ROYAL BANK OF SCOTLAND GROUP PLC
Form 6-K
August 13, 2010

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 6-K

Report of Foreign Private Issuer

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

August 13, 2010

The Royal Bank of Scotland Group plc

Gogarburn
PO Box 1000
Edinburgh EH12 1HQ
Scotland
United Kingdom

(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 X 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 X

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

This report on Form 6-K shall be deemed incorporated by reference in each of The Royal Bank of Scotland Group plc's Registration Statement on Form F-3 (File Nos. 333-162219 and 333-162219-01) and to be a part thereof from the date on which this report is furnished, to the extent not superseded by documents or reports subsequently filed or furnished.

Business Review

Presentation of information

In this document, and unless specified otherwise, the term ‘company’ means The Royal Bank of Scotland Group plc, ‘RBS’ 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 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 International Financial Reporting Interpretations Committee of the IASB (together ‘IFRS’) as adopted by the European Union. They also comply with IFRS as issued by the IASB.

Acquisition of ABN AMRO

On 17 October 2007, RFS Holdings B.V. (“RFS Holdings”), which at the time was owned by RBSG, Fortis N.V., Fortis S.A./N.V., Fortis Bank Nederland (Holding) N.V. (“Fortis”) and Banco Santander, S.A. (“Santander”), completed the acquisition of ABN AMRO Holding N.V. (which was renamed RBS Holdings N.V. on 1 April 2010).

RFS Holdings, which is now jointly owned by RBSG, the Dutch State (following its acquisition of Fortis) and Santander (the “Consortium Members”), is continuing the process of implementing an orderly separation of the business units of RBS Holdings N.V. As part of this reorganisation, on 6 February 2010, the businesses of RBS Holdings N.V. acquired by the Dutch State were legally demerged from the RBS Holdings N.V. businesses acquired by the Group and were transferred into a newly established holding company, ABN AMRO Bank N.V. (save for certain assets and liabilities acquired by the Dutch State that were not part of the legal separation and which will be transferred to the

Dutch State as soon as possible).

Legal separation of ABN AMRO Bank N.V. occurred on 1 April 2010, with the shares in that entity being transferred by RBS Holdings N.V. to a holding company called ABN AMRO Group N.V., which is owned by the Dutch State. Certain assets within RBS Holdings N.V. continue to be shared by the Consortium Members. RBS Holdings N.V. is a fully operational bank within the Group and is independently rated and licensed and regulated by the Dutch Central Bank.

Statutory results

RFS Holdings is jointly owned by the consortium members. It is controlled by the company and is therefore fully consolidated in its financial statements. Consequently, the statutory results of the Group include the results of ABN AMRO. The interests of Fortis, and its successor the State of the Netherlands, and Santander in RFS Holdings are included in minority interests.

Restatements
Divisional results for 2008 have been restated to reflect the Group's new organisational structure that includes a Non-Core division comprising individual assets, portfolios and lines of business that the Group intends to run off or dispose. The Non-Core division is reported separately from the divisions which form the Core Group. In addition, separate reporting of Business Services (formerly Group Manufacturing) and Centre results has changed and, with the exception of certain items of a one off nature, costs incurred are now allocated to the customer-facing divisions and included in the measurement of the returns which they generate. The changes do not affect the Group's results. Comparatives have been restated accordingly.

IAS 1 (Revised 2007) 'Presentation of Financial Statements' has required the Group to present a third balance sheet (31 December 2007) as a result of the restatement of the Group's income statement following the implementation of IFRS 2 (see below). A fourth balance sheet (31 December 2006) has not been presented as there is no material impact on that period.

Legal separation of ABN AMRO Bank NV took place on 1 April 2010. As a result, RBS no longer consolidates the interests in ABN AMRO of its consortium partners in its results. Consortium partners' results for 2009, 2008 and 2007 are classified as discontinued operations and have been restated accordingly.

