-testing exercises.

During 2012, additional operational risk scenarios will be run, further broadening the Group's understanding of its exposures to tail risks.

Management, monitoring and reporting

Issues management

The objective of the operational risk issues management framework is the adoption of a consistent approach to the identification, capture, classification, monitoring, closure and acceptance of operational risk issues and associated actions across the Group, in accordance with the Group's three lines of defence model.

Significant enhancements were made to the issues management process during 2010 including rollout of a single repository for capturing issues and actions; mapping issues to GPF; and a tightening of governance over issue management. These improvements were further embedded during 2011, through training and assurance reviews.

The enhancements have improved risk management by allowing Group-wide analyses of all operational risk issues. In certain cases, this has resulted in global assurance reviews focused on specific areas, helping to identify operational risks to be mitigated.

Event and loss data management

Event and loss data management (ELDM) covers the discovery, escalation, capture, investigation, approval and closure, and reporting and analysis of operational risk events and loss data. It also provides for the clear, simple, quick and consistent communication of operational risk events that meet defined threshold criteria to those members of the Group's senior management and Executives who need to know of these events.

During 2011, an enhanced ELDM process was launched to promote consistency in the management of operational risk events and the collection of loss data across the Group. It included the introduction of a single repository to capture all events and loss data in the Group and the establishment of thresholds above which operational risk events will trigger a risk assessment.

The improvements in approach, and use of a single Group-wide database, have enhanced the completeness and accuracy of the Group's internal loss data, and therefore better inform the Group's operational risk profile.

At the start of 2012, the robustness of the historic data migrated into the new repository will be reviewed to confirm its suitability as an input to capital modelling. In addition, the process will be further enhanced to ensure continued compliance with changing regulatory and industry standards regarding the collection of internal loss data.

#### Insurance

The Group purchases insurance to provide the business with financial protection against specific losses and to comply with statutory or contractual requirements. Insurance is used as a risk mitigation tool in controlling the Group's exposures, providing protection against financial loss once a risk has crystallised.

#### Reporting and monitoring

Reporting and monitoring forms an integral part of all of the Group's operational risk management processes, which are designed to ensure that risks and issues are identified, escalated and managed on a timely basis. Exposures for each division are reported through monthly risk and control reports, which provide detail on the risk exposures and action plans. Enhancements made to reporting and monitoring during the year include analysing operational risk events, losses and issues against the GPF components; this has led to better identification of areas requiring management focus and remediation.

\* unaudited

#### Control environment certification

Control environment certification (CEC) is used by the Group Executive management to review and assess its internal control framework, and provide a self-certification of its current state. It demonstrates that the Group is operating a robust control framework, with mechanisms in place to understand and manage its risks, and to drive action to resolve areas of weakness or concern.

CEC provides a twice-yearly assessment of the robustness of the Group's internal control environment including:

- compliance with the GPF and key divisional/functional policy standards;
- compliance with the requirements of the UK Corporate Governance Code; and
- effectiveness of the risk frameworks, culture and governance structures for each division or function.

CEC was enhanced during 2011 to improve the quality and depth of certification, and to implement a risk-based approach to the analysis of policy compliance. The enhancements have delivered a greater degree of analysis of the key risk areas for each business and Group policy standard owner. Improved alignment with Group Internal Audit has been delivered through the implementation of a common rating system for the assessment of the control environment, and CEC outcomes are reported at both the divisional risk and audit committees and Group Audit Committee.

#### Capital model development

At the end of 2011, the Group started to develop a statistical modelling capability for operational risk based on the requirements set out under the Basel II advanced measurement approach. The model is a hybrid encompassing internal and external loss data as well as scenarios. Business environment and internal control factors will be utilised when constructing scenarios and allocating capital. Development activities in 2011 focused on building the standalone loss data and scenario components within the model; integration activities, correlation and allocation will continue in 2012. Final model validation is expected to take place during 2012.

#### Compliance risk\*

Compliance risk arises from non-compliance with national and international laws, rules and regulations. The Group believes that being a compliant organisation is fundamental to protecting sustainable growth, rebuilding its reputation and maintaining stakeholder confidence.

The regulatory environment remained highly challenging during 2011, as policymakers and regulators continued to strengthen regulation and supervision in response to the events of 2007/2008 and subsequent economic and financial stress.

The regulatory agenda - largely framed by the G20 but with many instances of EU and national initiatives - constitutes the most sweeping set of changes seen in many decades. At 31 December 2011, the Group was managing some 140 major regulatory or legislative policy initiatives; during the year as a whole, it had also reviewed over 300 consultations in its core markets. In addition to these changes, many supervisory authorities also continued to intensify their ongoing level of scrutiny and intervention.

These trends have posed multiple challenges for banking groups, including RBS, namely:

- tracking, analysing and engaging with policymakers on proposed changes;
- implementing change programmes to ensure compliance with new requirements;

- revisiting strategy, business and operating models in response to the new environment; and
- driving through cultural and other changes to minimise compliance and enforcement risks.

Below is an outline of some of the key developments in the regulatory environment that took place during 2011. An explanation of how the Group manages compliance risk begins on page 200.

#### Global regulatory developments

The global agenda continues to be guided by the G20, drawing on the original action plan for strengthening financial stability agreed by G20 leaders at the November 2008 Washington summit. During 2011, G20 countries continued to implement various elements of this action plan, culminating in the G20 leaders' summit held in Cannes in November 2011.

\* unaudited

Business review Risk and balance sheet management [continued](#)

Risk management: Compliance risk\* continued

A progress report on the action plan was issued at the Cannes summit. Key developments during 2011 included the following:

#### Basel III

Following publication by the Basel Committee on Banking Supervision in December 2010 of rules for the new Basel III capital and liquidity framework, work during 2011 focused on finalising the remaining elements of policy and preparing for implementation. Highlights were:

- The issuance of minimum requirements regarding the loss absorbency of capital instruments at the point of non-viability (January 2011);
- The finalisation of rules for the capital treatment of counterparty credit risk in bilateral trades (June 2011);
- Technical changes to Basel III relating to the treatment of trade finance, aimed at helping promote trade with low-income countries (October 2011);
- Further work on the capitalisation of bank exposures to central counterparties (November 2011); and
- A Basel Committee paper proposing that debit valuation adjustments for over-the-counter derivatives and securities financing transactions should be fully deducted from Common Equity Tier 1 capital (December 2011). The Group is evaluating the potential impact of this proposal.

#### Systemic financial institutions

The main focus of policy development at the global level during 2011 was delivering on the G20-mandated target of agreeing a framework by the end of 2011 for dealing with global systemically important financial institutions (G-SIFIs). This target was met, with the Cannes summit endorsing:

- A new Financial Stability Board (FSB) international standard, “The Key Attributes of Effective Resolution Regimes for Financial Institutions”, which amongst other things provides a benchmark for national resolution regimes, as well as mandatory requirements for resolvability assessments and recovery and resolution plans for each G-SIFI; and
- A new Basel Committee framework for identifying an initial list of global systemically important banks (G-SIBs), and applying to these an additional common equity capital requirement, above the Basel III minimum standards, rising from 1% to 2.5% of risk-weighted assets in line with their systemic impact.

The names of the initial list of G-SIBs (though not their ranking) were published by the FSB at the end of the summit: RBS is included in the 29 names.

#### Shadow banking

In response to concerns, that heightened regulation of banks should not lead to risks being displaced into unregulated sectors, regulatory authorities started to pay growing attention to the “shadow banking” system during 2011. This term broadly refers to entities and financial transactions that fall outside the scope of existing financial (banking) regulation, such as hedge funds, money market funds and structured investment vehicles.

Work was initiated in five areas to assess the need for regulatory intervention, and this topic is likely to attract even more attention during 2012, when recommendations for action are expected.

The five areas include: banks' interactions with shadow banking entities; ways to reduce the susceptibility of money market funds to runs; the regulation of other shadow banking entities on prudential grounds; retention requirements and transparency in securitisation; and the possible regulation of margins and haircuts in securities lending and repos.

#### Other

During 2011, the authorities started to pay more attention to the consistent implementation of G20 and FSB financial reforms, with plans developed to focus more on monitoring and the public reporting of implementation progress. Although a priority, little progress was made during 2011 on developing a global policy framework for over-the-counter derivative reform, so as to help align ongoing activity in this space, particularly in the US and the EU (see below).

#### EU regulatory developments

The EU regulatory agenda in 2011 continued to focus mainly on prudential and market structure measures; retail issues also started receiving more attention and are likely to come under increased focus in 2012. Key highlights were as follows:

##### New regulatory architecture

2011 saw the implementation of a new EU regulatory architecture, with the start of operations of the ESRB and three supervisory authorities: the European Banking Authority (EBA), the European Securities and Markets Authority, and the European Insurance and Occupational Pensions Authority.

The new framework marks a significant transfer of power to the three supervisory authorities, particularly with respect to detailed rule-making, where over time they will be issuing "binding technical standards" across a range of policy areas that will replace national rules.

However, an early preoccupation of the new regulatory authorities was the eurozone crisis. In particular, the EBA was heavily engaged in overseeing the stress testing of EU banks, including UK groups.

\* unaudited

#### Prudential and related reforms

A key focus during 2011 was work on amending the EU's Capital Requirements Directive (CRD): a key step in that process was the publication of draft legislative text in September 2011, the CRD IV package, which is expected to be finalised during 2012 and will implement Basel III in the EU.

Another key area of work was the EU's "crisis management" legislative package, aimed at dealing with issues similar to those addressed by the FSB work on G-SIFIs. An early 2011 EU Commission consultation included proposals on enhanced supervision and early powers of intervention; recovery and resolution planning; resolution frameworks; resolution funds and debt write-down (but not capital surcharges). Draft legislation to implement these measures was at the time of writing expected to be issued in early 2012, after several postponements.

Other initiatives in the prudential space have included, notably, continued work on developing the Solvency II framework for insurers; the development of legislative proposals on corporate governance in financial institutions; and the further development and UK implementation of the EU's common reporting framework (COREP) for banks.

#### Market and structural reforms

Key developments in this space included:

- European Markets Infrastructure Regulation (EMIR) - negotiations continued during 2011 on this draft Regulation on OTC derivatives, central counterparties and trade repositories, which represents a major element of the financial crisis regulatory response agenda. Agreement was close to being reached in early 2012.
- Markets in Financial Instruments Directive Review (MiFID2) - the EU review of this directive, which sets the framework for investment markets, culminated in the publication of draft legislative text in October 2011.
- Financial Transaction Tax (FTT) - the EU Commission published proposals for an FTT, which would see trades in bonds and shares taxed at 0.1% and complex derivatives taxed at 0.01%. However, the proposal requires approval from all 27 EU members, but is opposed by some, including notably the UK, which reduces the likelihood of it being imposed.
- Other initiatives - these have included changes to the market abuse regime and prospectus requirements, initiatives on short-selling, further legislative developments impacting credit rating agencies and changes to depositor and investor protection.

#### EU retail market reforms

Notwithstanding the focus on prudential and market reforms in response to the financial crisis, the EU Commission during 2011 also continued to work on a wide range of retail agenda initiatives. These included a draft legislative proposal for a mortgage credit directive, with a focus on responsible lending and borrowing; the development of proposals on collective redress; and ongoing discussions with the banking industry to improve the transparency and comparability of bank fees. The Group also continued to work on implementing the requirements coming into force at the end of 2011, contained in the EU Payment Services Directive.

#### UK regulatory developments

UK regulatory developments during 2011 continued to be extensively determined by global and EU developments, with UK regulators working to implement requirements coming into force, such as the CRD III package of reforms, and actively participating in policy development at the EU and global levels. In addition, there were a number of developments specific to the UK.

#### Independent Commission on Banking (ICB)

The ICB was appointed by the UK Government in June 2010 to review possible structural measures to reform the UK banking system in order to promote, amongst other things, stability and competition. It published its final report to the Cabinet Committee on Banking Reform on 12 September 2011 (the 'Final Report'), which set out the ICB's views on possible reforms to improve stability and competition in UK banking.

The Final Report made a number of recommendations, including in relation to: (i) the implementation of a ring-fence of retail banking operations; (ii) increased loss-absorbency (including bail-in, i.e. the ability to write-down debt or convert it into an issuer's ordinary shares in certain circumstances); and (iii) promotion of competition.

On 19 December 2011, the UK Government published its response to the Final Report and indicated its support and intention to implement the recommendations set out in the Final Report substantially as proposed. The Government indicated that it would work towards putting in place the necessary legislation by May 2015, requiring compliance as soon as practicable thereafter and a final deadline for full implementation of 2019.

The Group will continue to participate in the debate and to consult with the UK Government on the implementation of the recommendations set out in the Final Report and in the Government's response.

#### Regulatory architecture reforms

Work on the UK coalition government's plans for reforming the UK's regulatory structure continued during 2011, with major consultations from HM Treasury, a number of calls for evidence from parliamentary committees and the publication of a draft Bill for pre-legislative scrutiny purposes in June 2011. In addition, the FSA and Bank of England published policy documents setting out initial high-level policy thinking on the new regulatory bodies; and an interim version of the Financial Policy Committee started to meet in advance of legislation being enacted. However, the timescale for completing the legislative process and fully implementing the new framework has been delayed until 2013 (from the end of 2012).

\* unaudited



Business review Risk and balance sheet management [continued](#)

Risk management: Compliance risk\* continued

Payment Protection Insurance (PPI)

The Judicial Review requested by the British Bankers' Association (BBA) in respect of the FSA's policy statement on PPI complaints and guidance published by the Financial Ombudsman Service concluded in April 2011 with an adverse ruling. The BBA and the banks concerned decided not to appeal and the UK banks including the Group have moved towards settling claims in accordance with the FSA's revised principles. Under the terms of a waiver granted by the FSA, the Group, along with the rest of the industry, has had to deal with the backlog of complaints within specified timescales.

Retail conduct issues

In addition to EU retail initiatives, the UK authorities continued to pursue additional issues during 2011. These included initiatives relating to financial inclusion, where the Government is seeking to widen access to bank accounts; the implementation of the recommendations of the Retail Distribution Review relating to the provision of investment advice; ongoing work on the Mortgage Market Review; the establishment of a Steering Group by HM Treasury to devise a suite of simple financial products; and a review of the insurance products that form part of packaged current accounts.

Supervisory developments

In line with that of other regulatory authorities, the FSA's supervisory scrutiny has intensified in response to the financial crisis and ongoing market stresses. Front-end supervisory resources have been increased and existing tools have been used more frequently and robustly – evidenced, for instance, in terms of the heightened number of information requests, the increased deployment by the FSA of skilled person reports as well as the increased fines charged against the industry. Across the industry fines for 2011 totalled £66.1 million versus £5.3 million in 2007. In addition, the FSA continued to develop new supervisory approaches, notably its Core Prudential Programme for those major financial institutions it oversees, which includes in-depth rolling thematic assessments on governance, business models, risk management, capital and liquidity.

US regulatory developments

In the US, activity was dominated by rulemaking following the 2010 Dodd-Frank Act. Although there was some slippage on, for example, derivatives rules, output from the authorities has still been considerable.

Key final rules were issued on a range of issues, including living wills, the Collins Amendment (which floors capital requirements at the level of Basel II advanced approaches), rights for shareholders to have an advisory "say on pay", and limits on debit card interchange fees. Meanwhile the new Consumer Financial Protection Bureau was established on the Act's first anniversary on 21 July 2011.

High-profile draft rules that were published included the Volcker Rule (limiting proprietary trading and investments in private equity or hedge funds), the securitisation risk retention rule and rules applicable to Nationally Recognized Statistical Rating Organizations (credit rating agencies).

Compliance risk management

The Group manages its compliance risk through a regulatory affairs and compliance framework that seeks to ensure it complies with all banking, securities, insurance and anti-money laundering regulations, defined by over 120 different regulatory bodies and central banks, wherever the Group operates. This framework is managed by the Group's Regulatory Affairs and Compliance functions and includes: the tracking and management of regulatory developments; regulatory relationship management; the implementation of global compliance risk policies; assurance and monitoring; training and awareness; and mitigation activity.

Against the backdrop of intensified regulatory pressure, Group Regulatory Affairs has managed the increased levels of scrutiny and legislation by increasing the capacity of its team, as well as improving and refining its operating model, tools, systems and processes. Simultaneously, in response to enforcement actions against the Group in 2010 and 2011, Group Compliance initiated and led large-scale remediation and infrastructure changes, driving both the definition and the proactive management of conduct risk.

#### Management of regulatory change

The early identification and effective management of changes in legislative, regulatory and other requirements that may impact the Group is critical to the successful mitigation of compliance risk.

Group Regulatory Affairs maintains a well-established policy and supporting processes for the identification and management of such changes across the Group. Group Board and Executive Committee oversight is supported by a Prudential Regulatory Developments Executive Steering Group, which was formed in early 2010 to provide a specific focus on a range of key regulatory changes. Communication and coordination were strengthened in 2011 with the formalisation of two Group-wide forums, one focusing on prudential and wholesale market issues, the other on retail conduct issues. In addition, a divisional Heads of Regulatory Developments forum was established, and RBS Americas' regional governance strengthened.

Reporting and internal communications activity expanded in 2011 in response to the growing regulatory change agenda. This included:

- The enhancement of quarterly reporting to the Group Audit Committee, with a particular focus on tracking progress on compliance readiness programmes implementing new requirements;
- Six-monthly reporting to the Board Risk Committee, in addition to the standard monthly risk reports produced for the Board and other governance committees; and
- Increased communications, such as the development of a fortnightly Regulatory Affairs Flash Report, circulated widely across the Group, which captures key regulatory developments and relationship topics.

\* unaudited

#### Regulatory relationship management

The Regulatory Relations Forum, chaired by Group Regulatory Affairs, meets fortnightly and now has global coverage with representatives from all divisions and regions. It facilitates the sharing of key regulatory engagements and the lessons learned from them.

Quarterly reporting to the Group Audit Committee captures all material regulatory reviews and investigations and upstream regulatory developments worldwide, as well as tracking the status and trends in key regulatory relationships.

Other key regulatory policies, specifically 'Group Relationships with Regulators' and 'Political, Legislative and Regulatory Environment', were reviewed and re-launched. Each incorporates a new risk appetite statement, a benchmarking exercise against the Group's peer banks and, for the latter, an end-to-end review and mapping of the upstream risk management process.

#### Recovery and resolution planning

The Group considers effective resolution regimes, coordination between regulators, and recovery and resolution planning, to be important components of an extensive reform agenda to improve safety and stability within the banking industry. Accordingly, the Group recognises the potential value of Recovery and Resolution Plans (RRPs) as mechanisms for preparing banks to deal with: severe stress events (through a range of developed recovery options in the Recovery Plan); and ensuring authorities will have all the critical information they need to identify and carry out appropriate resolutions in the event of failure (the Resolution Plan).

To ensure effective management of financial stability across jurisdictions, and to avoid duplication and inefficiency for cross-border banks, it is important that the approach, content and role of RRP are globally consistent across jurisdictions.

The Group intends to sustain its strong momentum on the development of RRP. As well as working with the UK authorities, the Group will continue to work with global policy developers in order to contribute to the development of RRP in other jurisdictions, in particular within the EU and the US. The timeframes for the development of RRP in these regions are considerably longer than in the UK, and it will be important to ensure that a consistent policy approach and format are adopted if the RRP of UK-based global banks are to meet local requirements, and do not have to be redrawn or duplicated.

#### Global compliance risk and compliance policies

Within the Group Policy Framework, compliance risk and compliance policies define minimum standards to which all businesses must adhere. The policies are primarily driven by the rules and regulations set by the FSA, the Group's lead regulator. However, these global minimum standards are supplemented, where appropriate, by divisional policies to meet local product or market requirements.

In compliance risk management, the term 'conduct risk' is used to refer to the risk of breaches of: (a) regulation or law; or (b) regulatory expectation. This is distinguished from 'prudential risk', i.e. compliance risks related to capital management, liquidity, credit risk, operational risk and market risk. A significantly enhanced compliance/conduct policy structure was outlined during 2011. It is aligned to a new Conduct Risk Appetite statement as well as the expected direction of the new Financial Conduct Authority, which will be one of the successors of the FSA. As a result, in future, it will be possible to assess the pan-Group risk profile for conduct risk against its risk appetite. In addition, it will be possible to provide more detailed policy direction to divisions on key areas of conduct risk.

#### Assurance and monitoring

Assurance and monitoring activities are essential to ensure that the Group can demonstrate compliance with existing rules and regulations.

During 2011, a 'heatmap' of the key inherent conduct risks across all the Group's global businesses, reflecting both internal and external change and divisional priorities, was developed. This, in turn, drove a comprehensive programme of assurance reviews across the Group. These reviews introduced a global, end-to-end thematic approach, looking at customer outcomes as well as process adherence. In addition to immediate issues, for which action plans were developed, the reviews identified a number of wider themes that required a more strategic approach.

#### Training and awareness

Maintaining compliance with existing rules and regulations requires continued investment in professional training, as well as maintaining risk awareness. During 2011, the Group focused on strengthening the capabilities of its compliance risk functions at both Group and divisional level. The Group facilitates extensive compliance training through computer-based Group Policy Learning modules, with each one designed to promote the relevant regulatory Group Policy Standard.

To support the professional development of the Group's compliance teams, it also has a comprehensive and progressive training programme that is deployed globally. All of the Group's regulatory staff are actively engaged in compliance e-learning, which incorporates a mandatory 'essentials' course, and the RBS Risk Academy, through which all staff are required to complete foundation courses in other risk disciplines, such as operational risk, market risk and retail credit risk. Formal training is supplemented by more informal regulatory familiarisation; this is designed to share knowledge, and support both personal development and technical training across the wider risk community.

\* unaudited

Business review Risk and balance sheet management [continued](#)

Risk management: Compliance risk\* continued

Anti-Money Laundering

During 2011, RBS continued to enhance its Anti Money Laundering (AML) Change Programme across the Group.

Key developments include:

- A new cohesive target operating model to support the capability required and reviewed divisional AML capabilities against the target operating model to identify and analyse gaps;
- A framework for understanding and managing compliance and conduct risk, including the introduction of a clear Group-level conduct risk appetite statement and the design of a new conduct risk policy framework; and
- An enhanced global whistle-blowing service 'Right Call' that allows all employees, irrespective of location, to escalate any concerns outside of their normal line management. Whistle-blowing call volumes have increased since the launch and the new framework is a further positive step to help the Group identify and manage compliance risk.

Reputational risk\*

Reputational risk is the risk of brand damage arising from financial and non-financial events due to a failure to meet stakeholders' expectations of the Group's performance and behaviour.

Such loss in reputation has the potential to put the entire business at risk. It could also lead to negative publicity, loss of revenue, costly litigation or a decline in the customer base.

Reputational risk can arise from actions taken by the Group or a failure to take action, such as failing to assess the environmental, social or ethical impacts of clients or projects to which the Group has provided products or services.

The Group seeks to safeguard its reputation by considering the impact on the value of its franchise from how it conducts business, its choice of customers and the way stakeholders view the Group. Managing the Group's reputation is the joint responsibility of all employees, and reputational considerations should, as part of standard practice, be integrated into the Group's day-to-day decision making structures.

Currently the Group manages reputational risk through a number of functions, such as divisions, Group Communications, Group Sustainability and an Environmental, Social and Ethical (ESE) risk management function. The latter function is responsible for assessing ESE risks associated with business engagements and business divisions.

The Board has ultimate responsibility for managing any impact on the reputation of the Group arising from its operations. The Group Sustainability Committee (established at the beginning of 2010) sets the overall strategy and approach for the management of Group sustainability. However, all parts of the Group take responsibility for reputation management.

The risk is viewed as material given the central nature of the Group's market reputation in the strategic risk objectives.

Business risk\*

Business risk is the potential risk of revenues being lower than expected and/or operating costs being higher than expected. It is influenced by a variety of factors, including pricing, sales volumes, input costs, regulations and the prevailing market and economic environment.

The Group seeks to minimise its exposure to business risk, subject to its wider strategic objectives (e.g. return on equity). As a large financial services group, it recognises and values the potential diversification benefits associated with differences in the nature and timing of potential business risk across its portfolio of businesses.

Business risk is identified, measured and managed through the Group's bi-annual strategic planning cycles. Expected profiles for revenues and costs are determined, on a bottom-up basis, through strategic plans and expectations of the external environment. These profiles are tested against a range of stress scenarios and factors to identify the key risk drivers behind any potential volatility, along with management actions to address and manage them.

The Group Board has ultimate responsibility for the impact of any volatility in revenues and costs on the Group's performance. Business risk is incorporated within the Group's risk appetite target for earnings volatility, with an assessment of volatility in revenues and costs a key component in determining whether the Group and its underlying businesses are within risk appetite.

The management of business risk lies primarily with divisional and business unit strategic teams, with oversight at the Group level from the Finance, Strategy and Risk functions. Elements of business risk (e.g. regulatory changes) also overlap with other areas and are managed by the appropriate risk functions.

The risk is viewed as material given the central nature of unexpected changes in revenues and costs on the Group's ability to achieve its strategic objectives.

\* unaudited

#### Pension risk\*

The Group is exposed to risk from its defined benefit pension schemes to the extent that the assets of the schemes do not fully match the timing and amount of the schemes' liabilities. Pension scheme liabilities vary with changes to long-term interest rates, inflation, pensionable salaries and the longevity of scheme members as well as changes in legislation. The Group is exposed to the risk that the market value of the schemes' assets, together with future returns and any additional future contributions could be considered insufficient to meet the liabilities as they fall due. In such circumstances, the Group could be obliged, or may choose, to make additional contributions to the schemes.

The RBS Group Pension Fund ('Main scheme') is the largest of the schemes and the main source of pension risk. The Main scheme operates under a trust deed under which the corporate trustee, RBS Pension Trustees Limited, is a wholly owned subsidiary of The Royal Bank of Scotland plc and the trustee board comprises six directors selected by the Group and four directors nominated by members.

The trustee is solely responsible for the investment of the Main scheme's assets which are held separately from the assets of the Group. Significant changes to asset strategy are discussed with the Groups Pension Risk Committee which was established in 2011. The Group and the trustee must agree on the Main scheme funding plan.

In October 2006, the Main scheme was closed to new employees. In November 2009, the Group confirmed that it was making changes to the Main scheme and a number of other defined benefit schemes including the introduction of a limit of 2% per annum (or the annual change in the Consumer Price Index, if lower) to the amount of any salary increase that will count for pensionable purposes.

Risk appetite and investment policy are agreed by the trustee with quantitative and qualitative input from the scheme actuaries and investment advisers. The trustee also consults with the Group to obtain its view on the appropriate level of risk within the pension fund.

#### Risk management framework

From a sponsor perspective, the Group manages this risk using a framework that encompasses risk reporting and monitoring, stress testing, modelling and an associated governance structure that helps ensure the Group is able to fulfil its obligation to support the defined benefit pension schemes to which it has exposure.

#### Reporting and monitoring

The Group maintains an independent review of risk from a sponsor perspective within its pension funds. It achieves this through underlying regular pension risk reporting and monitoring to the Group Board, Group Board Risk Committee and Group Risk Committee on the material pension schemes that the Group has an obligation to support.

#### Stress testing and modelling

Throughout 2011, various pension risk stress testing initiatives were undertaken, focused both on internally defined scenarios and on scenarios undertaken to meet integrated EBA, IMF and FSA stress testing requirements. On an annual basis, the Internal Capital Adequacy Assessment Process is also modelled; this entails assessing changes in pension asset and liability values over a 12-month horizon under various stresses and scenarios.

#### Governance

A key component of the pension risk framework is the Pension Risk Committee, which was established in 2011 and has the authority to articulate the Group's view of risk appetite for the various RBS pension schemes. The Pension Risk Committee also serves as a formal link between the Group and the Trustee of the Group's largest pension schemes on risk management asset strategy and financing issues and, during 2011, facilitated an agreement between the two on mechanisms for reducing risk within the RBS Group Pension Fund.

#### Improvements in 2011 and next steps

As part of the continuing development of the pension risk management framework within RBS Group, key achievements in 2011 focused on improved stress testing and risk governance mechanisms. The framework will continue to be developed in 2012 with improvements in risk reporting and monitoring, modelling and stress testing capability along with the embedding of the pension risk governance structure implemented in 2011.

#### Main scheme

The most recent funding valuation, at 31 March 2010, was agreed during 2011. It showed that the value of liabilities exceeded the value of assets by £3.5 billion at 31 March 2010, a ratio of assets to liabilities of 84%. In order to eliminate this deficit, the Group has agreed to pay additional contributions each year over the period 2011 to 2018. These contributions started at £375 million per annum in 2011, increasing to £400 million per annum in 2013 and from 2016 onwards will be further increased in line with price inflation. Further details are given in Note 4 of the consolidated accounts.

The assets of the Main scheme, which represent 84% of Group pension plan assets at 31 December 2011, are invested in a diversified portfolio of quoted and private equity, government and corporate fixed interest and index-linked bonds, and other assets including property and hedge funds. The trustee has taken measures to partially mitigate inflation and interest rate risks both by investment in suitable physical assets and by entering into inflation and interest rate swaps. The Main scheme also uses derivatives within its portfolio to manage the allocation to asset classes and to manage risk within asset classes.

\* unaudited



Business review Risk and balance sheet management [continued](#)

## Risk management: Pension risk\* continued

The table below shows the sensitivity of the Main scheme's assets and liabilities (measured according to IAS 19 'Employee Benefits') to changes in interest rates and equity values at the year end, taking account of the current asset allocation and hedging arrangements.

	Change in value of assets £m	Change in value of liabilities £m	Increase in net pension obligations £m
At 31 December 2011			
Fall in nominal swap yields of 0.25% at all durations with no change in credit spreads or real swap yields	106	200	(94)
Fall in real swap yields of 0.25% at all durations with no change in credit spreads or nominal swap yields	557	911	(354)
Fall in credit spreads of 0.25% at all durations with no change in nominal or real swap yields	104	1,118	(1,014)
Fall in equity values of 10%	(935)	—	(935)
At 31 December 2010			
Fall in nominal swap yields of 0.25% at all durations with no change in credit spreads or real swap yields	67	193	(126)
Fall in real swap yields of 0.25% at all durations with no change in credit spreads or nominal swap yields	355	799	(444)
Fall in credit spreads of 0.25% at all durations with no change in nominal or real swap yields	98	1,005	(907)
Fall in equity values of 10%	(1,083)	—	(1,083)

\* unaudited

### Asset Protection Scheme\*

All disclosures in this section (pages 205 to 207) are unaudited and are marked with an asterisk (\*).

#### Key aspects of the Scheme

On 22 December 2009, the Group acceded to the Asset Protection Scheme (APS or ‘the Scheme’) with HM Treasury acting on behalf of the UK Government. Under the Scheme, the Group purchased credit protection over a portfolio of specified assets and exposures (“covered assets”) from HM Treasury. The portfolio of covered assets had a par value of approximately £282 billion at 31 December 2008 and the protection is subject to a first loss of £60 billion and covers 90% of subsequent losses net of recoveries. Once through the first loss, when a covered asset has experienced a trigger event, losses and recoveries in respect of that asset are included in the balance receivable under the APS. Receipts from HM Treasury will, over time, amount to 90% of cumulative losses (net of cumulative recoveries) on the portfolio of covered assets less the first loss amount.

The Group has the right to terminate the Scheme at any time provided that the Financial Services Authority has confirmed in writing to HM Treasury that it has no objection. On termination, the Group is liable to pay HM Treasury a termination fee, which comprises the difference between £2.5 billion (or, if higher, a sum related to the economic benefit of regulatory capital relief obtained from the APS) and the aggregate fees paid. In addition, the Group would have to repay any amounts received from HM Treasury under the terms of the APS. The Group has paid APS premiums totalling £2,225 million (2011 - £125 million; 2010 - £700 million; 2009 - £1,400 million). From 31 December 2011 premiums of £125 million are payable quarterly until the earlier of 2099 and the date the Group leaves the Scheme.

Losses are recognised when a covered asset has experienced a trigger event which comprises failure to pay subject to grace periods, bankruptcy and restructuring.

APS assets are spread across the Group’s main divisions. High volume commercial and retail exposures were selected on a portfolio basis where assets were high risk and in arrears at 31 December 2008. Large corporate, International Banking and Markets exposures were selected at the counterparty/asset level based on individual risk reviews and defaulted assets in the workout/restructuring unit.

HM Treasury has the right to appoint step-in managers to carry out any oversight, management or additional functions on their behalf, to ensure that the covered assets are managed and administered in compliance with the agreed terms and conditions. This right is exercisable if certain step-in triggers occur. These include:

- losses on covered assets in total exceed 125% of the first loss amount or losses on an individual covered asset class exceed specified thresholds;
- a breach of specified obligations in the APS rules or the accession agreement;
- the Group has failed or is failing to comply with any of the conditions in the APS rules in relation to asset management, monitoring and reporting, and governance and oversight, and such failure is persistent and material or it is evidence of a systematic problem; and
- material or systematic data deficiencies in the information provided to HM Treasury in accordance with the terms of the APS.

HM Treasury may at any time elect to cease to exercise its step-in rights in whole or part when it is satisfied that the step-in triggers have been remedied.

\* unaudited

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Business review Risk and balance sheet management [continued](#)

## Risk management: Asset Protection Scheme\* continued

## Covered assets

The table below shows the movement in covered assets.

	£bn
At 1 January 2009	282.0
Disposals	(3.0)
Non-contractual early repayments	(8.9)
Maturities and amortisation	(26.1)
Rollovers and covered amount cap adjustments	(1.7)
Currency translation and other adjustments	(11.8)
At 31 December 2009	230.5
Disposals	(9.7)
Maturities, amortisation and early repayments	(28.7)
Reclassified assets	3.1
Withdrawals	(2.9)
Currency translation and other adjustments	2.4
At 31 December 2010	194.7
Disposals	(5.3)
Maturities, amortisation and early repayments	(42.4)
Withdrawals	(12.4)
Currency translation and other adjustments	(2.8)
At 31 December 2011	131.8

## Key points

- The reduction in covered assets was due to run-off of the portfolio, disposals, early repayments and maturing loans.
- The Group continues to take advantage of market conditions and execute sales from a number of its portfolios.
- The Group withdrew £12.4 billion of covered assets with a lower than average risk profile from the Scheme.

## Credit impairments and write-downs

The table below analyses the credit impairment provision (adjusted for write-downs) and adjustments to par value (including available-for-sale reserves) relating to covered assets.

	2011	2010	2009
	£m	£m	£m
Loans and advances	20,586	18,033	14,240
Debt securities	10,703	11,747	7,816
Derivatives	3,056	2,043	6,834
	34,345	31,823	28,890
Core	7,626	6,646	5,552
Non-Core	26,719	25,177	23,338
	34,345	31,823	28,890

Key points

- The increase in Non-Core impairments of £1.5 billion accounted for the majority of the increase in credit impairments and write-downs in 2011.
- The increase in Core is largely accounted for by impairments offset by asset withdrawals.

\* unaudited

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## First loss utilisation

The Group has agreed with HM Treasury modifications to the Scheme rules, which affect most APS portfolios in International Banking and Markets and an APS portfolio in UK Corporate that relates to larger clients. All other APS portfolios in the Group are unaffected. The overall economic aspects of the Scheme are unchanged, including value and term of cover, credit derivative valuation and capital effects.

The modified rules for recognition of triggered assets align more closely to the Group's normal accounting and risk management procedures and will reduce the administrative burden of operating the Scheme. For the portfolios subject to these changes, the calculation of loss now takes into account expected recoveries in addition to those already received. This has resulted in a reduction in first loss utilisation. A comparison of losses arising under the original Scheme rules with those arising under the modified Scheme rules is set out below. This covers the period from the Scheme inception to 31 March 2011 (the last point at which the original rules applied for the affected assets).

	£m
Original first loss utilisation	38,961
Assets not triggered under modified rules (1)	(4,126)
Assets triggered under modified rules (2)	997
Expected recoveries (3)	(6,272)
Revised first loss utilisation	29,560

## Notes:

- (1) Assets that had triggered under the original Scheme rules but were not impaired or defaulted are not triggered under the modified rules.
- (2) Assets that had not yet triggered under the original Scheme rules but had impaired or defaulted are triggered under the modified rules.
- (3) For assets which have triggered under both original and modified rules, this amount represents the excess of expected recoveries over cash recoveries received to date.

The table below shows the first loss utilisation under the original and modified rules.

	2011				2010			
	Original Scheme rules		Modified Scheme rules	Net	Original Scheme rules		Modified Scheme rules	Net
	Gross loss amount	Cash recoveries to date	Net triggered loss	Net triggered total	Gross loss amount	Cash recoveries to date	Net triggered loss	Net triggered total
	£m	£m	£m	£m	£m	£m	£m	£m
Core	8,451	(2,240)	1,567	7,778	6,865	(1,042)	1,559	7,382
Non-Core	17,486	(2,992)	8,158	22,652	13,946	(1,876)	6,923	18,993
	25,937	(5,232)	9,725	30,430	20,811	(2,918)	8,482	26,375
Loss credits				1,802				1,241
				32,232				27,616

## Key points

- The cumulative first loss is £32.2 billion however, the Group does not expect to claim under the Scheme, which has a first loss of £60 billion.
- The Group received loss credits of £0.6 billion in 2011 which related to disposals. Cumulative loss credits at 31 December 2011 were £1.8 billion.

- The Group continues to expect an average recovery rate of approximately 40% across all portfolios.

Risk-weighted assets

The table below analyses risk-weighted assets (RWAs) covered by the APS.

	2011	2010	2009
	£bn	£bn	£bn
Core	40.2	54.7	76.1
Non-Core	28.9	50.9	51.5
APS RWAs	69.1	105.6	127.6

Key point

- The decrease of £36.5 billion in RWAs covered by the Scheme reflects pool movements, assets moving into default and changes in risk parameters.

\* unaudited

Governance report

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## Letter from the Chairman

Dear Shareholder,

I am pleased to present our Corporate governance report for the 2011 financial year.

2011 has been a challenging year for the Group given the continued pressure on financial markets and the Eurozone challenges as well as UK developments such as the recommendations from the Independent Commission on Banking. During 2011, key areas of focus for the Board were: financial performance; strategy; risk; and regulatory developments and reports. The Board was supported by the work of key Board committees.

Further details on the role and principal activities of the Board are contained within the Corporate governance report on pages 210 to 253. Individual reports from the Group Audit Committee, Board Risk Committee and Group Remuneration Committee are also included.

### Corporate governance in RBS

The Group is working hard to achieve a very challenging and complex turnaround and good corporate governance is a key element of supporting delivery of our strategy and underpinning cultural change across the Group.

In May 2011, the Board introduced a new Corporate Governance Policy to demonstrate that we are committed to the highest standards of governance, integrity and professionalism throughout the Group. The policy comprises ten principles and related guidance that apply across the Group in all divisions and jurisdictions. The principles cover areas such as decision making, individual and collective responsibility, identifying and managing risks, risk and reward and escalation and transparency. We want to ensure we have the right structures and systems in place so that sound business decisions are made and it is important to us that we demonstrate high standards of governance in all of our activities. A clear corporate governance policy is helping us achieve this and we will be monitoring compliance with the policy on a continuing basis.

Our statement of compliance with the UK Corporate Governance Code issued by the Financial Reporting Council in May 2010 (the "Code") is set out on page 254.

### The Board

During 2011, we were pleased to welcome three new independent non-executive directors to the Board: Alison Davis, Tony Di Iorio and Baroness Noakes. They have brought with them a wealth of relevant and diverse experience in both the public and private sectors, along with a strong global perspective and have made a significant contribution to the work of the Board since joining. Their appointments have also strengthened the membership of a number of Board committees with Alison Davis joining the Group Remuneration Committee, Tony Di Iorio joining the Group Audit Committee and Board Risk Committee, and Baroness Noakes joining the Group Audit Committee. In addition to our new Board members, Colin Buchan retired as a director in August 2011 following nine years on the Board and John McFarlane will step down from the Board on 31 March 2012. We have greatly appreciated the experience, commitment and knowledge they brought to the Board and Committees.

### Leadership and Board effectiveness

As Chairman, I am responsible for ensuring we have an effective Board and for leading the Board. I am supported by the Group Nominations Committee in reviewing Board composition and the recruitment of new directors and by the Group Secretary on induction, continuing professional development, Board process and evaluation.

A key part of my role in leading the Board is to ensure that directors develop a good understanding of the Group's business so that the Board is able to provide input to help shape future strategy. This is achieved through site visits, in-depth board presentations and, for new directors, their induction programme. I believe it is important to encourage a culture and environment in the boardroom that facilitates debate and where non-executive directors are able to provide constructive challenge to the executive team.

We conduct an annual evaluation of the effectiveness of the Board and this year's evaluation was conducted internally, led by the Group Secretary. I also evaluate the individual performance of each of the non-executive directors and all directors stand for re-election annually. Further details on performance evaluation are set out on page 218. During 2011, we saw further improvements to the flow of information to the Board both in terms of the quality of papers and the use of new technology to deliver these to directors. The Board continued to focus on strategic priorities and the composition of the Board, including succession planning for senior executives, was kept under review by the Group Nominations Committee.

#### Diversity

The diversity agenda has remained a key priority for RBS in 2011. The Group made a public statement on its website [www.rbs.com](http://www.rbs.com) in September 2011 regarding its aspirations in relation to gender diversity in the boardroom. We expect to meet the aspirational target of 25 per cent female board representation in 2012. In December 2011, the Board approved a formal boardroom diversity policy which aims to promote diversity in the composition of the Board. Under this policy, all Board appointments will be made on the basis of individual competence, skills and expertise measured against identified objective criteria. Further details on the boardroom diversity policy can be found on page 220.