Glossary
A glossary of terms is detailed on pages 355 to 359.

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’, ‘probability’, ‘risk’, ‘Value-at-Risk (VaR)’, ‘target’, ‘goal’, ‘objective’, ‘will’, ‘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, capitalisation, portfolios, capital ratios, liquidity, risk weighted assets, return on equity, cost:income ratios, leverage and loan:deposit ratios, funding and risk profile; the Group’s future financial performance; the level and extent of future impairments and write-downs; the protection provided by the APS; and to 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 of the 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 full nationalisation of the Group or other resolution procedures under the Banking Act 2009; the global economy and instability in the global financial markets, and their impact on the financial industry in general and on the Group in particular; the financial stability of other financial institutions, and the Group’s counterparties and borrowers; the ability to complete restructurings on a timely basis, or at all, including the disposal of certain non-core assets and assets and businesses required as part of the EC State Aid restructuring plan; organizational restructuring; the ability to access sufficient funding to meet liquidity needs; cancellation or failure to renew governmental support schemes; the extent of future write-downs and impairment charges caused by depressed asset valuations; the inability to hedge certain risks economically; the value and effectiveness of any credit protection purchased by the Group; unanticipated turbulence in interest rates, foreign currency exchange rates, credit spreads, bond prices, commodity prices and equity prices; changes in the credit ratings of the Group; ineffective management of capital or changes to capital adequacy or liquidity requirements; changes to the valuation of financial instruments recorded at fair value; competition and consolidation in the banking sector; HM Treasury exercising influence over the operations of the Group; the ability of the Group to attract or retain senior management or other key employees; regulatory change or a change in UK Government policy; changes to the monetary and interest rate policies of the Bank of England, the Board of Governors of the Federal Reserve System and other G7 central banks; impairment of goodwill; pension fund shortfall; litigation and regulatory investigations; general operational risks; insurance claims; reputational risk; general geopolitical and economic conditions in the UK and in other countries in which the Group has significant business activities or investments, including the United States; the ability to achieve revenue benefits and cost savings from the integration of certain of RBS Holdings N.V.’s businesses and assets; changes in UK and foreign laws, regulations, accounting standards and taxes, including changes in regulatory capital regulations and liquidity requirements; the participation of the Group in the APS and the effect of such Scheme on the Group’s financial and capital position; the ability to access the contingent capital arrangements with HM Treasury; 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 report, 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.

For a further discussion of certain risks faced by the Group, see Risk factors on pages 7 to 22.

Explanatory note
The company is filing this Form 6-K to restate certain disclosures in the company's annual report on Form 20-F for the year ended 31 December 2009, filed with the Securities and Exchange Commission on 27 April 2010 (the "2009 Form 20-F") in connection with the reclassification of the results attributable to ABN AMRO Bank N.V. as discontinued operations. This reclassification resulted from the transfer of ABN AMRO Bank N.V. to ABN AMRO Group N.V., a company wholly owned by the State of the Netherlands on 1 April 2010.

The Group presented certain disclosures that reflect the reclassification in its results for the six months ended 30 June 2010, which were filed with the Securities and Exchange Commission on a separate Form 6-K on 13 August 2010. To facilitate comparison with these interim results, the disclosures included in the 2009 Form 20-F have been restated in this Form 6-K.

Accordingly, the following pages that correspond to the 2009 Form 20-F have been restated to reflect the reclassification of results attributable to ABN AMRO Bank N.V. as discontinued operations.

Item 3: Key Information
Page 23 (Key financials)
Page 24 (Summary consolidated income statement)
Pages 311 and 312 (Financial summary)

Item 4: Information on the Company
Page 28 (Business review)
Pages 98 to 101 (credit risk – loan impairment)
Page 248 (Note 12 – Financial assets – impairments)
Page 254 (Note 14 – Debt securities)
Page 255 (Note 15 – Equity shares)
Pages 260 and 261 (Note 18 – Property, plant and equipment)
Pages 262 and 263 (Note 20 – Discontinued operations)
Pages 298 to 302 (Note 38 – Segmental analysis)
Pages 311 and 312 (Financial summary)
Page 314 (Loan impairment provisions)
Page 317 (risk elements in lending and potential problem loans)

Item 5: Operating and Financial Review and Prospects
Pages 25 to 28, 32, 33, 35, 37, 38, 64, (Business review)
Pages 98 to 101 (credit risk – loan impairment)
Page 251 (Note 13 – Derivatives – hedge ineffectiveness)
Pages 260 and 261 (Note 18 – Property, plant and equipment)
Page 266 (Note 24 – Insurance business)
Page 285 (Note 29 – Leases)
Page 289 (Note 32 – Memorandum items)
Page 293 (Note 33 – Net cash (outflow)/inflow from operating activities)

Item 6: Directors, Senior Management and Employees
Page 64 (Business review)
Page 217 and 218 (Note 3 – Operating expenses)
Page 220 (Note 4 – Pension costs)

This Form 6-K includes Items 3, 4, 5, 6, 8, 11, 15 and 18 from the 2009 Form 20-F in their entirety and also retains the page numbering of the 2009 Form 20-F, in respect of Items 3, 4, 5, 6, 8, 11, 15 and 18 for ease of reference.

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 two principal subsidiaries, the Royal Bank and NatWest. Both the Royal Bank and NatWest are major UK clearing banks whose origins go back over 275 years. In the United States, the Group's subsidiary Citizens is a large commercial banking organisation. The Group has a large and diversified customer base and provides a wide range of products and services to personal, commercial and large corporate and institutional customers in over 50 countries.

Following placing and open offers in December 2008 and in April 2009, HM Treasury owned 70.3% of the enlarged ordinary share capital of the company.

In December 2009, the company issued £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 one capital.

Following the issuance of B shares, HM Treasury's holding of ordinary shares of the company remained at 70.3% although its economic interest rose to 84.4%.

HM Treasury has agreed not to convert its B shares into ordinary shares to the extent that its holding of ordinary shares following the conversion would represent more than 75% of the company's issued ordinary share capital.

In March 2010, the company converted 935,228 non-cumulative dollar preference shares in the company into ordinary shares resulting in approximately 1.6 billion ordinary shares being issued. This increase in the company's issued ordinary share capital resulted in HMT's holding in the company's ordinary shares reducing to approximately 68.4%.

The Group had total assets of £1,696.5 billion and owners' equity of £77.7 billion at 31 December 2009. The Group's capital ratios, which included the equity minority interest of the State of the Netherlands and Santander in ABN AMRO, were a total capital ratio of 16.1 per cent., a core Tier 1 capital ratio of 11.0 per cent. and a Tier 1 capital ratio of 14.1 per cent., as at 31 December 2009.

Organisational structure and business overview

Following a comprehensive strategic review, changes have been made to the Group's operating segments in 2009. A Non-Core division has been created comprising those lines of business, portfolios and individual assets that the Group intends to run off or sell. Furthermore, Business Services (formerly Group Manufacturing) is no longer reported as a separate division and its costs are now allocated to the customer-facing divisions along with certain central costs. UK Retail & Commercial Banking has been split into three segments (UK Retail, UK Corporate and Wealth). Ulster Bank has become a specific segment. The remaining elements of Europe & Middle East Retail & Commercial Banking, Asia Retail & Commercial Banking and Share of shared assets form part of Non-Core. The segment measure is now Operating profit/(loss) before tax which differs from Contribution used previously; it excludes certain infrequent items and RFS Holdings minority interest, which is not an operating segment of the Group. Comparative data have been restated accordingly.

UK Retail offers a comprehensive range of banking products and related financial services to the personal market. It serves customers through the RBS and NatWest networks of branches and ATMs in the United Kingdom, and also through telephone and internet channels.