I would like to thank both the executive and non-executive directors for their outstanding commitment and their contributions to the Board and Committees in 2011. This year is shaping up to be another challenging year for the Group and the Board but I am confident that we are on track to restore the performance of the Group in all material aspects.

Philip Hampton  
Chairman  
22 February 2012

## Our governance structure

### Group Board and Board committee structure

Group Board is the main decision making forum at Group level, setting the strategic direction of the Group and ensuring that the Group manages risk effectively. The Group Board is accountable to shareholders for financial and operational performance.

Group Audit Committee assists the Group Board in discharging its responsibilities for the disclosure of the financial affairs of the Group. It reviews the accounting policies, financial reporting and regulatory compliance practices of the Group and the Group's system and standards of internal controls, and monitors the Group's processes for internal audit and external audit.

Board Risk Committee provides oversight and advice to the Group Board on current and potential future risk exposures of the Group and risk strategy. It reviews the Group's performance on risk appetite and oversees the operation of the Group Policy Framework.

Group Remuneration Committee has oversight of the Group's policy on remuneration. It also considers senior executive remuneration and makes recommendations to the Group Board on remuneration of executive directors.

Group Nominations Committee assists the Group Board in the selection and appointment of directors. It reviews the structure, size and composition of the Group Board, and membership and chairmanship of Group Board committees.

Group Sustainability Committee is responsible for reviewing the Group's overall sustainability strategy, values and policies and aligning the Group's approach to ethical, social and environmental issues.

Executive Committee is responsible for managing Group-wide issues and those operational issues that affect the broader Group. It reviews strategic issues and initiatives, monitors financial performance and capital allocations and considers risk strategy, policy and risk management.

Our Board

Chairman

<p>Philip Hampton (age 58) Date of appointment: appointed to the Board on 19 January 2009 and to the position of Chairman on 3 February 2009</p> <p>Previously chairman of J Sainsbury plc and group finance director at Lloyds TSB Group, BT Group plc, BG Group plc, British Gas and British Steel plc, an executive director of Lazard's and a non-executive director of RMC Group plc and Belgacom SA. He is also a former chairman of UK Financial Investments Limited, which manages the UK Government's shareholdings in banks.</p>	<p>External appointments</p> <ul style="list-style-type: none"> <li>· Non-executive director of Anglo American plc</li> </ul> <p>Board Committee membership</p> <ul style="list-style-type: none"> <li>· Group Nominations Committee (Chair)</li> </ul>
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Executive directors

Group Chief Executive

<p>Stephen Hester (age 51) Date of appointment: appointed to the Board on 1 October 2008 and to the position of Group Chief Executive on 21 November 2008</p> <p>Previously chief executive of The British Land Company PLC, chief operating officer of Abbey National plc and prior to that held positions with Credit Suisse First Boston including chief financial officer, head of fixed income and co-head of European investment banking. In 2008 he served as a non-executive director of Northern Rock plc.</p>	<p>External appointments</p> <ul style="list-style-type: none"> <li>· Trustee of The Foundation and Friends of the Royal Botanical Gardens, Kew</li> </ul> <p>Board Committee membership</p> <ul style="list-style-type: none"> <li>· Executive Committee</li> </ul>
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Group Finance Director

<p>Bruce Van Saun (age 54) Date of appointment: 1 October 2009</p> <p>Over 25 years of financial services experience. From 1997 to 2008 he held a number of senior positions with Bank of New York and later Bank of New York Mellon, most recently as</p>	<p>External appointments</p> <ul style="list-style-type: none"> <li>· ConvergEx Holdings, LLC</li> </ul> <p>Board Committee membership</p> <ul style="list-style-type: none"> <li>· Executive Committee</li> </ul>
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vice-chairman and chief financial officer and before that was responsible for Asset Management and Market Related businesses. Prior to that he held senior positions with Deutsche Bank, Wasserstein Perella Group and Kidder Peabody & Co. He has served on several corporate boards as a non-executive director and has been active in numerous community organisations.

Our Board continued

Independent non-executive directors

<p>Sandy Crombie (age 63) Senior Independent Director Date of appointment: 1 June 2009</p> <p>Previously group chief executive of Standard Life plc. He was also previously a director of the Association of British Insurers, a member of the former Chancellor of the Exchequer's High Level Group on Financial Services and Chairman of the Edinburgh World City of Literature Trust. In 2007 he was the Prince of Wales' Ambassador for Corporate Social Responsibility in Scotland.</p>	<p>External appointments</p> <ul style="list-style-type: none"> <li>· Chairman of Creative Scotland</li> <li>· Member and vice-chairman of the Board of Governors of The Royal Conservatoire of Scotland</li> <li>· President of the Cockburn Association</li> </ul> <p>Board Committee membership</p> <ul style="list-style-type: none"> <li>· Group Sustainability Committee (Chair)</li> <li>· Board Risk Committee</li> <li>· Group Nominations Committee</li> <li>· Group Remuneration Committee</li> </ul>
<p>Alison Davis (age 50) Date of appointment: 1 August 2011</p> <p>Former director of First Data Corporation and chair of the board of LECG Corporation. She previously worked at McKinsey &amp; Company, AT Kearney, as chief financial officer at Barclays Global Investors (now BlackRock) and managing partner of Belvedere Capital, a private equity firm focused on buy-outs in the financial services sector.</p>	<p>External appointments</p> <ul style="list-style-type: none"> <li>· Member of the Advisory Board of City National Bank</li> <li>· Non-executive director of Unisys Corporation</li> <li>· Chair of the Governing Board of Women's Initiative for Self Employment</li> </ul> <p>Board Committee membership</p> <ul style="list-style-type: none"> <li>· Group Nominations Committee</li> <li>· Group Remuneration Committee</li> </ul>
<p>Tony Di Iorio (age 68) Date of appointment: 1 September 2011</p> <p>Has worked for a variety of financial institutions starting with Peat Marwick (now KPMG) and then Goldman Sachs, ultimately as controller of the global firm. He was chief financial officer of the investment bank of NationsBank (now Bank of America) before joining Paine Webber and then Deutsche Bank where he became chief financial officer in 2006. After retiring in 2008 he</p>	<p>External appointments</p> <ul style="list-style-type: none"> <li>· None</li> </ul> <p>Board Committee membership</p> <ul style="list-style-type: none"> <li>· Board Risk Committee</li> <li>· Group Audit Committee</li> <li>· Group Nominations Committee</li> </ul>

served as senior adviser to Ernst & Young working with the firm's financial services partners in the UK, Europe, the Middle East and Africa.

Penny Hughes, CBE (age 52)

Date of appointment: 1 January 2010

Previously a director and chairman of the Remuneration Committee of Skandinaviska Enskilda Banken AB and a non-executive director of Home Retail Group plc and chairman of its Remuneration Committee. She spent the majority of her executive career at Coca-Cola where she held a number of leadership positions, latterly as President, Coca-Cola Great Britain and Ireland. Former non-executive directorships include Vodafone Group plc, Reuters Group PLC and The Gap Inc.

External appointments

- Senior independent director of Cable & Wireless Worldwide plc
  - Non-executive director of Wm Morrison Supermarkets plc
  - Trustee of the British Museum
- Board Committee membership
- Group Remuneration Committee (Chair)
  - Group Nominations Committee

Independent non-executive directors

Joe MacHale (age 60)  
 Date of appointment: 1 September 2004

Held a number of senior executive positions with J.P. Morgan between 1979 and 2001 and was latterly chief executive of J P Morgan Europe, Middle East and Africa Region. Previously held non-executive roles at The Morgan Crucible Company plc and Brit Insurance Holdings plc. He is a fellow of the Institute of Chartered Accountants.

External appointments  
 · Trustee of MacMillan Cancer Support  
 · Chairman of Prytania Holdings LLP

Board Committee membership  
 · Board Risk Committee  
 · Group Nominations Committee

John McFarlane (age 64)  
 Date of appointment: 1 October 2008

Former chief executive officer of Australia and New Zealand Banking Group Limited. Previously he was a group executive director of Standard Chartered and head of Citicorp/Citibank in the UK and Ireland. Former president of the International Monetary Conference and a former chairman of the Australian Bankers Association and has previously served as a director of the London Stock Exchange and a member of the Auditing Practices Board.

External appointments  
 · Non-executive director of Westfield Holdings Limited  
 · Deputy chairman and chairman designate of Aviva plc

Board Committee membership  
 · Group Nominations Committee  
 · Group Remuneration Committee

Brendan Nelson (age 62)  
 Date of appointment: 1 April 2010

Former global chairman, financial services for KPMG. Previously held senior leadership roles within KPMG including as a member of the KPMG UK board from 1999 to 2006 and as vice chairman from 2006. Chairman of the Audit Committee of the Institute of Chartered Accountants of Scotland from 2005 to 2008.

External appointments  
 · Non-executive director and chairman of the Audit Committee of BP plc  
 · Board member of Financial Skills Partnership  
 · Member of the Financial Reporting Review Panel  
 · Vice President of the Institute of Chartered Accountants of Scotland

Board Committee membership



	<ul style="list-style-type: none"><li>· Group Audit Committee (Chair)</li><li>· Board Risk Committee</li><li>· Group Nominations Committee</li></ul>
Baroness Noakes, DBE (age 62) Date of appointment: 1 August 2011	External appointments <ul style="list-style-type: none"><li>· Non-executive director and chairman of Audit Committee of Severn Trent plc</li><li>· Senior independent director and chairman of Audit and Nominations Committees of Carpetright plc</li><li>· Trustee of the Thomson Reuters Founders Share Company Ltd</li></ul>
An experienced director on UK listed company boards with extensive and varied political and public sector experience. A qualified chartered accountant, she previously headed KPMG's European and International Government practices and has been President of the Institute of Chartered Accountants in England and Wales. She was appointed to the House of Lords in 2000 and has served on the Conservative front bench in various roles including as shadow treasury minister between 2003 and May 2010. Previously held non-executive roles on the Court of the Bank of England, Hanson, ICI, John Laing and SThree.	Board Committee membership <ul style="list-style-type: none"><li>· Group Audit Committee</li><li>· Group Nominations Committee</li></ul>

Our Board continued

Independent non-executive directors

<p>Arthur ‘Art’ Ryan (age 69) Date of appointment: 1 October 2008</p> <p>Former chairman, chief executive officer and president of Prudential Financial Inc. Previously he held senior positions with Chase Manhattan Bank N.A. and was a founding member of the Financial Services Forum. He is a non-executive director of Citizens Financial Group, Inc.</p>	<p>External appointments</p> <ul style="list-style-type: none"> <li>· Non-executive director of Regeneron Pharmaceuticals Inc.</li> <li>· Active member of numerous community boards</li> </ul> <p>Board Committee membership</p> <ul style="list-style-type: none"> <li>· Group Nominations Committee</li> </ul>
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<p>Philip Scott (age 58) Date of appointment: 1 November 2009</p> <p>Wide-ranging experience of financial services and risk management, including previous responsibility for Aviva’s continental European and International life and long-term savings businesses. He held a number of senior executive positions during his career at Aviva including his role as group finance director until January 2010. President Elect of the Institute and Faculty of Actuaries and Fellow of the Association of Certified Public Accountants.</p>	<p>External appointments</p> <ul style="list-style-type: none"> <li>· Non-executive director and chairman of the Audit Committee of Diageo plc</li> </ul> <p>Board Committee membership</p> <ul style="list-style-type: none"> <li>· Board Risk Committee (Chair)</li> <li>· Group Audit Committee</li> <li>· Group Nominations Committee</li> </ul>
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Group Secretary

<p>Aileen Taylor (age 39) Date of appointment: 1 May 2010</p> <p>A qualified solicitor, joined RBS in 2000. She was appointed Deputy Group Secretary and Head of Group Secretariat in 2007, and prior to that held various legal, secretariat and risk roles including Head of External Risk, Retail, Head of Regulatory Risk, Retail Direct and Head of Legal and Compliance at Direct Line Financial</p>	<p>She is a fellow of the Chartered Institute of Bankers in Scotland, a fellow of the Industry and Parliament Trust and a member of the European Corporate Governance Council.</p>
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Executive Committee

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Stephen Hester, Group Chief Executive

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Bruce Van Saun, Group Finance Director

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For biographies see page 211

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Ellen Alemany (age 56)

Chief Executive, Citizens and Head of Americas

Ellen Alemany joined the RBS Group in June 2007 as Head of RBS Americas. She became Chief Executive Officer of Citizens Financial Group, Inc. in March 2008 and Chairman in March 2009. Prior to these appointments, Ellen was the chief executive officer for Global Transaction Services at Citigroup, one of Citi's 12 publicly reported product lines. Ellen joined Citibank in 1987 and held various positions including executive vice-president for Commercial Business Group, chairman and chief executive officer for Citibank International plc and Citibank's European bank. She also served on the Citibank, N.A., Board of Directors. Ellen was elected to serve on the Board of Directors of Automatic Data Processing, Inc., beginning in January 2012.

Nathan Bostock (age 51)

Head of Restructuring & Risk

Nathan Bostock joined the RBS Group in June 2009. He is Head of Restructuring and Risk with responsibility for Risk Management, Legal & Regulatory Affairs, Global Restructuring Group and the Asset Protection Scheme. Before joining RBS, Nathan spent eight years with Abbey National plc in several roles and was latterly the chief financial officer and main board director responsible for Products & Marketing, HR, Insurance and Cards. Before joining Abbey in 2001, Nathan spent ten years with RBS in a number of roles, including Chief Operating Officer of Treasury and Capital Markets and Group Risk Director. A Chartered Accountant, Nathan worked with Coopers & Lybrand, before starting his career in banking. He spent seven years in Chase Manhattan Bank in a variety of areas and functions. He also holds a BSc (Hons) in Mathematics.

Paul Geddes (age 42)

Chief Executive, RBS Insurance

Paul Geddes was appointed as Chief Executive of RBS Insurance (subsequently renamed Direct Line Group) in August 2009, and is leading a significant transformation of the business ahead of its planned divestment from the Group. Prior to his move to Insurance, Paul was CEO of RBS Group's UK retail banking business, having joined RBS Retail in 2004 as Managing Director with responsibility for products and marketing. Before financial services, Paul held a number of senior roles in multi-channel retailing in the GUS and Kingfisher groups. Paul started his career in Marketing with Procter & Gamble in UK and European roles. Paul read PPE at Oxford, graduating in 1990, and remains a supporter of his college through music scholarships. He is a Fellow of the Chartered Institute of Bankers in Scotland, a member of the ABI Board and a member of the FSA Practitioner Panel.

Brian Hartzler (age 45)

Chief Executive, UK Retail, Wealth and Ulster Bank

Brian Hartzler has been the Chief Executive Officer for Retail, Wealth and Ulster Bank since August 2009. He joined RBS from ANZ in Australia, where he was chief executive officer Australia, as well as global segment lead for retail and wealth. Brian joined ANZ in 1999 as managing director, consumer finance, and later ran ANZ's personal banking

division. Prior to joining ANZ, Brian spent ten years as a financial services consultant in New York, San Francisco, and Melbourne. Brian is a graduate of Princeton University and holds joint US and Australian citizenship. Brian will leave the RBS Group in summer 2012.

John Hourican (age 41)

Chief Executive, Markets & International Banking

John Hourican was appointed Chief Executive, Markets & International Banking in January 2012 having served as Chief Executive of its predecessor, Global Banking & Markets, since October 2008. Prior to this John held a variety of positions across the RBS Group, including Chief Financial Officer of ABN AMRO Group, Head of Leveraged Finance and Chief Operating Officer of Global Banking & Markets. John received a degree in Economics and Sociology from the National University of Ireland and received a Postgraduate Diploma in Accounting from Dublin City University before starting his career at Price Waterhouse, where he worked in Dublin, London and Hong Kong. He is a fellow of the Institute of Chartered Accountants in Ireland.

Chris Sullivan (age 54)

Chief Executive, UK Corporate

Chris Sullivan was appointed Chief Executive of the UK Corporate Banking Division (including Global Transaction Services) in August 2009. His previous role was Chief Executive of RBS Insurance. Prior to this, Chris was Chief Executive of Retail and Deputy Chief Executive of Retail Markets. Chris is a member of the CBI President's Committee, vice-chairman of the Global Banking Alliance for Women, a governor of the IFS and a governor of Ashridge Management College. Chris is also chairman of the Interalpha group of banks. He spent five years as chief executive of Lombard Asset Finance and under his leadership it attained a leading position in the UK and Europe. Chris Sullivan earned his Fellowship of the Chartered Institute of Bankers in Scotland for his services to Scottish Banking.

Ron Teerlink (age 51)

Chief [Administrative](#) Officer

Ron Teerlink joined the RBS Group in April 2008 as Chief Executive of Business Services, becoming the Group Chief Administrative Officer in February 2009. At the same time he was re-appointed to the Managing Board of ABN AMRO to oversee the integration programme. Ron started his career with ABN Bank in 1986 as an IT/Systems analyst and held various functional positions before becoming Chief Operating Officer of the Wholesale Clients Business in 2002. He was appointed Chief Executive Officer of Group Shared Services in 2004 and joined ABN AMRO's Managing Board in January 2006, where he was responsible for Services and Market Infrastructure. Ron holds a Masters degree in Economics from Amsterdam's Vrije Universiteit.

Management [Committee](#)

The Management Committee, comprising our major business and functional leaders, meets regularly, up to four times annually, as a vehicle for strategy and business performance review.

It comprises members of the Executive Committee plus a number of other senior executives. Full details of membership of the Management Committee can be found on the Group's website [www.rbs.com](http://www.rbs.com).

## Corporate governance

### The Role of the Board

The Board is the main decision-making forum for the company. It is collectively responsible for the long-term success of the company and is accountable to shareholders for financial and operational performance.

The Board has overall responsibility for:

- establishment of Group strategy and consideration of strategic challenges;
- management of the business and affairs of the Group;
- ensuring the Group manages risk effectively through the approval and monitoring of the Group's risk appetite;
- considering stress scenarios and agreed mitigants and identifying longer term strategic threats to the Group's business operations;
- the allocation and raising of capital; and
- the preparation and approval of the Group's annual report and accounts.

The Board's terms of reference includes key aspects of the company's affairs reserved for the Board's decision and are reviewed bi-annually. The terms of reference are available on the Group's website [www.rbs.com](http://www.rbs.com).

There are a number of areas where the Board has delegated specific responsibility to management, including the Group Chief Executive and the Group Finance Director. These include responsibility for the operational management of the Group's businesses as well as reviewing high level strategic issues and considering risk appetite, risk policies and risk management strategies in advance of these being considered by the Board and/or its Committees. Specific delegated authorities are also in place in relation to business commitments across the Group.

All directors participate in discussing strategy, performance and the financial and risk management of the company. Meetings of the Board are structured to allow sufficient time for consideration of all items and the Chairman encourages constructive challenge and debate.

### Membership of the Board

The Board currently comprises the Chairman, two executive directors and ten independent non-executive directors, one of whom is the Senior Independent Director. The Board functions effectively and efficiently and is considered to be of an appropriate size. The directors provide the Group with the knowledge, mix of skills and experience required. The Board Committees comprise directors with a variety of relevant skills and experience so that no undue reliance is placed on any individual.

The names and biographical details of the members of the Board are shown on pages 211 to 214.

The Board is aware of the other commitments of its directors and is satisfied that all directors allocate sufficient time to enable them to discharge their responsibilities effectively.

The Board has established procedures for ensuring that the Board's powers for authorising directors' conflicts of interest are being operated effectively. With effect from 1 October 2008, the Companies Act 2006 introduced a statutory duty on directors to avoid conflicts of interest unless authorised. Since that date, the Board has considered,

and where appropriate authorised, any actual or potential conflicts of interest that directors may have. The Board reviews its conflicts register annually.

#### Election and re-election of directors

In accordance with the provisions of the Code, all directors of the company, with the exception of John McFarlane, will stand for election or re-election by shareholders at the company's Annual General Meeting. John McFarlane will step down from the Board on 31 March 2012. Further information in relation to the company's Annual General Meeting can be found in the Chairman's letter to shareholders which accompanies the notice of meeting.

#### Board balance and independence

The roles of Chairman and Group Chief Executive are distinct and separate, with a clear division of responsibilities. The Chairman leads the Board and ensures the effective engagement and contribution of all executive and non-executive directors. The Group Chief Executive has responsibility for all Group businesses and acts in accordance with the authority delegated by the Board.

The non-executive directors combine broad business and commercial experience with independent and objective judgement. The non-executive directors provide independent challenge to the executive directors and leadership team. The balance between non-executive and executive directors enables the Board to provide clear and effective leadership and maintain the highest standards of integrity across the Group's business activities.