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 RBS Coutts.

Global Banking & Markets (GBM) is a leading banking partner to major corporations and financial institutions around the world, providing an extensive range of debt and equity financing, risk management and investment services to its customers. The division is organised along six principal business lines: money markets; rates flow trading; currencies and commodities; equities; credit markets and portfolio management & origination.

Global Transaction Services ranks among the top five global transaction services providers, offering global payments, cash and liquidity management, and trade finance and commercial card products and services. It includes the Group’s corporate money transmission activities in the United Kingdom and the United States as well as Global Merchant Services, the Group’s United Kingdom and international merchant acquiring business.

Ulster Bank is the leading retail and commercial bank in Northern Ireland and the third largest banking group on the island of Ireland. It provides a comprehensive range of financial services through both its Retail Markets division which has a network of branches and operates in the personal and bancassurance sectors, and its Corporate Markets division which provides services to SME business customers, corporates and institutional markets.

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. It ranks among the top five banks in New England.

RBS Insurance sells and underwrites retail and SME insurance over the telephone and internet, as well as through brokers and partnerships. Its brands include Direct Line, Churchill and Privilege, which sell general insurance products direct to the customer, as well as Green Flag and NIG.

Through its international division, RBS Insurance sells general insurance, mainly motor, in Germany and Italy. The Intermediary and Broker division sells general insurance products through independent brokers.

Business Services (formerly Group Manufacturing) 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.

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. The division contains a range of businesses and asset portfolios primarily from the GBM division including RBS Sempra Commodities, linked to proprietary trading, 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 divestments

To comply with European Commission State Aid (EC State Aid) requirements the Group has agreed a series of restructuring measures to be implemented over a four year period. This will supplement the measures in the strategic plan previously announced by the Group. These include divesting fully RBS Insurance, Global Merchant Services and RBS Sempra Commodities, as well as divesting the RBS branch-based business in England & Wales and the NatWest branches in Scotland, along with the Direct SME customers across the UK.

Relationship with major shareholder

The UK Government currently owns 68.4 per cent. of the issued ordinary share capital of RBS. The UK Government's shareholding in RBS is currently held by the Solicitor for the Affairs of HM Treasury as nominee for HM Treasury and managed by UK Financial Investments Limited ("UKFI"), a company wholly owned by HM Treasury. The relationship between HM Treasury and UKFI, and between UKFI and Government investee banks is set out in the UKFI Framework Document and Investment Mandate, agreed between HM Treasury and UKFI.

The Framework Document sets out UKFI's overarching objective, to "develop and execute an investment strategy for disposing of the investments [in the banks] in an orderly and active way through sale, redemption, buy-back or other means within the context of an overarching objective of protecting and creating value for the taxpayer as shareholder, paying due regard to the maintenance of financial stability and to acting in a way that promotes competition."

It states that UKFI will manage the UK financial institutions in which HM Treasury holds an interest "at an arms length and on a commercial basis and will not intervene in day-to-day management decisions of the Investee Companies (including with respect to individual lending or remuneration decisions)".This document also makes it clear that such UK financial institutions "will continue to have their own independent boards and management teams, determining their own strategies and commercial policies (including business plans and budgets)."

HM Treasury expects UKFI to act in the same way as any other engaged institutional shareholder would. The UKFI Investment Mandate states that it will "follow best institutional shareholder practice. This includes compliance with the

Institutional Shareholders' Committee's Statement of Principles together with any developments to best institutional shareholder practice arising from recommendations or guidance contained in the Walker Review or elsewhere."

For example, RBS announced on 17 February 2009 that it had reached an agreement with UKFI in respect of certain changes to its remuneration policy. RBS also undertook to conduct a review of its strategy and UKFI was actively engaged in reviewing the output of this review, as any other engaged shareholder would be expected to be. RBS has made a commitment to comply with the FSA Remuneration Code. These rules came into force on 1 January 2010 and are in line with the agreement reached by the G-20, setting global standards for the implementation of the Financial Stability Board's remuneration principles. RBS agreed that it will be at the leading edge of implementing the G-20 principles. UKFI was granted consent rights over the shape and size of the RBS aggregate bonus pool for the 2009 performance year. Separate to the shareholding relationship, RBS has a number of relationships with the UK Government arising out of the Government's provision of support.

As a result of the Government's recapitalisation of RBS, an undertaking was given to UKFI in 2008 to appoint a new Chairman and three new Non-executive Directors to the Group Board. This undertaking has been completed by the following appointments: Philip Hampton as Chairman, Sandy Crombie as Senior Independent Director and Philip Scott and Penny Hughes as Non-executive Directors. In addition, Brendan Nelson was appointed as a Non-executive Director with effect from 1 April 2010. Subsequently, UKFI were consulted as majority shareholder on proposed Non-executive Director appointments but in all cases the usual process for appointments was followed i.e. candidates were considered by the Nominations Committee and then recommended to the Group Board for approval. For the avoidance of doubt, no member of the Board represents or acts on the instructions of UKFI or HMT. There is no further arrangement with UKFI in this regard, beyond usual shareholder rights, and no such arrangements with any other shareholder.

In connection with its accession to the APS (further details of which are set out above), RBS has undertaken to provide lending to creditworthy UK homeowners and businesses in a commercial manner. RBS's compliance with this commitment is subject to a monthly reporting process to the UK Government. The lending commitment does not require RBS to engage in uncommercial practices.

Certain other considerations relating to RBS's relationship with HM Treasury and UKFI are set out in the risk factors headed "HM Treasury (or UKFI on its behalf) may be able to exercise a significant degree of influence over the Group".

Other than in relation to these areas, however, the UK Government has confirmed publicly that its intention is to allow the financial institutions in which it holds an interest to operate their business independently, as set out in UKFI's governance documents described above.

As a result of the UK Government's holding, the UK Government and UK Government controlled bodies became related parties of the Group. In the normal course of business the Group enters into transactions with many of these bodies on an arms' length basis.

The Group is not a party to any transaction with the UK Government or any UK Government controlled body involving goods or services which is material to the Group, or any such transaction that is unusual in its nature or conditions. To the Group's knowledge, the Group is not a party to any transaction with the UK Government or any UK Government controlled body involving goods or services which is material to the UK Government or any UK Government controlled body. However, given the nature and extent of the UK Government controlled bodies, the Group may not know whether a transaction is material for such a party.

Any outstanding loans made by the Group to or for the benefit of the UK Government or any UK Government controlled body, were made on an arm's length basis and (A) such loans were made in the ordinary course of business, (B) were made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with other persons, and (C) did not involve more than the normal risk of collectibility or present other unfavorable features. The Group notes, however, that with respect to outstanding loans made by the Group to or for the benefit of the UK Government or any UK Government controlled body, there may not exist any comparable transactions with other persons.

Recent Developments

On 25 March 2010, the RBS Group announced its intention to launch (i) an offer to exchange certain subordinated debt securities issued by Group members for new senior debt and (ii) tender offers in respect of certain preference shares, preferred securities and perpetual securities issued by Group members. The RBS Group announced the offers on 6 April 2010 and will seek shareholder approvals as required in coordination with the annual general meeting of The Royal Bank of Scotland Group plc scheduled to take place on 28 April 2010.

In January 2010, the FSA informed the Group that it intended to commence an investigation into certain aspects of the handling of customer complaints. On 25 March 2010 FSA formally notified the Group of the appointment of investigators in respect of aspects of complaint handling relating to RBS and NatWest retail bank products and services. The company and its subsidiaries intend to co-operate fully with this investigation.

In March 2010, the company converted 935,228 non-cumulative dollar preference shares in the company into ordinary shares resulting in approximately 1.6 billion ordinary shares being issued. This increase in the company's issued ordinary share capital resulted in HMT's holding in the company's ordinary shares reducing to approximately 68.4%.