The Board considers that the Chairman was independent on appointment and that all non-executive directors are independent for the purposes of the Code. The standard terms and conditions of appointment of non-executive directors are available on the Group's website [www.rbs.com](http://www.rbs.com) and copies are available on request from RBS Secretariat.

Board meetings

In 2011, nine Board meetings were scheduled and individual attendance by directors at these meetings is shown in the following table. Two of the Board meetings took place overseas during Board visits to the Netherlands in May 2011 and the United States in September 2011.

In addition to the nine scheduled meetings, 24 additional meetings of the Board and Committees of the Board were held, including meetings to consider and approve financial statements. The Chairman and the non-executive directors meet at least once per year without executive directors present.

	Attended/ scheduled
Total number of Board meetings in 2011	
Sandy Crombie	9/9
Alison Davis (1)	4/4
Tony Di Iorio (2)	3/3
Philip Hampton	9/9
Stephen Hester	9/9
Penny Hughes	9/9
Joe MacHale	9/9
John McFarlane	8/9
Brendan Nelson	9/9
Baroness Noakes (1)	4/4
Art Ryan	9/9
Philip Scott	9/9
Bruce Van Saun	9/9
Former director	
Colin Buchan (3)	6/6

Notes:

- (1) Joined the Board on 1 August 2011.
- (2) Joined the Board on 1 September 2011.
- (3) Retired from the Board on 5 August 2011.

Principal activities of the Board during 2011

In advance of each Board meeting, the directors were supplied with comprehensive papers in hard copy and electronic form.

At each Board meeting, the Chairman provided a verbal update and the Group Chief Executive provided a written report on business activities.

The directors also received reports on the Group's financial performance, capital, funding and liquidity position, risk management and government lending commitments together with regular reports on strategy, risk appetite, litigation and treating customers fairly. Specific strategy sessions and updates were considered in June, August and December.

Members of the executive management team attend and make regular presentations at meetings of the Board to give the directors greater insight into the business areas.

An annual programme of divisional presentations is agreed by the Board each year. During 2011, the Board received in-depth presentations from the former Global Transaction Services and Global Banking & Markets divisions,



Non-Core division, RBS Insurance (subsequently renamed Direct Line Group), Citizens, UK Retail and Ulster Bank. These presentations enhance the Board's knowledge of the Group's key divisions and afford directors the opportunity for discussion and debate with divisional senior management. Other key areas of focus for the Board during 2011 included the Independent Commission on Banking reports, Recovery and Resolution Planning and other regulatory reports and updates and these will continue to be key areas of focus for the Board during 2012.

#### Board Committees

In order to provide effective oversight and leadership, the Board has established a number of Board Committees with particular responsibilities. The Committee chairmanship and membership are reviewed on a regular basis. The names and biographies of all Board Committee members are set out on pages 211 to 214.

The terms of reference of the undernoted committees are available on the Group's website [www.rbs.com](http://www.rbs.com) and copies are available on request.

The Board Committees are discussed in their individual reports:

Group Audit Committee - pages 221 to 225

Board Risk Committee - pages 226 to 229

Group Remuneration Committee - pages 230 to 251

#### Information, induction and professional development

All directors receive accurate, timely and clear information on all relevant matters. All directors also have access to the advice and services of the Group Secretary who is responsible to the Board for ensuring that Board procedures are followed and for advising on all governance matters. In addition, all directors are able, if necessary, to obtain independent professional advice at the company's expense.

In line with the recommendations of the Walker Review of Governance in Banks and Financial Institutions (the Walker Review) and the Code, the Group Secretary has reviewed the induction programme for new directors. Each new director receives a formal induction on joining the Board, including visits to the Group's major divisions and meetings with directors and senior management and key stakeholders. The induction is tailored to the director's specific requirements.

Drawing on the previous experiences of the new directors appointed to the Group Board in 2011, the Group Secretary created tailored induction programmes for each of Alison Davis, Baroness Noakes and Tony Di Iorio which were designed to give them an in-depth insight into the range of businesses of the Group. Each induction programme included a mandatory element which comprised 12 meetings, visits and sessions. The remainder of the induction programme included in excess of 30 meetings with key executives and their teams, stakeholders and visits to divisions, businesses and Group Functions, both in the UK and overseas.

### Corporate governance continued

The Group Secretary also provides a comprehensive and ongoing professional development programme for directors. Directors are advised of appropriate external training and professional development opportunities and undertake the training and professional development they consider necessary to assist them to carry out their duties as directors. Internal training is also provided, tailored to the business of the Group. As part of their ongoing development in 2011, the directors received briefings on the UK Bribery Act 2010, the European Commission Green Paper on the EU Corporate Governance Framework, various Financial Reporting Council Consultations, amendments to the Code, the Capital Requirements Directive IV, a Group Treasury presentation on Balance Sheet Management and Capital Management & Term Funding and participated in a business visit to Group Technology.

Business visits are also arranged as part of the Group Audit Committee and Board Risk Committee schedule and all non-executive directors are invited to attend. During 2011, visits were made to Group Internal Audit, RBS N.V., Restructuring and Risk and RBS Insurance (subsequently renamed Direct Line Group).

### Performance evaluation

In accordance with the Code, an external evaluation of the Board takes place every three years with the last externally facilitated evaluation having taken place in 2009.

The 2010 evaluation was conducted internally and a number of initiatives were implemented aimed at improving the overall performance and effectiveness of the Board. These included further improvements to the flow of information to the Board, both in terms of the quality of papers and the use of new technology to deliver these to directors. The 2011 evaluation concluded that the recommendations from the 2010 evaluation had been implemented in full.

### Performance evaluation process

The directors agreed that the 2011 evaluation of the Board and its key Board Committees be conducted internally, led by the Group Secretary. The Group Secretary undertook a formal and rigorous evaluation by:

- circulating a detailed framework of questions to all directors and regular meeting attendees;
- collating the responses and conducting structured individual meetings with each director and regular meeting attendees;
- discussing the outcomes and recommendations with the Chairman; and
- agreeing the recommendations and outcomes with the Board and Board Committee members.

Amongst the areas reviewed were Board role and composition, Group strategy, risk management, Board meetings and processes, external relationships, Board committees, directors' support and information, and continuing professional development.

### Findings of performance evaluation 2011

The Board has considered and discussed reports on the outcomes of the evaluation and is satisfied with the way in which the evaluation was conducted.

The evaluation concluded that the Board is strong, operating effectively and meeting its objectives. Headed by an excellent Chairman, the Board is currently viewed as an appropriate size, although Board composition should be kept under continual review. Meetings are of an appropriate length and frequency with sufficient opportunity for debate and discussion, although it was suggested the Board continue to make use of evening and lunch slots to facilitate

further debate and discussion on key areas such as strategy and risk management.

A summary of the objectives and actions proposed to be taken to address the objectives arising from the 2011 performance evaluation is set out below:

Key themes	Proposed action
Board role and composition	In light of John McFarlane stepping down from the Board in March 2012 the composition of the Board and Board committees should be reviewed to ensure the current balance of skills, experiences, independence and knowledge is maintained.
Strategy	The Board should continue the focus on Group strategy in the short, medium and long term to ensure the strategy is appropriate and sustainable in the current environment.
Risk management	Risk reporting should continue to be developed to ensure the Group Board has adequate oversight of risk management and risk appetite.
Succession planning	Group executives should be invited to the Group Board to discuss bench strength and succession planning in their respective functions.

#### Individual director and Chairman effectiveness reviews

Within the performance evaluation questionnaires, directors were asked to provide feedback on their fellow directors. This feedback was shared with each director by the Chairman, who met with each director individually to discuss their own performance and ongoing professional development. Separately, the Senior Independent Director canvassed the views of the executive directors and met with the non-executive directors as a group, without the Chairman present, to consider the Chairman's performance. Feedback was sought on governance and stewardship of the Group, relationships with key external and internal stakeholders, execution of the Group's Strategic Plan and delivery of value and return to shareholders. The Senior Independent Director also canvassed views from United Kingdom Financial Investments Limited (UKFI), the FSA and the Asset Protection Agency. The results of the Chairman effectiveness review were then shared with the Chairman who agreed to consider the points raised and provide separate responses in due course.

Group Nominations Committee

Role of the Group Nominations Committee

The Group Nominations Committee is responsible for:

- reviewing the structure, size and composition of the Board and making recommendations to the Board on any appropriate changes;
- assisting the Board in the formal selection and appointment of directors (executive and non-executive) having regard to the overall balance of skills, knowledge, experience and diversity on the Board;
- reviewing membership and chairmanship of Group Board Committees;
- considering succession planning for the Chairman and the executive and non-executive directors, taking into account the skills and expertise which will be needed on the Board in the future. No director is involved in decisions regarding his or her own succession; and
- making recommendations to the Board concerning the re-election by shareholders of directors under the provisions of the Code. In so doing, they will have due regard to their performance and ability to continue to contribute to the Board in light of the knowledge, skills and experience required and the need for progressive refreshing of the Board.

The terms of reference of the Group Nominations Committee are available on the Group's website [www.rbs.com](http://www.rbs.com).

The Group Nominations Committee engages with external consultants, considers potential candidates and recommends appointments of new directors to the Board.

Membership of the Group Nominations Committee

All non-executive directors are members of the Group Nominations Committee which is chaired by the Chairman of the Group. The Group Chief Executive is invited to attend meetings. The Group Nominations Committee holds at least two scheduled meetings per year, and also meets on an ad hoc basis as required. In 2011, five meetings of the Group Nominations Committee were held. The Chairman and members of the Committee during 2011, together with their attendance at meetings in 2011, is shown below.

	Attended/ scheduled
Total number of meetings in 2011	5/5
Philip Hampton (Chairman)	5/5
Sandy Crombie	5/5
Penny Hughes	4/5
Joe MacHale	5/5
John McFarlane	5/5
Brendan Nelson	5/5
Art Ryan	5/5
Philip Scott	5/5
Former member Colin Buchan (1)	5/5

Note:

(1) Retired from the Board on 5 August 2011.

The table below sets out the tenure of non-executive directors.

#### Principal activity of the Group Nominations Committee during 2011

##### Appointment of new non-executive directors

During 2011, the Group Nominations Committee focussed on changes to the Board's composition and succession planning for the executive directors.

The Group Nominations Committee reviewed the structure, size and composition of the Board and agreed that the composition of the Board could be enhanced with the recruitment of candidates with financial services expertise and experience of European and regulatory issues. It was also agreed that non-UK based candidates should be considered, ideally from the US or Europe. It was recognised that investment banking as well as governmental experience would be useful.

To ensure the Group had access to a wide pool of suitable candidates, the Chairman and Group Secretary contacted two executive search firms with a role profile and a description of the skills required to enhance the Board composition. The Chairman considered a number of candidates before submitting several shortlists to the Group Nominations Committee for consideration. Following discussion, it was agreed that the combination of skills, knowledge and experience of Alison Davis, Baroness Noakes and Tony Di Iorio would enhance the composition of the Board.

##### Board and Committee membership

When considering the appointment of Alison Davis, Baroness Noakes and Tony Di Iorio, and the retirement of Colin Buchan, the Group Nominations Committee also reviewed the membership of the Group Board Committees. Based on the expertise of the incoming non-executive directors, the Group Nominations Committee agreed to strengthen the Group Board Committees with additional members.

## Corporate governance continued

### Diversity

At its meeting in June 2011, the Group Nominations Committee considered a letter from Lord Davies recommending that a Board discussion be held prior to the announcement of aspirational diversity targets in September 2011. The statement released in September 2011 announced that the Group is supportive of Lord Davies' recommendations and aspires to meet the target of 25 per cent female board representation in 2012 as set out in Lord Davies' report and confirmed that the Group will continue to meet or exceed this standard. In December 2011, in accordance with the recommendations contained within Lord Davies' report, the Board established a boardroom diversity policy including measurable objectives for implementing the policy.

The Group understands the importance of diversity and recognises the importance of women having greater representation at key decision making points in organisations. The search for Board candidates will continue to be conducted, and nominations/appointments made, with due regard to the benefits of diversity on the Board. However, all appointments to the Group Board are based on merit, measured against objective criteria, and the skills and experience the individual can bring to the Group Board.

The balance of skills, experience, independence, knowledge and diversity on the Board, and how the Board operates together as a unit is reviewed annually as part of the Board evaluation. Where appropriate, findings from the evaluation will be considered in the search, nomination and appointment process. If appropriate, additional targets on diversity will be developed in due course.

Further details on the Group's approach to diversity can be found on page 258.

### Succession planning

The Group Nominations Committee considers succession planning on an ongoing basis. The Board considered talent and succession planning for the Group Chief Executive and each member of the Executive Committee at a meeting in June 2011. The meeting concluded that the executive team was extremely strong and the Board should continue to monitor the position as industry developments progress.

### Group Sustainability Committee

The Group Sustainability Committee (GSC) is chaired by the Senior Independent Director and meets quarterly. The GSC is responsible for reviewing the Group's overall sustainability strategy, values and policies and aligning the Group's approach to ethical, social and environmental issues. All key business areas are represented on the GSC and it is attended by the Group Chairman. Further details of the Group's sustainability policies are available on the Group's website [www.rbs.com/sustainability](http://www.rbs.com/sustainability) and in the Annual Sustainability Report.

### Relations with shareholders

The Chairman is responsible for ensuring effective communication with shareholders. The company communicates with shareholders through the Annual Report and Accounts and by providing information in advance of the Annual General Meeting. Individual shareholders can raise matters relating to their shareholdings and the business of the Group at any time throughout the year by letter, telephone or email via the Group's website [www.rbs.com/ir](http://www.rbs.com/ir).

Shareholders are given the opportunity to ask questions at the Annual General Meeting or can submit written questions in advance. Directors including the chairs of the Group Audit, Board Risk, Group Remuneration and Group Nominations Committees are available to answer questions at the Annual General Meeting. The Senior Independent Director is also available.

Communication with the company's largest institutional shareholders is undertaken as part of the Investor Relations programme:

- the Group Chief Executive and Group Finance Director meet regularly with UKFI, the organisation set up to manage the Government's investments in financial institutions, to discuss the strategy and financial performance of the Group. The Group Chief Executive and Group Finance Director also undertake an extensive annual programme of meetings with the company's largest institutional shareholders.
- the Chairman independently meets with the Group's largest institutional shareholders annually to hear their feedback on management, strategy, business performance and corporate governance. Additionally, the Chairman, Senior Independent Director and chairs of the Board Committees met with the governance representatives of a number of institutional shareholders during the year.
- the Senior Independent Director is available if any shareholder has concerns that they feel are not being addressed through the normal channels.
- the Chair of the Group Remuneration Committee consults extensively with institutional shareholders in respect of the Group's remuneration policy.

Throughout the year, the Chairman, Group Chief Executive, Group Finance Director and Chair of the Group Remuneration Committee communicate shareholder feedback to the Board and the directors receive independent analyst notes and reports reviewing share price movements and the Group's performance against the sector. Detailed market and shareholder feedback is also provided to the Board after major public announcements such as results announcements. The arrangements used to ensure that directors develop an understanding of the views of major shareholders are considered as part of the annual Board evaluation.

## Report of the Group Audit Committee

Letter from Brendan Nelson,  
Chairman of the Group Audit Committee

Dear Shareholder,

I am pleased to bring you this report following my first full year as Chairman of the Group Audit Committee.

I would like to begin by welcoming Baroness Noakes and Tony Di Iorio who joined the Committee in August and September 2011, respectively; coinciding with Colin Buchan's retirement from the Group Board. They bring with them a wealth of experience and knowledge. I am grateful to Colin for his commitment to the Committee.

2011 has been a difficult year for the industry and for the Group and the Committee has concentrated its efforts on key emerging issues. In particular, it has considered and, where appropriate, made recommendations to the Group Board in respect of:

- the continued market turmoil and its effect on the Group's businesses, in particular the former GBM division;
  - the ongoing Eurozone crisis and impairment of the Group's sovereign debt exposure;
  - impairment charges in the UK Corporate and Ulster Bank divisions;
  - Payment Protection Insurance (PPI) provision;
- the implications, including the capital, risk and control assumptions and dependencies of the proposed structured transfer of the assets and liabilities of RBS N.V. to RBS plc;
  - the adequacy of internal change processes and controls;
  - the activity, performance and findings of Internal and External Audit; and
- the quality and transparency of disclosures contained in external financial statements.

The oversight role of the Committee in these areas is explained in more detail in the Committee's full report given below.

It is clear that 2012 will be as challenging as 2011. External conditions, internal change and the remediation of known and future issues, while managing the regulatory agenda, will make 'business as usual' extremely challenging. The Committee will continue to monitor compliance with the Group's current regulatory requirements and monitor the implications of proposed future regulatory change, including the Independent Commission on Banking's recommendations as they develop through 2012. Internal organisational change will also present challenges and the Committee will provide oversight of the revised control framework within the new Markets and International Banking division as it fully embeds.

I am pleased to report the recent appointment of Nicholas Crapp as our new Head of Group Internal Audit. Nicholas joined the Group at the beginning of 2012 and I look forward to his contribution to this challenging agenda. Overall, I am confident that with the continued commitment of my fellow colleagues and the support of the Group executive, the



Committee is well placed to meet the challenges of 2012.

Brendan Nelson  
Chairman of the Group Audit Committee  
22 February 2012

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## Report of the Group Audit Committee continued

## Report of the Group Audit Committee

## The role and responsibilities of the Group Audit Committee

The Group Audit Committee's primary responsibilities, as set out in its terms of reference, are to assist the Board in discharging its responsibilities in respect of: financial reporting and policy; systems of internal control; processes for Internal and External Audit and oversight of the Group's relationship with its regulators. The terms of reference of the Group Audit Committee are reviewed annually by the Group Audit Committee and approved by the Board. They are available on the Group's website [www.rbs.com](http://www.rbs.com).

## Meetings and visits

A total of seven meetings of the Group Audit Committee were held in 2011, including meetings held immediately before the submission of the annual and interim financial statements and the quarterly Interim Management Statements to the Board. Group Audit Committee meetings are attended by relevant executive directors, the Internal and External Auditors and Finance and Risk management executives. Other executives, subject matter experts and external advisers are also invited to attend the Group Audit Committee, as required, to present and advise on reports commissioned by the Committee. At least twice per annum the Group Audit Committee meets privately with the External Auditors. The Committee also meets privately with the Internal Audit function.

The annual programme of joint visits by the Group Audit and Board Risk Committees to the Group's business divisions and control functions continued in 2011. The object of the programme is to promote the Committees' understanding of the Group; invitations to attend are extended to all non-executive directors. The programme of visits is considered annually. The Group Audit Committee and the Board Risk Committee undertook four visits - to Group Internal Audit, RBS N.V., Restructuring and Risk and RBS Insurance (subsequently renamed Direct Line Group) - during 2011.

## Membership of the Group Audit Committee

The Group Audit Committee comprises at least three independent non-executive directors. The Chairman and members of the Committee, together with their attendance at meetings, are shown below.

		Attended/ scheduled
Brendan Nelson (chairman)	Independent	7/7
Tony Di Iorio (1)	Independent	2/2
Baroness Noakes (2)	Independent	3/3
Philip Scott	Independent	7/7
Former member		
Colin Buchan (3)	Independent	5/5

## Notes:

- (1) Joined the Committee on 1 September 2011.  
 (2) Joined the Committee on 1 August 2011.  
 (3) Retired from the Committee on 5 August 2011.

Brendan Nelson, Tony Di Iorio and Philip Scott are also members of the Board Risk Committee facilitating the effective governance of finance and risk issues and the alignment of agendas. The Group Audit and Board Risk Committees also have strong links with the Group Remuneration Committee ensuring that levels of compensation

reflect relevant finance and risk considerations.

The members of the Group Audit Committee are selected with a view to the expertise and experience of the Group Audit Committee as a whole. The Board is satisfied that all Group Audit Committee members have recent and relevant financial experience, and that each member of the Group Audit Committee is an 'Audit Committee Financial Expert' and is independent, each as defined in the SEC rules under the US Securities Exchange Act of 1934 ("Exchange Act") and related guidance. Full biographical details are set out on pages 211 to 214.

Principal activity of the Group Audit Committee during 2011

Financial reporting

During 2011, the Group Audit Committee received regular updates on accounting issues and developments from both the Group Chief Accountant and from the External Auditors who presented for approval their audit plan, their audit fee proposal and engagement letter, as well as confirmation of their independence and a comprehensive report of all non-audit fees.

The Group Audit Committee focused on a number of salient judgments and reporting issues in the preparation of the 2011 accounts, including:

- valuation methodologies and assumptions for financial instruments carried at fair value including the Group's credit market exposures;
  - disclosures, including those in relation to forbearance and sovereign debt;
- impairment losses in the Group's loans and advances and available-for-sale securities; with particular emphasis on Eurozone issues, sovereign debt exposures, Ulster Bank and UK Corporate impairment;
  - PPI provision;
- actuarial assumptions for the Group Pension Fund and the Group's general insurance claims reserves;
  - impairment of goodwill; and
- the Group's tax position, including the recognition of deferred tax assets.