In the UK, the OFT has been investigating RBS Group for alleged conduct in breach of Article 101 of the Treaty on the Functioning of the European Union and/or the Chapter 1 prohibition of the Competition Act 1998 relating to the provision of loan products to professional services firms. RBS Group co-operated fully with the OFT's investigation. On 30 March 2010 the OFT announced that it has arrived at an early resolution agreement with RBS Group by which RBS Group will pay a (discounted) fine of £28.59 million and admit a breach in competition law relating to the provision of loan products to professional services firms.

Brendan Nelson has been appointed as a non-executive director with effect from 1 April 2010. Brendan will succeed Archie Hunter as Chairman of the Group Audit Committee with effect from the conclusion of the Group's Annual General Meeting on 28 April 2010.

Legal separation of ABN AMRO Bank N.V. occurred on 1 April 2010, with the shares in that entity being transferred by RBS Holdings N.V. to a holding company called ABN AMRO Group N.V., which is owned by the Dutch State. Certain assets within RBS Holdings N.V. continue to be shared by the Consortium Members. RBS Holdings N.V. is a fully operational bank within the Group and is independently rated and licensed and regulated by the Dutch Central Bank. The presentation of ABN AMRO Bank N.V. as a discontinued operation is included in this document.

Competition

The Group faces strong competition in all the markets it serves. However, the global banking crisis has reduced either the capacity or appetite of many institutions to lend and has resulted in the withdrawal or disappearance of a number of market participants and significant consolidation of competitors, particularly in the US and UK. Competition for retail deposits has intensified significantly as institutions have re-orientated their funding strategies following the difficulties experienced in the wholesale markets since late 2007.

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 specialised 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 banks and building societies, major retailers and life assurance companies. In the mortgage market the Group competes with UK banks and building societies. A number of competitors have either left or scaled back their lending in the mortgage and unsecured markets. The Group's life assurance businesses compete with Independent Financial Advisers and life assurance companies.

In the UK credit card market large retailers and specialist card issuers, including major US operators, 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.

RBS Insurance 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 particularly intense, and price comparison internet sites now play a major role in the marketplace. RBS Insurance 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.

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.

Risk factors

Set out below are certain risk factors which could affect the Group's future results and cause them to be materially different from expected results. The Group's results are also affected by competition and other factors. The factors discussed in this report should not be regarded as a complete and comprehensive statement of all potential risks and uncertainties.

The company and its United Kingdom bank subsidiaries may face the risk of full nationalisation or other resolution procedures under the Banking Act 2009.

Under the provisions of the Banking Act , substantial powers have been granted to HM Treasury and the Bank of England as part of the special resolution regime to stabilise banks that are in financial difficulties (the "SRR"), which includes certain consultation and consent rights granted to the FSA (the FSA, together with HM Treasury and the Bank of England, the "Authorities"). The SRR confers powers on the Bank of England: (i) to transfer to the private sector all or part of the business of a United Kingdom incorporated institution with permission to accept deposits pursuant to Part IV of the FSMA (a "relevant entity") or the securities of such relevant entity; (ii) to transfer all or part of the business of the relevant entity to a "bridge bank" established by the Bank of England and also confers a power on HM Treasury to transfer into temporary public ownership (nationalise) the relevant entity or its United Kingdom incorporated holding company. The Banking Act also provides for two new insolvency and administration procedures for relevant entities.