The Committee sought to understand and to challenge in a robust manner management's accounting judgments and estimates. It reviewed the conclusions of the External Auditors and, where applicable, other experts and satisfied itself that disclosures in the financial statements about these judgements and estimates are transparent and appropriate.

#### Internal Control

In 2011, the Group Audit Committee tracked progress in the development and implementation of the new Group Policy Framework across the Group and will continue to monitor progress in embedding the framework throughout 2012. It will review the results of assurance activity in respect of the new framework in the latter half of the year.

The Group Audit Committee reviewed the control framework in place to ensure that it is operating effectively and specifically reviewed progress against its plan for a number of large strategic initiatives such as the Finance and Risk Transformation Programme. It also tracked progress in relation to mandatory and remedial projects including the Group's Anti-Money Laundering Programme and the progress of the Group's US regulatory initiatives.

The Committee reviewed the effectiveness of the Group New Product Approval Process, the Credit Quality Assurance Process and considered the operation of the Group Notifiable Event Process as it applies in specific circumstances.

The Committee received reports and considered the Group's compliance with the requirements of the Sarbanes-Oxley Act of 2002. It was regularly advised of: whistle-blowing events which occurred within the Group; complaints raised with members of the Group's executive team; and significant internal investigations undertaken within the Group.

Divisional Risk and Audit Committees have been established with responsibility for reviewing the business of each division and reporting to the Group Audit Committee and Board Risk Committee. Given the size and complexity of the Group, these committees are an essential component of the governance framework that supports the effective operation of the Group Audit Committee and Board Risk Committee across the organisation. The Committee has agreed changes to the Divisional Risk Reporting framework and these improvements will be implemented during 2012. Quarterly reports are received by the Group Audit Committee and Board Risk Committee from each Divisional Committee.

#### Internal audit

The Group Audit Committee oversees the work of Group Internal Audit, and receives a quarterly report from the Head of Group Internal Audit. This report rates the quality of the control environment of all the Group's divisions and of management's level of awareness on these matters. It offers the Group Audit Committee oversight of Group Internal Audit's work, and allows the Group Audit Committee to monitor the level of internal control within the Group by reporting on areas where improvements are required to the control environment.

During 2011, the Committee sought to enhance further management responsiveness to Group Internal Audit findings and has developed a process to invite management to respond, either directly or in writing, to the Committee regarding identified deficiencies. The Group Audit Committee monitors these findings and management responses ensuring that issues raised are dealt with in a timely and appropriate manner.

The Group Audit Committee also considers Group Internal Audit's annual plan and the adequacy of its resources and budget. During 2011, the Group Audit Committee actively supported the development of the Internal Audit vision and strategy and the transition to thematic reporting and the development of centres of excellence. It has supported increased resources for the function and has been directly involved in the process for the appointment of the new Head of Group Internal Audit.

An external review of the effectiveness of Group Internal Audit takes place every three to five years, in line with best practice, with internal reviews continuing in intervening years. In January 2012, the Group Audit Committee undertook an internal evaluation of Group Internal Audit. The evaluation concluded that Group Internal Audit had operated effectively throughout 2011.

External audit

Deloitte LLP have been the company's auditors since March 2000. There are no contractual obligations restricting the company's choice of external auditor.

During 2011, the External Auditors provided the Group Audit Committee with reports summarising their main observations and conclusions arising from their year end audit, their half year review and their work in connection with the first and third quarters and their recommendations for enhancements to the Group's reporting and controls. Deloitte also presented for approval to the Committee their audit plan, their audit fee proposal and engagement letter, as well as confirmation of their independence and a comprehensive report of all non-audit fees.

The Group Audit Committee undertakes an annual evaluation to assess the independence and objectivity of the External Auditors and the effectiveness of the audit process, taking into consideration relevant professional and regulatory requirements. The annual evaluation is carried out following completion of the annual accounts and audit. In assessing the effectiveness of the Group's External Auditors, the Group Audit Committee has regard to:

- the experience and expertise of the senior members of the engagement team;
  - the proposed scope of the audit work planned and executed;
- the quality of dialogue between the External Auditors, the Committee and senior management;
- the clarity, quality and robustness of written reports presented to the Committee setting out the External Auditors' findings arising from the audit;
- the quality of observations provided to the company by the External Auditor on the Group's systems of internal control; and
  - the views of management on the performance of the External Auditors.

## Report of the Group Audit Committee continued

In addition to the annual evaluation performed by the Group Audit Committee, the External Auditors also conduct their own annual review of audit quality. Twelve service criteria for the audit have been defined by the External Auditors to measure their performance against the quality commitments set out in their annual audit plan, under the headings of 'quality of audit, approach and conduct', 'independence and objectivity', 'quality of the team' and 'value added'. Feedback will be obtained and discussed with the relevant internal stakeholders. The results of this exercise will be presented to the Group Audit Committee, with actions defined and agreed to address any areas where performance has fallen below expected standards.

The Group Audit Committee is responsible for making recommendations to the Board in relation to the appointment, re-appointment and removal of the External Auditors. In order to make a recommendation to the Board, the Group Audit Committee considers and discusses the performance of the External Auditor in the previous year, taking account of the outcomes of the annual evaluation carried out. The Board submits the Group Audit Committee's recommendations to shareholders for their approval at the Annual General Meeting. The Board has endorsed the Group Audit Committee's recommendation that shareholders be requested to approve the reappointment of Deloitte LLP as External Auditors at the Annual General Meeting in 2012. The Group Audit Committee has considered the proposals for reform of the audit market as published by the EU Commission. It will continue to monitor developments in this regard including the potential implications for External Auditor appointment in the UK.

The Group Audit Committee approves the terms of engagement of the External Auditors. The Group Audit Committee also fixes the remuneration of the External Auditors as authorised by shareholders at the Annual General Meeting.

### Audit and non-audit services

The Group Audit Committee has adopted a policy on the engagement of the External Auditors to supply audit and non-audit services, which takes into account relevant legislation regarding the provision of such services by an external audit firm.

In particular, the Group may not engage the External Auditors to provide any of the non-audit services described below:

- bookkeeping or other services related to the accounting records or financial statements;
  - financial information systems design and implementation;
- appraisal or valuation services, fairness opinions or contribution-in-kind reports;
  - actuarial services;
  - internal audit outsourcing services;
  - management functions or human resources;
- broker or dealer, investment adviser, or investment banking services;
  - legal services and expert services unrelated to the audit; or
- other services determined to be impermissible by the US Public Company Accounting Oversight Board.

The Group Audit Committee reviews the policy annually and prospectively approves the provision of audit services and certain non-audit services by the External Auditors. Annual audit services include all services detailed in the annual engagement letter including the annual audit and interim reviews (including US reporting requirements) and periodic profit verifications.

Annual audit services also include statutory or non-statutory audits required by any Group companies that are not incorporated in the UK. Terms of engagement for these audits are agreed separately with management, and are consistent with those set out in the audit engagement letter insofar as local regulations permit. During 2011, prospectively approved non-audit services included the following classes of service:

- capital raising, including consents, comfort letters and relevant reviews of registration statements;
- provision of accounting opinions relating to the financial statements of the Group;
- provision of reports that, according to law or regulation, must be rendered by the External Auditors;
  - tax compliance services;
  - permissible services relating to companies that will remain outside the Group;
  - restructuring services relating to the Group's customers; and
- reports providing assurance to third parties over certain of the Group's internal controls prepared under US Statement of Auditing Standards 70 or similar auditing standards in other jurisdictions.

For all other permitted non-audit services, Group Audit Committee approval must be sought, on a case by case basis, before the provision of the service commences. The Group Audit Committee reviews and monitors the independence and objectivity of the External Auditors when it approves non-audit work, taking into consideration relevant legislation, ethical guidance and the level of non-audit services relative to audit services. The approval process is rigorously applied to prevent the External Auditors from functioning in the role of management, auditing their own work, or serving in an advocacy role.

During 2011, the Group Audit Committee approved changes to the Group's non-audit services policy. Tax compliance services, permissible services to companies that will remain outwith the Group and restructuring services will require ad hoc approval of the Group Audit Committee in 2012. In addition, a competitive tender process will be required for all proposed engagements where the fees are expected to exceed £100,000. Engagements below £100,000 may be approved by the Chairman of the Group Audit Committee; as an additional governance control all engagements have to be approved by the Group Chief Accountant and Group Sourcing and Vendor Management. Ad hoc approvals of non-audit services are ratified by the Group Audit Committee each quarter. During 2011, the External Auditor was approved to undertake certain significant engagements which are categorised and explained more fully below:

Summary of category of engagement	Reason for selection of External Auditor
Provision of advice, best-practice options and support to management on a number of projects (four engagements)	<p>The External Auditor was appointed in relation to these engagements because it was the market leader in the subject matter or because the external audit team included personnel who were uniquely positioned, experienced and qualified to provide the necessary advice.</p> <p>A full tender process was undertaken in relation to two engagements and the External Auditor was appointed following presentation of a thorough proposal and a willingness to leverage existing knowledge to ensure a competitive price proposition.</p>
Assurance testing RBS, NatWest and Ulster Bank customer charters and the Group's Corporate Governance Policy (three engagements)	<p>The External Auditors prior experience and ability to make use of previous work made them a competitive choice for the assurance of the various customer charters.</p> <p>A selective tender was undertaken to provide support and advice to the Group Secretary for the assurance of the Group Corporate Governance Policy. The External Auditor was judged to be both financially competitive and provided the clearest, and most comprehensive approach to supporting the Group Secretary in this assignment.</p>
Agreed upon procedures (AUP) review for Wealth Management (one engagement)	<p>The External Auditor was experienced in this field and had performed three previous AUP reviews. Timing was also an issue for this request but a competitive tender process will be considered prior to the next review.</p>
Tax and accounting advice (two engagements)	<p>The External Auditor was appointed for one of the engagements following submission of a detailed proposal document, formal presentation and lengthy discussion with RBS management. Given the nature of the engagement it was determined that appointment of the External Auditor was appropriate.</p> <p>Following a tender process in the other instance the External Auditor was judged to be the best firm to employ and was agreed by the co-sponsors to the engagement.</p>

Information on fees paid in respect of audit and non-audit services carried out by the External Auditors is detailed in Note 5 on the Group's consolidated accounts.

Group's relationship with its regulators



The Group Audit Committee has a responsibility to monitor the Group's relationship with the Financial Services Authority (FSA) and other regulatory bodies. During 2011, it received regular reports on the Group's relationship with all its regulators and significant developments or changes to those interactions. It receives reports on regulatory actions and investigations. Over the course of the year the chairmen of the Group's Senior Board Committees met with the FSA on an individual basis and also participated in certain Regulatory College meetings with the Group's primary regulators. The non-executive directors also collectively participated in meetings with the FSA on two occasions and the FSA were invited to attend certain discussions of the Board.

The non-executive directors closely monitor the Group's relationship with its international regulators and during 2011 significant time has been dedicated in particular to understanding the regulatory requirements in the US and the implications on the Group's US operations and structure.

The Group Board met with the Federal Reserve Bank of Boston collectively in this regard during 2011. The Chairman of the Group Audit Committee also met with the US regulator on an individual basis.

#### Performance evaluation

An external review evaluating the effectiveness of the Group Audit Committee takes place every three to five years, with internal reviews by the Board in intervening years. An internal review took place during 2011 covering the role of the Committee; its composition, meetings and processes, performance and reporting, policy and procedures; induction and continuing professional development; communication; and divisional committees. Overall the review concluded that the Committee continued to operate effectively.

Brendan Nelson,  
Chairman of the Group Audit Committee  
22 February 2012

## Report of the Board Risk Committee

Letter from Philip Scott,  
Chairman of the Board Risk Committee

Dear Shareholder,

I am pleased to bring you this report on the activity of the Board Risk Committee during 2011.

As one would expect, managing the risks presented by the challenging external market conditions that have continued throughout 2011 has been a key priority of the Committee. Market, credit and liquidity risk have featured prominently in the discussions of the members in the period. The regulatory agenda has continued to exert pressures on the organisation and the Committee has sought to understand the global implications of proposed regulation while managing and overseeing remediation of known issues. The Committee has continued to build upon existing relationships with the Group's regulators globally, wherever possible.

Tony Di Iorio joined the Committee with effect from 1 September 2011. It is my pleasure to welcome Tony to the Committee. I am certain that his broad background in financial services and global investment banking will prove to be immensely useful to the Committee, particularly in managing the complex risks presented by the Group's new Markets and International Banking Division. Colin Buchan retired from the Group Board in August 2011 and I would like to thank Colin for his contribution to the Committee during the first half of the year.

The Board Risk Committee was created in January 2010 following the recommendations set out in the Walker Review and it is therefore a relatively new committee to the Group. Notwithstanding the challenges presented by external market forces, it was important that the Committee, during its second year of operation, continued to fully refine and enhance its approach to risk oversight and its interaction with other senior Board Committees. I am pleased to report that during 2011 the Committee has made progress in the following areas:

- further development of a risk appetite framework and methodology;
- development of a new conduct risk appetite framework;
- enhancement of the Group Policy Framework. This has been a major project for the Group in 2011 and the Board Risk Committee has provided oversight of the project which has now completed its critical initial phase;
  - interaction with the Group Remuneration Committee. Penny Hughes, Chair of the Group Remuneration Committee, and I sponsored a project in 2011 to review and improve interaction between both committees. This has led to clarification of responsibilities, improved planning and the identification of additional trigger points outwith pay cycles where risk should be taken into consideration;
  - improvement of reporting standards;
  - promotion of a risk awareness culture; and
- oversight of the enhancement of the risk governance framework that supports the Committee at an executive level.

The activity of the Committee is set out more fully in the Report of the Board Risk Committee below. However, while progress has been made, the work of the Committee is in no way complete and these risk areas will remain a key area

of focus and refinement in 2012. The risk appetite framework must be fully embedded across divisions and the Committee recognises that development of an economic capital model must be prioritised in 2012. Furthermore, the difficulties being experienced in Europe and the US will necessitate a continued focus on market and sovereign risk in the year ahead.

It is not yet possible to determine the impact of the recommendations contained within the Report of the Independent Commission on Banking. The recommendations are complex and it will take time to fully consider what they mean for the Group and any corresponding strategic and organisational change. The Board Risk Committee will monitor developments and will fully consider the risk implications of any decision in this regard.

Philip Scott  
Chairman of the Board Risk Committee  
22 February 2012

## Report of the Board Risk Committee

### Role of the Board Risk Committee

The Board Risk Committee is responsible for providing oversight and advice to the Board in relation to current and potential future risk exposures of the Group and future risk strategy, including determination of risk appetite and tolerance. The Committee reviews the performance of the Group relative to risk appetite and provides oversight of the effectiveness of key Group policies. The Board Risk Committee has responsibility for promoting a risk awareness culture within the Group.

Authority is delegated to the Board Risk Committee by the Group Board and the Committee will report and make recommendations to the Group Board as required. The terms of reference of the Board Risk Committee are available on the Group's website [www.rbs.com](http://www.rbs.com) and these are considered annually by the Board Risk Committee and approved by the Board.

### Meetings and visits

The Board Risk Committee held six scheduled meetings and three additional ad hoc meetings in 2011. Meetings are held alongside Group Audit Committee meetings to ensure that the work of the two Committees is coordinated and consistent. Board Risk Committee meetings are attended by relevant executive directors, risk management and finance executives and the internal auditors. External advice may be sought by the Board Risk Committee where considered appropriate. During 2011, the members of Board Risk Committee in conjunction with the members of the Group Audit Committee took part in an annual programme of visits to the Group's business divisions and control functions. Details about the programme of visits is set out in the Report of the Group Audit Committee on page 222.

### Membership

The Board Risk Committee is comprised of at least three independent non-executive directors. The Chairman and members of the Committee, together with their attendance at meetings, are shown below.

		Attended/ scheduled
Philip Scott (chairman)	Independent	6/6
Sandy Crombie	Independent	5/6
Tony Di Iorio (1)	Independent	1/1
Joe MacHale	Independent	6/6
Brendan Nelson	Independent	6/6
Former member		
Colin Buchan (2)	Independent	4/5

### Notes:

- (1) Joined the Committee on 1 September 2011.
- (2) Retired from the Committee on 5 August 2011.

Philip Scott, Tony Di Iorio and Brendan Nelson are also members of the Group Audit Committee. This common membership ensures effective governance across all Finance and Risk issues, and that agendas are aligned and overlap is avoided.

Principal activity of the Board Risk Committee during 2011  
Risk strategy and policy

The Board Risk Committee is fully engaged in the risks deriving from the recently announced organisational changes to form the new Markets and International Banking division and consideration of the impact of the FSA's Recovery and Resolution programme and where possible the ICB proposals on the wider Group, will be a priority of the Committee over the course of 2012 and beyond.

Development of the Group Policy Framework has been a major project for the Group in 2011 and the Board Risk Committee has provided oversight and direction to the project. Standards have now been developed, benchmarked and are now being implemented across the organisation. The Board Risk Committee will continue to ensure that the standards are properly embedded globally and will review the output of assurance testing to ensure that the standards are operating effectively. Risk governance across the Group, including the operation of the Board Risk Committee, will be reviewed pursuant to the Corporate Governance Policy standard and the Committee will take forward any recommendations from that review during the course of 2012.

The Committee has overseen the development of a conduct risk appetite statement and framework during 2011. The Committee regards conduct risk to be a fundamental tenet of risk and will receive reports in 2012 on the implementation of the standard and framework across the organisation, including how conduct risk is considered from the point of product inception to conclusion of a relationship with a customer. The terms of reference of the Committee have been extended to cover conduct risk specifically.

#### Risk profile

The Committee receives a detailed report on key risks and metrics at each meeting and receives an oral report from the Chief Risk Officer at each meeting on the key risks to the organisation. This enables the Committee to identify the key risk areas where more focus should be directed. The Committee reported to the Board following each meeting on its consideration of the risk profile of the Group and any longer term macro or perceived strategic threats to the Group and made recommendations as appropriate.

The Board Risk Committee has assumed responsibility on behalf of the Group Board for considering key areas of risk in a deeper level of granularity. In particular, during 2011 it has played an important governance role in the oversight and remediation of regulatory issues in the RBS Americas region. Brendan Nelson has personally provided oversight of the Executive Steering Group established with responsibility for remediation of known issues in the region and the Committee receives regular reports on progress.

In response to market events, the Committee has reviewed its controls for potential weaknesses from a rogue trading perspective. This review identified that most controls were effective and the Committee will oversee the remedial work that is underway to resolve all potential weaknesses identified.

## Report of the Board Risk Committee continued

The Committee has also considered the risks inherent within large strategic transactions such as the proposed transfers of a substantial part of the business activities of RBS N.V. to the Royal Bank.

The Committee reviewed the capital and liquidity position of the Group regularly during 2011 in light of external conditions and has reviewed the output of stress tests, including the Group results under the EU wide stress testing exercise of the European Banking Authority, the results of which were published in July 2011. It has considered and made recommendations to the Group Board in relation to the Individual Liquidity Adequacy Assessment and the Individual Capital Adequacy Assessment required by the FSA.

Regulatory risk has featured highly on the agenda of the Committee. The members have received reports on the status of ongoing regulatory investigations and have considered individual remuneration impacts (if any), as those investigations progress. Regulatory developments have been monitored and the regulatory risks associated with the sale of complex products to certain customers have been considered. Operational risks inherent in the Groups processes have also been considered and the Committee has specifically considered continuity and data control.

The difficulties being experienced in Europe and the US necessitated a continued focus on market and sovereign risk over the course of 2011. The Committee received additional reports in this regard and will continue to closely monitor and manage these risks in 2012.

### Risk appetite, framework and limits

The Committee has kept the Group Board apprised of the considerable progress made in relation to development of a risk appetite framework and methodology during 2011 and it has made recommendations to the Board in this regard. The Committee will ensure this framework is fully aligned with the conduct risk framework and is rolled out and embedded across divisions in 2012.

As set out in the Group Audit Committee report on page 223 a framework of Divisional Risk and Audit Committees are responsible for reviewing the business of each division and reporting to the Group Audit Committee and Board Risk Committee. The risk agenda of these committees continues to evolve alongside the Board Risk Committee agenda. In 2011, a quarterly risk assessment process was introduced to raise awareness and understanding of risk appetite at divisional level. While this assessment has had some success, risk reporting at a divisional level has been further refined and aligned with regulatory process. A new Material Risk Assessment process will be implemented within the divisions in 2012 and will be overseen by the Divisional Risk and Audit Committees. This will streamline reporting and standardise structure across the divisions. Progress will be closely monitored by the Board Risk Committee in 2012.

While some progress has been made, significant work is still required to fully develop an operational economic capital model for the Group. This will be an area of focus for the Committee over the coming year.

### Risk management operating model

Culture is key to driving the correct behaviours from a risk perspective. In recognition of this, the Committee received regular updates during 2011 on the One Risk programme, including the risk management vision and values. The Committee has reviewed the calibre of senior risk personnel and succession planning arrangements. It has also reviewed the adequacy of that resource alongside its review of the scope and nature of work undertaken by the risk management function.

During 2011, the risk governance model has been extensively reviewed and streamlined at executive level. The role of the Executive Risk Forum has been clarified. The Executive Risk Forum has responsibility for consideration of

strategic risk and policy issues in advance of the Board Risk Committee and aims to provide an effective filter of the key risks for the consideration of the Board Risk Committee.

#### Risk architecture

The Committee has sought continually to drive improvements to reporting standards and has implemented new guidance for the presentation of papers for the consideration of the Committee. It has held separate discussions to refine and enhance the quality of the key risk report and metrics and following those discussions a revised risk report will be operational in 2012. Work is ongoing to develop risk reporting at entity level (in addition to reporting at a Group and divisional level).

The Committee has monitored the standards of data quality across the Group and the programmes in place to improve management information and reporting. In particular, the Committee has tracked progress of the Finance and Risk Transformation Programme designed to develop a golden source of data for use in reporting across the Group.

#### Remuneration

The Board Risk Committee has continued to strengthen its relationship with the Group Remuneration Committee with the aim of ensuring that risk is adequately reflected in objectives and compensation arrangements and decisions. Significant improvements have been made in 2011 including clarification of responsibilities, improved planning and the identification of additional trigger points outwith pay cycles where risk should be taken into consideration. This improved interaction has led to a number of additional meetings of the Board Risk Committee specifically to consider the risk implications of remuneration decisions.

Performance evaluation

An internal review of the effectiveness of the Board Risk Committee during 2011 was conducted. Amongst the areas reviewed were the role of the Committee, composition, meetings and processes, performance and reporting, policy and procedures, divisional committees, induction and continuing professional development and communication. The Committee has considered and discussed the report on the outcomes of the evaluation and is satisfied with the way in which the evaluation has been conducted, the conclusions and the recommendations for action. The outcomes of the evaluation have been reported to the Board, and during 2012, the Committee will place focus on driving improvements to:

- the structure of the agendas to ensure the Committee is focused on consideration of the key issues - while recognising the remit of the Committee is extremely onerous;
- Divisional Risk and Audit Committees: implementing the changes to the risk assessment process and reporting;
  - enhance the bench strength of the Risk Management function; and
  - the Committee's interaction with the Executive Risk Forum.

Philip Scott  
Chairman of the Board Risk Committee  
22 February 2012



## Directors' remuneration report

Letter from Penny Hughes  
Chair of the Group Remuneration Committee

Dear Shareholder,

Remuneration in banks continues to be an important and sensitive topic and this is particularly true at RBS. And so it has been another eventful and challenging year for the Group Remuneration Committee.

It is worth reiterating that since 2008, there has been a complete change of the executive leadership team at RBS. Those who were responsible for the problems of the past have been replaced by a team charged with fixing them. On pay, we operate with a strong sense of restraint but it's important that our people believe that they'll be treated fairly and competitively. We consider that this is in the best interests of our shareholders and customers. We aim to set pay and incentives based on performance and market conditions, appropriate to the different markets in which our people operate, the objectives we set them and results we get from them, and a desire to minimise costs where consistent with our wider goals. We are a commercially run bank and that principle must apply to how we pay all of our employees. Overall, our pay is towards the lower end of market norms in aggregate.

My priority as Chair of the Group Remuneration Committee is to implement a remuneration policy that serves the long-term interests of our shareholders including, of course, the UK taxpayer. We recognise the duty of public accountability and therefore the need to be sensitive to the public's views on pay, particularly for senior people. It is a difficult balance that we are trying to achieve in reconciling the, at times, conflicting objectives of our various stakeholders.

### Financial Performance

A key factor in the Committee's deliberations is the financial performance of the Group. RBS is a unique recovery challenge and success must be measured by the progress we are making towards being a safer, stronger and more sustainable bank. Effectively we are asking our management team to do two jobs; to successfully compete with strong banking competitors across our ongoing businesses AND to recover RBS from its legacy risk profile, itself the largest corporate restructuring on record. In 2011 the Group put even greater priority on actions to strengthen its balance sheet and reduce risks in the face of difficult economic and financial market conditions, as it continued to work through the restructuring plan embarked upon in 2009. Key financial achievements for 2011 were:

- Core Bank Operating Profit of £6.0 billion represents a strong performance and compares well with other similar sized banks;
- Core Bank's Return on Equity (ROE) was 10.4%, with Retail & Commercial ROE at 10.7%, or 14.8% excluding Ulster Bank. Our investment bank's ROE was 6.1%, notwithstanding the challenging market conditions;
  - The Group funded balance sheet decreased by £49 billion to £977 billion;
- The Core Tier 1 ratio of 10.6% and tangible net asset value per share of 501p were broadly stable over the year, in spite of de-risking costs and regulatory impacts;
- Group operating profit was £1.8 billion, up 11% after adjusting for the disposal of Global Merchant Services at the end of 2010;
  - Group expenses were 7% lower in 2011 than in 2010 at £15.5 billion; with staff costs down 9%;

- Impairment losses totalled £7.4 billion, which is down 20% from 2010; and
- Targets for reducing Non-Core assets have been exceeded, reducing by £44 billion to £94 billion in 2011.

As well as the financial achievements above, the Committee takes into account the Group's performance against a range of broader strategic objectives, including support to personal and business customers in the communities in which it operates. In 2011 gross new lending to business increased by 22%, with lending to SMEs up 4%, exceeding the Group's Merlin targets. The Committee also considers the scale of the businesses our leadership team are managing. For example, during 2011, our 2,000 UK retail branches served 18 million customers; our corporate banking division accounted for almost half of all new lending to UK SMEs; and our investment bank operated in 38 countries and arranged €12 billion of loans and €10 billion of bonds for UK corporates.

Whilst there is still much to do to deliver an overall profitable business as we pay for the costs of repair, we are already much better positioned as a safer, stronger bank.

#### Executive directors

Events at the start of 2012 put the difficulty of balancing our stakeholders' interests firmly into the public spotlight. The bonus for Stephen Hester in relation to the 2011 performance year attracted considerable attention from the media and politicians and I wanted to explain the reasons behind that decision.

We have been very clear over recent years that pay for performance, not failure, is at the heart of our remuneration policy. Under the leadership of the current executive directors, RBS has made significant progress in exceptionally difficult circumstances. In recognition of this, the Board believed, and still believe, that the award to its Group Chief Executive was justified in the context of the market and appropriate based on achievement against the performance objectives that had been set (see page 240 for further details). The Board's decision was well-balanced and took into account all the circumstances, including the fall in share price over 2011, which was mirrored in most other banks. The award was offered on terms that are arguably amongst the most reformed in our industry and endorsed at the 2011 AGM by over 99% of our shareholders. The award would have been delivered entirely in shares, been deferred and subject to clawback.

## Directors' remuneration report

Stephen Hester subsequently decided to waive his bonus because the attention it received had become a damaging distraction for him and the Group. Since this announcement, many of our major shareholders have expressed overwhelming support for all members of our leadership team and are supportive of the Group Remuneration Committee's efforts to ensure that these individuals are fairly rewarded as they continue to lead the turnaround of the Group. There is significant concern that the alternative - attempting to operate on a less-than-commercial basis - would be value destructive if RBS becomes an unattractive place to work.

I am convinced that the remuneration approach that we have developed will serve all our stakeholders well in the long term.

### Group-wide remuneration arrangements

It is not only the executive directors' interests that the Committee considers. It is also tasked with recognising the work of all our employees, whilst maintaining a balance and showing restraint. Examples of where we have shown such restraint are as follows:

- More than 10,000 of the Group's most senior employees will not receive a pay increase for 2012;
  - Average salary increases for 2012 will be less than 1%;
- 85% of employees eligible for a bonus will receive less than £10,000. The majority of employees eligible for a bonus will receive less than £2,000;
  - The investment bank bonus pool is down by 58% over the last year. This follows a 33% reduction between 2009 and 2010; and
- There has been a 43% reduction at Group level in variable compensation. Details of our variable compensation can be found in Note 3 on the consolidated accounts on page 291.

The Committee recognises the importance of driving cultural change, not just through pay, but in the wider sense. As Group Remuneration Committee Chair, I am actively involved in the Group's initiatives relating to diversity, graduate recruitment and management development. I'm impressed by the quality and depth of these initiatives around the Group, many of which have received award-winning recognition.

Another area of focus for the Group Remuneration Committee in 2011 has been how value is shared between investors and employees. Shareholders have rightly questioned whether banks, and in particular investment banks, have got this right in the past. We are working hard to get this right now and in the future. A balance is always required between minimising compensation costs, and so maximising profits in the year, and protecting the business from which future profits can flow.

We have sought to strike this balance fairly, while erring on the side of restraint, reflecting the nature of our ownership. In this context, I am pleased to report that the returns achieved in our investment bank, while below our targets, compare favourably to our competitors. Yet our compensation ratios are among the lowest and this has been the position for the last three years.

We do consider that pay at all investment banks became overheated during the exuberant period of growth pre-financial crisis. It is clear that the industry as a whole delivered results in 2011 below the cost of capital. This is an unsustainable position with further significant costs of regulation to come. We are committed to taking necessary action on pay alongside the other strategic business decisions we make around the reduced size and scope of our

activities in order to build a sustainable business, capable of serving customers and delivering fair and adequate returns for shareholders and employees.

Our restrained approach to pay is not without risk. Employees at all levels of RBS have choices about where they work. If we allow a sizeable gap to open up between how we pay and how others pay, then it will affect our ability to attract and retain good, well-motivated people to work here. We do not believe that this would be in the interests of our shareholders, our customers, or the taxpayer.

We believe we are getting the balance right in difficult circumstances. Under the leadership of Stephen Hester and his team, RBS is a challenging but inspiring place to work. Employee engagement continues to improve, which demonstrates the pride our people have in helping to fix and recover from one of the biggest failures in corporate history. Whilst the road to recovery is proving more challenging than probably any of us envisaged, our people are working hard to help return the Group to financial strength and the Group Remuneration Committee remains committed to helping create an environment in which they can meet their ambitions.

The remuneration process undertaken by the Group Remuneration Committee is thorough and robust. This year's report contains more detail on the decision process to demonstrate to you how engaged and committed the Committee is to making the best decisions for the benefit of shareholders, employees and wider stakeholders.

Finally, let me thank my fellow Committee members for their extensive contributions and all those who supported the Committee to help us weigh up all the relevant factors and seek the right balance in our decision-making.

Penny Hughes  
Chair of the Group Remuneration Committee  
22 February 2012

Directors' remuneration report continued

Report of the Group Remuneration Committee

The role and responsibilities of the Group Remuneration Committee

The Group Remuneration Committee is responsible for setting the Group's policy on remuneration and overseeing its implementation. It considers and makes recommendations to the Group Board in respect of the remuneration arrangements of the executive directors of the Group. No director is included in decisions regarding his or her own remuneration.

The Group Remuneration Committee is also responsible for approving remuneration and severance arrangements for members of the Group's Executive and Management Committees, as well as overseeing arrangements for employees who are 'In-Scope' under the Asset Protection Scheme (APS) or 'Code Staff' under the FSA Remuneration Code. Details of the FSA Remuneration Code can be found at [www.fsa.gov.uk](http://www.fsa.gov.uk) and a definition of Code Staff is provided on page 237.

The terms of reference of the Group Remuneration Committee are available on the Group's website [www.rbs.com](http://www.rbs.com) and these are reviewed annually by the Committee and approved by the Group Board.

Membership of the Group Remuneration Committee

All members of the Committee are independent non-executive directors. The Committee held nine meetings in 2011. The Chair and members of the Committee, together with their attendance at meetings, are shown below:

	Attended / Scheduled
Penny Hughes (chair)	9/9
Sandy Crombie	9/9
Alison Davis (1)	4/4
John McFarlane (2)	9/9

Notes:

- (1) Became a member of the Committee on 1 August 2011.
- (2) Will step down as a member of the Committee on 31 March 2012.

Enhanced governance

The Group Remuneration Committee has taken a number of steps during 2011 to enhance its governance arrangements:

- Alison Davis was appointed as an additional member to bring further financial experience and fresh expertise;
- private sessions are held at each Committee meeting with only the Group Chairman and non-executive directors present;
  - a strategy session is carried out to ensure agendas focus on key issues in relation to remuneration;
- reporting between the Committee and the Group Board has been improved so that all directors are fully informed and able to discuss the approach being taken; and
- greater focus was placed on international regulatory compliance as requirements emerge across the territories in which we operate.

Principal activity of the Group Remuneration Committee during 2011

First quarter

- new arrangements for the executive directors. Following extensive shareholder consultation and consideration by the Committee, Share Bank arrangements and new long term incentive plans (LTIP) performance measures were introduced;
- remuneration arrangements and year-end performance reports for members of the Executive Committee, Management Committee and annual performance objectives for 2011 and also LTIP performance objectives;
  - remuneration arrangements and year-end performance reports for APS In-Scope employees and Code Staff;
- new process for divisional bonus pools implemented with advice from the Board Risk Committee on risk performance;
  - progress against unvested LTIP performance measures;
  - approval of the Group and divisional bonus pools; and
    - approval of Directors' remuneration report.

Second quarter

- key business and strategic priorities; presentations from Non-Core, RBS Insurance (subsequently renamed Direct Line Group) and the former GBM division;
  - project to enhance risk input into remuneration; and
- formal remuneration strategy session - compensation structure and priorities for the forthcoming year were agreed.

## Directors' remuneration report continued

### Third quarter

- half year performance reviews for executive directors, members of the Executive Committee and Management Committee; and
- outcome of Group Internal Audit review on how the FSA Remuneration Code has been implemented which showed management is aware of the key risks and are pro-active in identifying issues relating to remuneration.

### Fourth quarter

- review of risk-adjusted performance across the Group and divisions;
- preliminary bonus pools discussions for Group and divisions;
- enhanced process for review of risk trigger events for clawback and bonus reduction;
- content for shareholder consultations undertaken in December 2011 and January 2012; and
- report from the project to enhance risk input into remuneration with recommendations for actions.

In addition, the Committee received regular knowledge updates on global remuneration regulatory developments; pay consultations issued by the FSA, Department for Business, Innovation & Skills, HM Treasury and the High Pay Commission; guidelines from shareholders and investor bodies; and market trends reports.

### Advisers to the Group Remuneration Committee

The advisers to the Group Remuneration Committee are appointed independently by the Committee, which reviews its selection of advisers annually. The advisers are instructed by and report directly to the Committee. The Committee Chair oversees the fees for the advisers.

PricewaterhouseCoopers LLP (PwC) were appointed as the Committee's remuneration advisers on 14 September 2010, and their appointment was reconfirmed by the Committee in June 2011 after an annual review of the quality of the advice received and fees charged. PwC are signatories to the voluntary code of conduct in relation to remuneration consulting in the UK.

PwC also provide professional services in the ordinary course of business including assurance, advisory, tax and legal advice to subsidiaries of the Group. The Committee Chair is notified of other work that is being undertaken by PwC and is satisfied that there are processes in place to ensure that the advice the Committee receives is independent.

As well as receiving advice from PwC during 2011, the Committee took account at meetings of the views of the Group Chairman, Group Chief Executive, Group Finance Director, Group Human Resources Director, Group Head of Reward, Group Secretary and the Chief Risk Officer.

### Performance evaluation process

An internal review of the effectiveness of the Group Remuneration Committee was conducted by the Group Secretary during 2011. The evaluation was based on detailed questionnaires and individual meetings with each member and attendee. Amongst the areas reviewed were the role of the Committee, composition, meetings and processes, continuing professional development and communication. Generally, the Committee was considered to be effective and meeting its objectives, with members willing to spend the time necessary to discharge their responsibilities. The evaluation respondents agreed that the Committee was the right size, with an appropriate composition and was headed by a committed Chair. The respondents were also impressed by the level of work undertaken outside of the meetings,

particularly by the Chair.

A number of actions arose from the evaluation relating to the further improvement of the meeting arrangements, including:

- improved performance from the Committee's internal and external resources;
- further improvement on length and clarity of materials provided to the Committee; and
- monitoring of the new processes for risk input into remuneration and processes for reporting and escalation of trigger events which may lead to clawback or bonus reduction.

The Committee has considered and discussed the report on the outcomes of the evaluation and is satisfied with the way in which the evaluation was conducted, the conclusions and the recommendations for actions. The outcomes of the evaluation have been reported to the Group Board and the actions are being progressed.



Directors' remuneration report continued

Key inputs to the Group Remuneration Committee to assist its decision-making

The Group Remuneration Committee receives regular updates on regulatory developments and general remuneration issues, as well as market and benchmarking data to support its decisions. It also received information from a number of external and internal sources during 2011. The diagram below illustrates this:

## Directors' remuneration report continued

### Shareholder consultation and its impact on remuneration policy

In late 2011 and early 2012, an extensive consultation was undertaken with institutional shareholders and other stakeholders on the Group's remuneration approach. Investors recognised the difficult challenge faced by the Group Remuneration Committee in balancing the need to pay competitively to support business goals but at the same time being mindful of the wider economic environment and the need to show restraint.

The shareholders gave a clear message that increases to base pay and pension contributions for executive directors were not appropriate. However, the overall shape of executive remuneration structure received widespread support. Shareholders recognised the need for retention of the current executive team and the potentially destructive effect that any break up would have on rebuilding the Group.

This consultation included UKFI and as with other shareholders, the Committee received their input. However, in line with the Group's mandate to operate commercially, the Committee did not receive formal direction from UK Government.

The consultation process involved one-to-one meetings, a roundtable session hosted by the Association of British Insurers and National Association of Pension Funds and a number of follow-up letters and meetings.

Topics discussed with investors included both Group-wide and executive directors' pay positioning, scale and design of incentive structures, risk alignment of remuneration, deferral, clawback and remuneration disclosures.

The importance of value sharing between investors and employees, retaining capital, and taking this into account in remuneration decisions were key themes from the shareholder consultation. As mentioned in the letter from the Committee Chair, value sharing between investors and employees and retention of capital have been key areas for the Remuneration Committee during 2011. In 2011 variable compensation was 11% of Core Bank operating profit, down from 16% in 2010. This proportion compares favourably with other banks.

There was also concern over falling share prices across the industry. Some shareholders proposed that LTIP award levels to employees should be scaled back given the fall in the share price over 2011. The Committee recognises the impact that the fall in share price has had both on shareholders and employees. The share awards that were made to employees at the beginning of 2011, under bonus deferral or the long term incentive plan, have fallen in value. This is clear alignment with the value reduction that shareholders have experienced. It is also true in the case of prior year unvested and vested but retained awards.

The Committee has considered the LTIP award policy for 2012 in light of the Group's current share price and has reduced potential awards to executive directors by capping them at 300% of salary.

The population receiving LTIP awards has also been reviewed, and for 2012, there will be a significant reduction as LTIP awards are targeted at the Group's most senior management. All LTIP awards are subject to both group-wide and division/function specific performance conditions to ensure that the leadership team is focused on both value creation and other key objectives. Group performance targets will be aligned to the executive director LTIP performance targets to ensure a consistent view of performance.

The Group Remuneration Committee and the Group Board have considered carefully their responsibilities and have applied judgement to achieve a balance whereby remuneration policy supports business goals without causing unacceptably high people risks.

The support received by shareholders during the consultation period has been greatly encouraging. Shareholders have played a key role in developing remuneration practices that support the long term goals of the business.

#### Risk and regulatory environment

##### FSA Remuneration Code compliance

The Group has been fully compliant throughout 2011, in practice and in spirit, with all aspects of the FSA Remuneration Code.

##### How risk is reflected in our remuneration process

Focus on risk is achieved through clear risk input into incentive plan design and target setting, as well as thorough risk review of performance, bonus pools and clawback. The Group Remuneration Committee is supported in this by the Board Risk Committee and the Group's risk management function.

During 2011, a project was undertaken, co-sponsored by the Chairs of the Group Remuneration Committee and Board Risk Committee, to identify and implement further areas of improvement in risk/remuneration alignment. The project focussed on three workstreams:

- robust governance (clarify and enhance respective roles of the Group Remuneration Committee and Board Risk Committee and the interaction between them);
- pay-for-performance (risk input into objectives and performance reviews and enhanced clawback process); and
  - control function input and risk adjusted performance measures.

##### How do we apply this in practice?

The assessment undertaken by the risk function and Board Risk Committee confirmed that, for some divisions, a number of risk-related events needed to be taken account of when determining bonus pools, including regulatory, compliance and credit and market risk issues.

## Directors' remuneration report continued

The enhanced process for individual accountability review assessments (which consider material risk management, control and general policy breach failures, accountability for those events and appropriate action against individuals) is operated across divisions and functions. RBS Risk Management has concluded that the accountability review assessments approach is robust and complete from a perspective of all known material events having been considered.

The outcomes from recent accountability reviews for the performance year 2011 have included:

- adjustment of current year bonus awards;
  - dismissal;
- clawback of previously awarded deferred and LTIP awards; and
- suspended vesting pending further investigation.

### External developments

In September 2011, the Department for Business Innovation and Skills (BIS) issued a consultation on plans for investors to have greater clarity on how companies are run and how executive pay is matched to performance. The Group Remuneration Committee played an active role in this consultation process, providing responses and meeting with representatives from BIS on a number of occasions to discuss possible outcomes. This demonstrates a real willingness to engage not just with shareholders but with wider stakeholders in developing a responsible approach to future remuneration practices.

HM Treasury published a consultation on 6 December 2011 with draft regulations on remuneration disclosure. This proposes that all large banks operating in the UK, publish the pay details of their eight highest paid senior executive officers who are not main board directors. The consultation follows the Project Merlin agreement in February 2011 that applied to the five major UK banks including RBS. Details are set out on page 252.

### Pay for performance

The Group Remuneration Committee's formal process for determining bonus pools is outlined in the diagram below. This process is designed to ensure that financial, risk and non-financial performance measures are all taken in to account in an integrated and structured way with appropriate reference being made to the business plan and capital adequacy.

There is strong central governance and oversight of both bonus pools and individual awards. Across the Group, bonus awards for the 2011 performance year are significantly lower than those made last year. This is due to a combination of factors including financial performance, particularly in the investment bank division, but also recognising the need for moderation and the external climate. This year we have recorded substantial losses for two issues: PPI and Greek sovereign debt. Whilst current management inherited these issues, the Committee's judgement is that reductions to shareholder value of this scale must be reflected in lower variable compensation across the Group and overall bonus pools have been reduced as a result.

The process for determining bonus pools is discretionary, to avoid the unintended consequences and incentives of formulaic systems. However, the Group Remuneration Committee's discretion is applied within a structured framework which starts with an assessment of financial performance measured against budget, prior year and long-term strategic plans. This analysis is used to adjust market median bonus funding levels (obtained from rigorous benchmarking against market compensation data) to a performance-adjusted basis.

Risk is taken into account in the performance assessment through a thorough risk analysis carried out by RBS Risk Management to a pre-agreed framework approved by the Group Remuneration and Board Risk Committees. Performance assessments may be adjusted in situations where risk performance is outside risk appetite or strategic plans. Non-financial factors such as turnover, succession issues, customer issues, market environment and franchise development are then taken into account in developing a final bonus proposal. Bonus proposals are reviewed in the context of key compensation framework ratios including: compensation to revenues, compensation to pre-compensation profit and bonus to pre-bonus profit. These ratios help to ensure appropriate sharing of value between employees and shareholders. Finally bonus proposals are reviewed against our capital adequacy framework to ensure that regulatory requirements are met.

Directors' remuneration report continued

Remuneration policy

The remuneration policy supports the Group's business strategy and is designed to:

- attract, retain, motivate and reward high calibre employees to deliver long term business performance within acceptable risk parameters;
- provide clear alignment between annual and long-term targets for individuals and Group/divisional strategic plans; and
- ensure that the Group's metrics, reward structures and governance processes as a whole provide coverage of the key risks in an appropriate way.

In the Non-Core division and businesses we are exiting, appropriate arrangements are put in place to ensure that employees are motivated to reduce risk effectively, to minimise losses taken on value of businesses/ assets at the point of divestment.

The remuneration policy applies the same principles to all employees including Code Staff (1). The current key principles underpinning the Group-wide remuneration policy are set out below:

Base salary	Base salaries are reviewed annually. Base salaries should be competitive in the specific market for the business in which the individual works; reflect the talents, skills and competencies that the individual brings to the Group; and be sufficient so that inappropriate risk-taking is not encouraged.
Annual incentives	<p>The annual incentive pool is based on a balanced scorecard of measures including financial performance, risk, people and customer measures. Capital adequacy and the impact of incentive awards on the balance sheet are also taken into account.</p> <p>Allocation from the pool depends on divisional, functional and individual performance. Individual performance assessment is supported by a structured performance management framework.</p> <p>Guaranteed bonuses are only used in limited circumstances in accordance with the FSA Remuneration Code.</p> <p>Immediate cash bonuses are limited to a maximum of £2,000.</p> <p>Deferred awards support a performance culture where employees recognise the importance of sustainable Group, business and individual performance. Under the Group-wide deferral arrangements a significant proportion of annual incentive awards for our more senior employees are deferred over a three year period. Deferred awards are subject to clawback.</p> <p>In certain circumstances, formulaic short-term incentive arrangements are used to align the objectives of employees with the strategy of the relevant division in which they work. For such schemes, specific design principles are in place, with strict governance procedures that ensures that all existing and future incentive schemes support our business strategy and risk appetite.</p>

	All incentive awards are subject to appropriate governance, including independent review by the Risk Management, Finance and HR functions, with oversight from the Group Performance and Reward Committee, which has delegated authority from the Group Remuneration Committee over incentive schemes operating over a period of 12 months or less.
LTIP	To encourage the creation of value over the long term and to further align the rewards of the participants with the returns to shareholders, the Group provides certain employees in senior roles with long-term incentive awards. Awards are structured as performance-vesting shares. Vesting will be based partly on divisional or functional performance and partly on performance across the Group. All awards are subject to clawback.
Other share plans	Employees in certain countries are eligible to participate in share plans which are not subject to performance conditions.
Benefits (including pension)	In most jurisdictions, employee benefits or a cash equivalent are provided from a flexible benefits account.

(1) The following groups of employees have been identified as meeting the FSA's criteria for Code Staff:

- Members of the Group Board and Group Executive and Management Committees;
  - Staff performing a Significant Influence Function within RBS Group;
- Employees who have approval authorities such that their decision-making could have a material impact on the RBS Group income statement;
- Employees who are responsible for a business or businesses whose performance could have a material impact on the RBS Group income statement; and
  - Key control function roles.

## Directors' remuneration report continued

## Executive directors

In determining directors' remuneration, the Group Remuneration Committee takes into account pay and employment conditions of employees of the company. It does so by reference to annual market data against an assessment of the competitiveness of the current base salary ranges or benchmarks and actual salaries in payment. Any salary increases awarded to executive directors are also considered in the context of salary increases for the wider employee population. A summary of executive directors' remuneration for 2011 and 2012 is set out below:

	Policy	2011 arrangements	2012 arrangements
Base salary	Base salaries are reviewed annually.	Stephen Hester: £1,200,000 Bruce Van Saun: £750,000 (from 1 April 2011)	No increase to executive directors' base salary.
Annual Incentive	Executive directors have a normal maximum incentive opportunity of 200% of salary (with an exceptional maximum of 250% of salary).	<p>For the 2011 performance year, the annual incentive was delivered as an allocation to Share Bank.</p> <p>Stephen Hester: Provisional maximum allocation of 6.0 million shares to Share Bank. Final allocation based on performance: 3.6 million shares (0.6 million and 0.36 million shares respectively as adjusted for the share sub-division and consolidation of ordinary shares that was approved by shareholders at the annual general meeting on 30 May 2012 and subsequently took effect on 6 June 2012) ('Sub-division and Consolidation'). Stephen Hester has waived this award.</p> <p>Bruce Van Saun: Provisional maximum allocation of 3.75 million shares to Share Bank. Final allocation based on performance: 3.0 million shares (0.375 million and 0.3 million shares respectively as adjusted for the Sub-division and Consolidation.</p> <p>The shares will vest in two equal tranches on the first and second anniversaries of the date of grant. Prior to vesting, shares will be subject to clawback and shares must be held for a further six months post vesting.</p>	<p>Both Stephen Hester and Bruce Van Saun will have a maximum incentive opportunity of 200% of salary (with an exceptional maximum of 250% of salary).</p> <p>Incentives will be awarded entirely in shares which will vest in two equal tranches on the first and second anniversaries of the date of grant. Prior to vesting, shares will be subject to clawback and shares must be held for a further six months post vesting.</p>
LTIP	Awards to executive directors have a normal maximum limit of 400% of salary.	Both Stephen Hester and Bruce Van Saun received share awards capped at 375% of basic salary.	Stephen Hester and Bruce Van Saun will be granted long term share awards which will ultimately vest in a range between zero and a



<p>All awards are subject to performance conditions, deferral and clawback.</p>	<p>The awards will vest in 2014 in an amount based on the achievement of performance conditions (see description on page 242). These will each have the ability to deliver a number of shares worth up to 100% of salary; however, the number of shares that vest will be subject to an overall cap in value of 375% of salary (based on salary and share price at the time the award was made).</p>	<p>cap of 300% of basic salary depending on performance over the next three years. These share awards have a notional value at grant assessed at £1.62 million and £1.01 million respectively.</p>	
	<p>An additional six month holding period after vesting will apply.</p>	<p>The awards will vest in 2015 in an amount based on the achievement of performance conditions (see description on page 245). These will each have the ability to deliver a number of shares worth up to 100% of salary; however, the number of shares that vest will be subject to an overall cap in value of 300% of salary (based on salary and share price at the time the award was made). The notional value of these awards would be 45% of face value, which is 135% of salary.</p>	
<p>Benefits (including Pension)</p>	<p>Benefits are available from a flexible account on a similar basis to other employees.</p>	<p>Benefits provided in line with Group policy. 35% (of base salary) pension allowance.</p>	<p>An additional six month holding period after vesting will apply. Benefits provided in line with Group policy. 35% (of base salary) pension allowance.</p>
	<p>None of the current executive directors are members of the Group's defined benefit pension plans. Current executive directors receive an allowance in lieu of pension contributions.</p>		



## Directors' remuneration report continued

### Shareholding guidelines

The Group operates shareholding guidelines for executive directors. The target shareholding level for the Group Chief Executive is 200% of gross annual salary and 100% of gross annual salary for executive directors. A period of five years is allowed in which to build up shareholdings to meet the guideline levels.

### The mix of executive directors' remuneration

The charts below show the composition of remuneration opportunity for on-target annual performance, with the long term incentive awards shown at the expected value. Short term incentive payments earned in relation to 2012 performance will be deferred and will vest, subject to satisfactory performance. The actual value of the long term incentive awards will depend on performance over the period 2012 to 2014 and the share price at the time the awards vest.

### Group Chief Executive - Stephen Hester

#### 2009-2011 average compensation outcome for Group Chief Executive

The preceding charts are based on target/expected values of total compensation. Press commentary tends to focus either on these values, or on maximum values assuming all performance conditions are met. However, in practice over the period 2009 to 2011, the value received will be significantly less than the maximum or even target value incentives, in light of bonus waivers, performance conditions and share price fall over the period. The chart below shows the likely average pay-out to the Group Chief Executive from salary, pension and incentives from awards made over the 2009-2011 period. The average maximum award is shown on the left, but is then adjusted allowing for the impact of LTIP performance conditions, bonus conditions and voluntary waivers and finally the impact of the share price fall on the remaining value of awards.

The data shows that Stephen Hester is likely to receive just 10% of the maximum value of his incentives awarded over the last three years, and around 29% of his maximum total compensation. This is despite the majority of financial and non-financial targets for RBS having been met when measured over the three year period since 2009. In comparison, levels of pay-out at RBS are expected to be at least one-third lower than recent levels of pay-out in the FTSE-30 and less than half recent pay-outs in the international banking sector.

## Directors' remuneration report continued

## Assessing past performance

## Executive directors' annual incentive 2011

Executive directors have a normal maximum incentive opportunity of 200% of salary (with an exceptional maximum of 250% of salary). Share Bank arrangements were put in place for the 2010 and 2011 performance years. The maximum potential allocation into Share Bank for the 2011 performance year was 6.0 million shares for the Group Chief Executive and 3.75 million shares for the Group Finance Director (0.6 million and 0.375 million shares respectively as adjusted for the Sub-division and Consolidation). This was based on the normal maximum annual incentive levels for executive directors at a share price of 40p per share (£4.00 per share as adjusted for the Sub-division and Consolidation) (calculated as an average share price over December 2010).

The Group Remuneration Committee has reviewed executive directors' performance against targets set at the beginning of the year as summarised in the table below. Accordingly, the Committee recommended, and the Group Board (excluding executive directors) approved, that the Group Chief Executive should receive an award of 60% and the Group Finance Director an award of 80% of their maximum allocation for the 2011 performance year, which equates to 3.6 million and 3.0 million shares respectively into Share Bank in 2012 (0.36 million and 0.3 millions shares respectively as adjusted for the Sub-division and Consolidation). The Group Chief Executive has waived his allocation. The shares vest in two equal tranches on the first and second anniversaries of the date of grant and are subject to a holding period of six months after vesting. Clawback provisions will apply prior to the vesting of shares.

## Stephen Hester

Stephen Hester's performance is measured against a number of strategic and business objectives. In the course of 2011 the Group's priority has been to strengthen its balance sheet and reduce risk as it works through the restructuring plan, and this is reflected in good progress on the key risk measures set out in 2009. Targets for capital, short-term wholesale funding, liquidity reserves and leverage have all been met ahead of schedule, while the Group loan:deposit ratio improved further.

Core objectives	Targets for 2011	Progress in 2011
Strategic progress	Delivery of the five year strategic plan.	The Group recovery strategy set out in 2009 has proven its effectiveness and in 2011, most tasks are on or ahead of Plan. This includes operation of Core/Non-Core structure, rebuilding management and operations and reducing risk. Key Group strategic plan risk measures set in 2009 were all significantly exceeded in 2011. However, the deterioration in external economic and financial conditions impacted profits and further led the Group to prioritise de-risking over driving returns, which affect profitability measures. An extra £1 billion was spent over 2011 in order to accelerate the achievement of RWAs reduction, liquidity and deposit-gathering goals. It was also necessary to make alterations to the strategic plan for the investment banking business in the light of new regulation and market developments.
Business delivery and financial performance	ROE, profitability, costs, core tier 1 ratio, funding and risk profile, lending commitments, EU mandated disposals.	Retail & Commercial's ROE improved to 10.7%, or 14.8% excluding Ulster Bank. Markets ROE was 6.1% above median compared to peers, leaving Core overall ROE at 10.4%. Core cost:income ratio was 60%, with Core Tier 1 ratio at 10.6%. The liquidity portfolio was held above target levels at £155 billion, while short-term funding was cut to £102 billion. Gross new lending to business increased by 22%, with lending to SMEs up 4%, exceeding

		the Group's Merlin targets. The branch sale to Santander made good progress as did the turnaround of RBS Insurance (subsequently renamed Direct Line Group); facilitating its planned divestment.
Risk and control	Funding, leverage ratio, risk measures and Asset protection Scheme (APS) compliance requirements.	All risk reduction and control measures were exceeded. This includes Group loan:deposit ratio (LDR) improved to 108%, with Core loan:deposit ratio ahead of target at 94%. Leverage was stable at 16.9x. Performance against agreed APS objectives was satisfactory and significantly improved compared with prior year.
Stakeholder management	Relationships with shareholders and other external stakeholders. Customer satisfaction and Treating Customers Fairly (TCF) measures.	Positive feedback from key shareholders and regulators. Increased engagement with external stakeholders in particular on sustainable lending policies. Good progress to address risks identified by UK/US regulators relating to TCF.
People management	Group's people strategy including performance, succession and people management. Improvements in employee engagement.	Stephen Hester is widely acknowledged internally and externally as having provided strong leadership to the Group in extraordinary circumstances. Talent and bench reviews completed in all businesses and actions plans agreed. Female executive representation increased to 18%. The Group's 'Your Feedback 2011' staff survey results showed a continued upward trend in the vast majority of categories.

## Directors' remuneration report continued

## Bruce Van Saun

Bruce Van Saun's performance is measured against a number of Group and divisional targets. Bruce continues to perform at the level of a world class Chief Financial Officer (CFO), providing strong individual and broader finance contribution to the Group's priority to strengthen the balance sheet and reduce risk. Group Treasury has facilitated a significant reduction on the Group's reliance on short-term funding and Bruce Van Saun has displayed strong leadership on a number of key strategic projects including negotiation of the EU mandated sale of retail branches, the response to the Independent Commission on Banking (ICB) and the preparations for the divestment of RBS Insurance.

Core objectives	Targets for 2011	Progress in 2011
Strategic progress	Monitoring/improvement of Group and Divisional Strategic Plans. Work with Group Chief Executive on Group Strategy/M&A and APS compliance requirements.	<p>Increased effectiveness of strategic planning process resulting in successful Board offsite and strong contribution to GBM strategy revisions and the APA analyses.</p> <p>Strong leadership displayed on key strategic projects including; branch disposal, ICB response, RBS Insurance (subsequently renamed Direct Line Group) divestment. 13 M&amp;A transactions delivered, with 70% managed by an in house team led by the CFO.</p> <p>Significant progress made on the Group's cost-reduction programme, with further progress targeted for 2012.</p> <p>Performance against agreed APS objectives was satisfactory and significantly improved compared with prior year.</p>
Business delivery and financial performance	Statutory/regulatory/management reporting. Strategic planning, budgeting and forecasting. Capital and funding planning.	Achievement of 'best in class' for external reporting within the UK market. Key contribution to de-risking strategy with significantly reduced reliance on short term funding and raised £20 billion for 2011 term funding in challenging conditions. Good interest rate positioning achieved. New central bank and lending target reporting requirements implemented. Improved capital planning capabilities, with detailed capital plans developed at Group and UK solo entity level.
Risk and control	Regulatory change impacting capital, funding, liquidity, improve quality of risk and financial data.	Strong stewardship over the financial risk and control environment, viewed as a strong risk partner by risk function. Effective management against FSA liquidity metrics. Balance sheet substantiation programme completed. Mobilisation of the FiRST programme, to enhance risk and finance data quality.
Stakeholder management	External relationships, including investors, rating agencies and regulators.	Strong external feedback received on Investor Relations programme.

		<p>Strong engagement with policy makers on the regulatory agenda; stronger relationship achieved with FSA. Major role in working with the FSA through capital and liquidity assessments, as well as the ICB response and RBS N.V. consolidation.</p>
People management	<p>Lead upgraded team and build positive culture.</p>	<p>Key strategic hires made for Group Internal Audit and Group Strategy positions, which are a key part of upgrade agenda. External hiring complemented by robust programmes for internal talent implemented across all levels. Number of key executive positions filled internally in 2011. Strong focus on programmes in mentoring, diversity and training &amp; development.</p>

## Directors' remuneration report continued

## Executive directors long-term incentive plan (LTIP) awards

The following tables provide a current assessment of executive directors' performance against LTIP awards granted in previous years. The Group Remuneration Committee does not believe that these outcomes are reflective of the executive directors' performance over the period 2009 to 2011. As highlighted in the opening letter to this remuneration report, very significant progress has been made across the Group's strategic plan targets since 2009, resulting in a significantly safer, more resilient and sustainable bank. However, this is not being reflected in the LTIP outcomes. In 2009 and 2010, LTIPs were linked entirely to share price and economic profit targets. In line with the whole sector, and exacerbated by its legacy portfolio, RBS's performance against these metrics has been heavily impacted by the economic and regulatory environment.

## 2011

The table below summarises the assessment of the first year of a three year performance period. Each measure has the ability to deliver a number of shares worth up to 100% of salary; however, the number of shares that vest will be subject to an overall cap in value of 375% of salary. Awards are due to vest in 2014. An assessment of performance of each relevant element is provided by the control functions and an external firm assesses relative Total Shareholder Return (TSR) performance. The Group Remuneration Committee determines overall vesting based on these assessments including consideration of the drivers of performance and the context against which it was delivered. The assessment is analytical and if any discretion is used, it would be explained. This award is due to be assessed in March 2014 to determine the level of vesting. The table below represents an early indication only.

Performance measure	Weighting	Rationale	Vesting	Current assessment of performance
Core Bank Economic Profit	25%	Ensures that performance reflects risk adjusted enduring earnings for the Bank.	Threshold: 25% vesting for average return on tangible equity over the performance period at a reasonable margin above the cost of capital. Maximum: 100% vesting for performance ahead of the Group's Strategic Plan.	Continued difficult economic conditions in a number of our key markets mean that based on performance to date, the threshold targets have not yet been met.
Relative TSR	25%	Ensure alignment with shareholders.	Threshold: 20% vesting if the Group's TSR is at the median of the companies in the comparator group. Maximum: 100% vesting if the Group's TSR is at the upper quartile of the companies in the comparator group. Pro-rata vesting in between these points.	Based on share price performance to date, the threshold targets have not yet been met.
Balance Sheet & Risk	25%	Ensure alignment with the advancement of the strategic position and	Vesting will be qualified by Group Remuneration Committee discretion. Indicative vesting levels are: · Over half of objectives not met: 0%;	Most targets have been met or exceeded. Strong performance on capital, leverage and funding measures, risk appetite embedded.
Strategic Scorecard	25%			



capability of the organisation and the building of a sustainable business.	<ul style="list-style-type: none"><li>· Half of objectives met: 25%;</li><li>· Two-thirds of objectives met: 62.5%; and</li><li>· Objectives met or exceeded in all material respects: 100%.</li></ul>	Good progress on brand franchises (e.g., 'Helpful Banking' in UK), sustainability and employee engagement measures. Further work needed on cost:income ratio.
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## Directors' remuneration report continued

2010

Awards to executive directors under the LTIP in 2010 are subject to improvements in Economic Profit, Relative TSR and Absolute TSR. The award is due to be assessed in May 2013 to determine the final level of vesting. The table below is an interim assessment and based on performance to date, the threshold targets have not yet been met.

Performance measure	Weighting	Rationale	Vesting	Current assessment of performance
Economic Profit	50%	Ensures that performance reflects enduring earnings for the Bank.	Maximum vesting of the Economic Profit measure will be triggered by early delivery of Core Business profitability, well ahead of the range implied by the published Strategic Plan targets and also in excess of the cost of capital.	Continued difficult economic conditions in a number of our key markets mean that based on performance to date, the threshold targets have not yet been met.
Relative TSR	25%	Ensure alignment with shareholders.	Threshold: 20% vesting if the Group's TSR is at the median of the companies in the comparator group.  Maximum: 100% vesting if the Group's TSR is at the upper quartile of the companies in the comparator group.  Pro-rata vesting in between these points.	Based on share price performance to date, the threshold targets have not yet been met.
Absolute TSR	25%	Ensure alignment with shareholders.	Threshold: 20% vesting if the Group's share price reaches 57.5p.  Maximum: 100% vesting if the Group's share price reaches 77.5p.  Pro-rata vesting in between these points.  Note that the absolute TSR performance measures above have now been adjusted by a factor of ten (to £5.75 and £7.75 respectively) to reflect the sub-division and consolidation of ordinary shares.	Based on share price performance to date, the threshold targets have not yet been met.

Note: For the formulaic performance conditions applying to the executive directors, the percent vesting outcomes were calculated by PwC, based on incremental economic profit figures from Group Finance (Group operating profit less 25% tax less a charge of 10% of tangible equity) and TSR for the period up to and including 3 January 2012.

2009

In 2009, executive directors received long-term incentives under two plans, the Medium Term Performance Plan (MPP) and Executive Share Option Plan (ESOP). These awards are due to be formally assessed in June 2012. It is currently anticipated that, based on performance to date, the threshold targets would not be met and there would be nil vesting under any of the elements of these awards.

Performance measure	Weighting	Rationale	Vesting	Current assessment of performance
Relative TSR	50%	Ensure alignment with shareholders.	<p>Threshold: 25% vesting if the Group's TSR is at the median of the companies in the comparator group.</p> <p>Maximum: 100% vesting if the Group's TSR is at the upper quartile of the companies in the comparator group.</p> <p>Pro-rata vesting in between these points.</p>	Based on share price performance to date, the threshold targets would not be met and there would be no vesting under this element of the award.
Absolute TSR	50%	Ensure alignment with shareholders.	<p>Threshold: 25% vesting if the Group's share price reaches 40p.</p> <p>50% vesting if the Group's share price reaches 55p.</p> <p>Maximum: 100% vesting if the Group's share price reaches 70p.</p> <p>Note that the absolute TSR performance measures above have now been adjusted by a factor of ten (to £4.00, £5.50 and £7.00 respectively) to reflect the sub-division and consolidation of ordinary shares.</p>	Based on share price performance to date, the threshold targets would not be met and there would be no vesting under this element of the award.

Note: The TSR calculations were provided by PwC based on TSR calculations up to and including 3 January 2012.

Directors' remuneration report continued

Total Shareholder Return performance

The first graph below shows the performance of the company over the past five years in terms of TSR compared with that of the companies comprising the FTSE 100 Index. This index has been selected because it represents a cross-section of leading UK companies. The TSR for FTSE banks for the same period has been added for comparison.

The TSR for the company and the indices have been rebased to 100 for 2006. The second graph shows the same performance of the company during 2011.

Implementation of the Group's recovery plan started in January 2009 with the publication of the preliminary 2008 losses. The share price reached a low point of just under 10p per share on the news.

Since that date to 22 February 2012, the day before the Group's 2011 results announcement, the Group's share price has risen 265% which compares to 164% and 145% respectively for the FTSE banks index and the FTSE 100 index as a whole.

Total shareholder return - one year

Financial shares outperformed the market for most of the first half of the year. However, focus shifted to the fiscal positions of peripheral Eurozone economies, particularly Greece and Italy, in the summer. This prompted investor concerns about the implications for banks exposed to these countries and caused stresses in European bank funding markets. The RBS share price was impacted broadly in line with other domestic UK banks and European peers, underperforming the market in the second half. Accompanying this was a reduction in the consensus outlook for bank earnings, driven by a weaker outlook for growth in the global economy.

In addition, the weight of new regulation on European banks raised concerns about banks' ability to generate attractive returns. Specifically in the UK, the publication of the ICB report in September recommending the ring-fencing of retail banking operations was perceived as detrimental for RBS and its UK domestic peers, although details of the regulations are yet to be finalised.

## Directors' remuneration report continued

## Setting performance for 2012

The executive directors' annual performance objectives are approved by the Group Remuneration Committee. The risk objectives are reviewed by the Board Risk Committee.

Core objectives	Stephen Hester	Bruce Van Saun
Strategic progress	Revise original Strategic Plan to respond to significant changes in the macro environment and outlook for wholesale banking. Deliver execution of revised strategy.	Monitor and improve the Group and Divisional Strategic Plans. Drive effective design and implementation of revised plan. Work with CEO on Group Strategy/M&A/APS.
Business delivery and financial performance	Lead delivery of overall performance, including measures relating to ROE, cost management, Core Tier 1 capital ratio, funding and risk profile, lending, EU mandated disposals and restructuring of the wholesale business.	Ensure statutory, regulatory and management reporting is compliant with all external and internal standards. Continue to improve 'best in class' external reporting. Provide strong CFO role to the business through strategic planning, budgeting, forecasting and reporting. Ensure a robust capital and funding planning framework. Drive efficiency. Successful completion of EU mandated disposals.
Risk and control	Continue culture change across the Group including delivery of measures relating to wholesale funding reliance and liquidity reserves and leverage ratio. Deliver against agreed APS objectives.	Implementation of effective regulatory changes impacting capital, funding, liquidity. Improve quality of risk and financial data. Continue development of Internal Audit function. Deliver against agreed APS objectives.
Stakeholder management	Achievement of customer franchise measures, maintain strong and effective relationships with external stakeholders and continue progress on TCF actions.	Continue to develop effective external relationships, including investors, rating agencies and regulators.
People management	Ensure each division/function has high quality leadership teams, build out performance management, talent management and succession planning across the Group. Maintain effective employee engagement.	Lead upgraded team and build positive culture. Contribute to overall Group management.

The Group Remuneration Committee will determine the actual value of the award by reference to the extent to which executive directors have met the performance targets. Awards will be paid entirely in shares and will vest in two equal tranches on the first and second anniversaries of the date of grant. Clawback provisions will apply prior to the vesting of the shares.

## Long-term incentive plan (LTIP)

2012 Awards have four performance categories, each with equal weighting.

Core bank economic profit (25%)

As the value of the Group will be determined by the Core Bank's ability to generate enduring returns for shareholders, the Economic Profit measure is focused on the Core Bank to ensure that performance reflects enduring earnings for the bank. Economic Profit, being a risk-adjusted financial measure, is consistent with the FSA Code and also provides a balance between measuring growth and the cost of capital employed in delivering that growth.

Core bank Economic Profit is defined as return attributable to shareholders less equity multiplied by the cost of equity, where:

Return attributable to shareholders is Core Operating Profit reported in the financial statements, excluding own credit adjustments and APS, taxed at a standard tax rate.

Equity is defined as tangible equity allocated to the Core businesses, with adjustments to strip out distorting impacts arising from movements in the fair value of own debt, available-for-sale reserves and cash flow hedging reserve.

Current Cost of Equity is 12%, which is subject to review at least annually.

At the end of the performance period for the 2012 awards, the Group Remuneration Committee will assess economic profit performance against plan in light of targets set by it at the start of the performance period. Details of the actual targets, and performance against these, will be disclosed retrospectively once the awards vest.

**Directors' remuneration report continued****Relative Total Shareholder Return (TSR) (25%)**

The relative TSR measure provides a direct connection between executive directors' awards and relative performance delivered to shareholders. The measure compares the Group's performance against a group of comparator banks from the UK and overseas, weighted towards those companies most similar to the Group. Performance is measured over a three year performance period. The Remuneration Committee reviewed the weightings within the TSR peer group, and made a small number of adjustments to reflect emerging regulatory influences, the future geographic and business focus of RBS, and consequent future relevance of peer companies. This has resulted in reducing the weightings of a small number of banks in the peer group for 2012 LTIP awards.

**Relative TSR Comparator Group**

		Weighting
1	Barclays	200%
2	Lloyds Banking Group	
3	HSBC	150%
4	Standard Chartered	
5	Bank of America	50%
6	BBVA	
7	BNP Paribas	
8	Citigroup	
9	Credit Agricole	
10	Credit Suisse Group	
11	Deutsche Bank	
12	JP Morgan Chase	
13	National Australia Bank Limited	
14	Royal Bank of Canada	
15	Santander	
16	Societe Generale	
17	The Toronto-Dominion Bank Group	
18	UBS	
19	Unicredito	
20	Wells Fargo & Company	

To receive any of the LTIP awards subject to this performance measure the Group's performance must be at least as good as the median of the comparator companies, with vesting as follows (with a pro-rata proportion of the award vesting in between these points):

- 20% of the award will vest if the Group's TSR is at the median of the companies in the comparator group.
- 100% of the award will vest if the Group's TSR is at the upper quartile of the companies in the comparator group.

**Balance Sheet & Risk (25%)**

The Balance Sheet & Risk measures have a particular focus on risk reduction, the resolution of the Non-Core business and the building of a sustainable and responsible franchise for the Group.

**Strategic Scorecard (25%)**

The balanced Strategic Scorecard rewards management for delivering a robust basis for future growth in terms of the strength of our franchise, efficiency, reputation, and the strength and engagement of employees.

Performance measures

	Non-Core assets
	Cumulative Non-Core loss
Balance	Core Tier 1 Capital
Sheet and Risk	Wholesale funding
measures	Liquidity reserves
and targets	Leverage ratio
	Loan:deposit ratio
	Earnings volatility
	Customer franchise
Strategic	Cost:income ratio in core bank
Scorecard measures	Lending targets
and targets	Sustainability performance
	Progress in people issues

Both quantitative and qualitative strategic measures are used, including measures relating to reputation, customer excellence, organisational capability and sustainability, given that these will support the long term goals of the business. Targets for each measure are set at the start of the performance period and where applicable, are aligned with the Group's strategic plan targets. At the end of the period each measure will be assessed against the target, and vesting will be based on the proportion of targets fully met (see below), qualified by the Group Remuneration Committee's discretion, taking other relevant factors into account.

Commentary will be provided on an annual basis in relation to progress against the targets, where these are not commercially sensitive.

Vesting point		Indicative performance
Does not meet	0%	Over half of objectives not met
Partially meets	25%	Half of objectives met
Significantly meets	62.5%	Two-thirds of objectives met
Fully meets	100%	Objectives met or exceeded in all material respects

Qualified by Group Remuneration Committee discretion taking into account changes in circumstances over the performance period, the relative importance of the measures, the margin by which individual targets have been missed or exceeded, and any other relevant factors.



## Directors' remuneration report continued

## Risk underpin and clawback

The Group Remuneration Committee will also review financial and operational performance against the Strategic Plan and risk performance prior to agreeing vesting of awards. In assessing this, the Committee will be advised independently by the Board Risk Committee. If the Group Remuneration Committee considers that the vesting outcome calibrated in line with the performance conditions outlined above does not reflect the Group's underlying financial results or if the Committee considers that the financial results have been achieved with excessive risk, then the terms of the awards allow for an underpin to be used to reduce vesting of an award, or to allow the award to lapse in its entirety. All awards are subject to clawback.

## Service contracts

The company's policy in relation to the duration of contracts with directors is that executive directors' contracts generally continue until termination by either party, subject to the required notice, or until retirement. The notice period under the service contracts of executive directors will not normally exceed twelve months. In relation to newly recruited executive directors, subject to the prior approval of the Group Remuneration Committee, the notice period may be extended beyond twelve months if there is a clear case for this. Where a longer period of notice is initially approved on appointment, it will normally be structured such that it will automatically reduce to twelve months in due course. All new service contracts for executive directors are subject to approval by the Group Remuneration Committee. Those contracts normally include standard clauses covering the performance review process, the company's normal disciplinary procedure, and terms for dismissal in the event of failure to perform or in situations involving actions in breach of the Group's policies and standards. Any compensation payment made in connection with the departure of an executive director will be subject to approval by the Group Remuneration Committee, having regard to the terms of the service contract and the reasons for termination.

Information regarding the executive directors' service contracts is shown below:

	Date of current contract	Notice period - from the company	Notice period - from executive
Stephen Hester	4 November 2008	12 months	12 months
Bruce Van Saun	8 September 2009	12 months	12 months

Except as noted below, in the event of severance where any contractual notice period is not worked, the employing company may pay a sum to the executive in lieu of the notice period. In the event of situations involving breach of the employing company's policies resulting in dismissal, reduced or no payments may be made to the executive. Depending on the circumstances of the termination of employment, the executive may be entitled, or the Group Remuneration Committee may allow, outstanding awards under long-term incentive arrangements to vest, subject to the rules of the relevant plan.

## Stephen Hester

In the event of his personal underperformance, the company is entitled, after giving reasonable opportunity to remedy any failure, to terminate Stephen Hester's contract by giving written notice with immediate effect and without making any payment in lieu thereof and Stephen Hester will forfeit any unvested stock awards. In the event that Stephen Hester's employment is terminated by the company (other than by reason of his personal underperformance), he will be entitled to receive a payment in lieu of notice to the value of base salary, bonus and benefits (including pension contributions). If he resigns voluntarily and the company does not require him to work out his notice period, Stephen Hester may receive a payment in lieu of notice based on salary only (i.e. no bonus or benefits). In both cases the treatment of any other unvested stock awards will be determined at the discretion of the Group Remuneration Committee.

**Bruce Van Saun**

In the event that Bruce Van Saun's employment is terminated by reason of his personal underperformance, the company is entitled, after giving reasonable opportunity to remedy any failure, to terminate by giving written notice with immediate effect and without making any payment in lieu of notice. Any payment in lieu of notice that may be made to Bruce Van Saun would be based on salary only (i.e. no bonus or benefits). The company has agreed that, provided certain conditions are met, on leaving employment, Bruce Van Saun will not forfeit awards under the rules of the Group's share plans.

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## Directors' remuneration report continued

### Chairman and non-executive directors

Information regarding the terms of appointment for the Chairman and non-executive directors is shown below.

#### Re-election

Under the Articles of Association of the company, directors must stand for re-election by shareholders at least once every three years. However, in accordance with the provisions of the Code, all directors of the company will stand for annual re-election by shareholders at the company's Annual General Meetings.

#### Letter of engagement

The non-executive directors do not have service contracts or notice periods although they have letters of engagement reflecting their responsibilities and commitments.

#### Time commitments

Letters of engagement make clear to non-executive directors the time commitment they are expected to give to their Board duties. Since 2010, non-executive directors letters of engagement specifically state that their time commitment should be in line with the Walker Review of corporate governance of banks and other financial institutions in respect of their general Board duties. Additional time will be spent as necessary in respect of Committee duties, including in particular any Committees which they chair.

#### Termination

No compensation would be paid to any non-executive director in the event of termination of appointment.

#### Arrangements for the Group Chairman

Philip Hampton is entitled to receive a cash payment in lieu of notice if his appointment is terminated as a result of the Group's majority shareholder seeking to effect the termination of his appointment. The applicable notice period is twelve months. In the event that the company terminates Philip Hampton's appointment without good reason, or his re-election is not approved by shareholders in General Meeting resulting in the termination of his appointment, he will be entitled to receive a cash payment in lieu of notice of twelve months' fees.

#### Fees for non-executive directors

The table below sets out the remuneration structure for non-executive directors for the year ended 31 December 2011. The Senior Independent Director and Chairs of the Board Committees receive a composite fee and therefore do not receive additional fees for membership of any other committees or the Group Board.

Chairman's fee	£750,000
Senior Independent Director (composite fee)	£150,000
Chairman of Group Audit Committee, Board Risk Committee or Group Remuneration Committee (composite fee)	£150,000
Non-executive director Group Board fee	£72,500
Membership of Group Audit Committee, Board Risk Committee or Group Remuneration Committee fee	£25,000
Membership of Nominations Committee fee	£5,500

No director received any expense allowances chargeable to UK income tax or compensation for loss of office/termination payment. The non-executive directors did not receive any bonus payments or benefits.



## Directors' remuneration report continued

## Remuneration in detail

The tables and explanatory notes on pages 249 to 251 detail the remuneration of each director for the year ended 31 December 2011 and have been audited by the company's auditors, Deloitte LLP.

## Directors' remuneration

	Salary/ fees £000	Benefits £000	2011 Total £000	2010 Total £000
Chairman				
Philip Hampton	750	—	750	750
Executive directors				
Stephen Hester (1)	1,200	26	1,226	3,267
Bruce Van Saun (1,2)	744	132	876	2,298

## Notes:

- (1) Stephen Hester waived his award of 3.6 million shares (0.36 million as adjusted for the sub-division and consolidation) which was approved by the Group Board and which was due to be awarded in March 2012. Bruce Van Saun will receive an award of 3.0 million shares (0.3 million as adjusted for the sub-division and consolidation) in respect of 2011 performance, which will be delivered into Share Bank in March 2012 and will vest in March 2013 and 2014. For subsequent reporting years, the 3.0 million shares (0.3 million shares as adjusted for the sub-division and consolidation) awarded to Bruce Van Saun will be detailed in the Deferred Awards table (see page 250). Further details of the performance assessment of the executive directors in 2011 is outlined on pages 240 and 241. Amounts disclosed as performance bonus under the remuneration table in the 2010 Report & Accounts represent the cash value that was subsequently converted to shares at the date of award in March 2011. The awards are shown as deferred awards granted in 2011 as set out on page 250.
- (2) Bruce Van Saun is director of ConvergeEx Holdings LLC and retains the fee paid to him in this respect. For 2011, he received a fee of \$75,000.

## Non-executive directors

The level of remuneration for non-executive directors reflects their responsibility and time commitment and the level of fees paid to non-executive directors of comparable major UK companies. Non-executive directors do not participate in any incentive or performance plan. Non-executive directors fees are reviewed regularly.

	Board		2011	2010
	Board fees £000	Committee fees £000	Total £000	Total £000
Non-executive directors				
Sandy Crombie	150	—	150	150
Alison Davis (1)	30	13	43	—
Tony Di Iorio (2)	24	19	43	—
Penny Hughes (3)	150	—	150	130
Joe MacHale (4)	73	60	133	141
John McFarlane	73	30	103	103
Brendan Nelson (5)	150	—	150	111
Baroness Noakes (6)	30	13	43	—
Art Ryan	73	22	95	103
Philip Scott	150	—	150	150

Former non-executive director Colin Buchan (7)	44	33	77	150
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Notes:

- (1) Appointed on 1 August 2011.
- (2) Appointed on 1 September 2011.
- (3) Fee has not increased in 2011. Lower fee in 2010 reflects appointment as Chair of Group Remuneration Committee with effect from 1 June 2010.
- (4) Board Committee fee includes membership of the Asset Protection Scheme Senior Oversight Committee.
- (5) Fee has not increased in 2011. Lower fee in 2010 reflects appointment to the Board from 1 April 2010 and as Chairman of the Group Audit Committee from 28 April 2010.
- (6) Appointed on 1 August 2011.
- (7) Retired from the Board with effect from 5 August 2011.

## Directors' remuneration report continued

## Long-Term Incentive Plan (LTIP)

No variation was made to any of the terms of the plan during the year. Awards to executive directors under the LTIP in 2011 are subject to performance conditions detailed on page 242. Performance conditions for awards made in 2010 are detailed on page 243. Awards held at 1 January 2011 and all subsequent figures have been restated to reflect the Sub-division and Consolidation.

Awards held at 1 January 2011	Awards granted in 2011	Market price on award £	Awards vested in 2011	Market price on vesting £	Awards held
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