The purpose of the stabilisation options is to address the situation where all or part of the business of a relevant entity has encountered, or is likely to encounter, financial difficulties. Accordingly, the stabilisation options may only be exercised if the FSA is satisfied that (i) a relevant entity such as the company's United Kingdom banking subsidiaries, including The Royal Bank of Scotland plc ("RBS") and National Westminster Bank Plc ("NatWest"), is failing, or is likely to fail, to satisfy the threshold conditions set out in Schedule 6 to the FSMA; and (ii) having regard to timing and other relevant circumstances, it is not reasonably likely that (ignoring the stabilisation options) action will be taken that will enable the relevant entity to satisfy those threshold conditions. The threshold conditions are conditions which an FSA-authorised institution must satisfy in order to retain its FSA authorisation. They are relatively wide-ranging and deal with most aspects of a relevant entity's business, including, but not limited to, minimum capital resource requirements. It is therefore possible that the FSA may trigger one of the stabilisation options before an application for an insolvency or administration order could be made.

The stabilisation options may be exercised by means of powers to transfer property, rights or liabilities of a relevant entity and shares and other securities issued by a relevant entity. HM Treasury may also take the parent company of a relevant entity (such as the company) into temporary public ownership provided that certain conditions set out in Section 82 of the Banking Act are met. Temporary public ownership is effected by way of a share transfer order and can be actioned irrespective of the financial condition of the parent company.

If HM Treasury makes the decision to take the company into temporary public ownership, it may take various actions in relation to any securities issued by the company (the “Securities”) without the consent of holders of the Securities, including (among other things):

(i) transferring the Securities free from any contractual or legislative restrictions on transfer;
(ii) transferring the Securities free from any trust, liability or encumbrance;
(iii) extinguishing any rights to acquire Securities;
(iv) delisting the Securities;
(v) converting the Securities into another form or class (including for example, into equity securities); or
(vi) disapplying any termination or acceleration rights or events of default under the terms of the Securities which would be triggered by the transfer.

Where HM Treasury has made a share transfer order in respect of securities issued by the holding company of a relevant entity, HM Treasury may make an order providing for the property, rights or liabilities of the holding company or of any relevant entity in the holding company group to be transferred and where such property is held on trust, removing or altering the terms of such trust.

Accordingly, there can be no assurance that the taking of any such actions would not adversely affect the rights of holders of the Securities and/or adversely affect the price or value of their investment or that the ability of the company to satisfy its obligations under contracts related to the Securities would be unaffected. In such circumstances, such holders may have a claim for compensation under one of the compensation schemes currently existing under, or contemplated by, the Banking Act if any action is taken in respect of the Securities (for the purposes of determining an amount of compensation, an independent valuer must disregard actual or potential financial assistance provided by the Bank of England or HM Treasury). There can be no assurance that holders of the Securities would thereby recover compensation promptly and/or equal to any loss actually incurred.

If the company was taken into temporary public ownership and a partial transfer of its or any relevant entity’s business was effected, or if a relevant entity were made subject to the SRR and a partial transfer of its business to another entity was effected, the transfer may directly affect the company and/or its Group companies by creating, modifying or cancelling their contractual arrangements with a view to ensuring the provision of such services and facilities as are required to enable the bridge bank or private sector purchaser to operate the transferred business (or any part of it) effectively. For example, the transfer may (among other things) (i) require the company or Group companies to support and co-operate with the bridge bank or private sector purchaser; (ii) cancel or modify contracts or arrangements between the company or the transferred business and a Group company; or (iii) impose additional obligations on the company under new or existing contracts. There can be no assurance that the taking of any such actions would not adversely affect the ability of the company to satisfy its obligations under the issued Securities or related contracts.

If the company was taken into temporary public ownership and a partial transfer of its or any relevant entity's business was effected, or if a relevant entity were made subject to the SRR and a partial transfer of its business to another entity was effected, the nature and mix of the assets and liabilities not transferred may adversely affect the company's financial condition and increase the risk that the company may eventually become subject to administration or insolvency proceedings pursuant to the Banking Act.

While the main provisions of the Banking (Special Provisions) Act 2008 were in force, which conferred certain transfer powers on HM Treasury, the United Kingdom Government took action under that Act in respect of a number of United Kingdom financial institutions, including, in extreme circumstances, full and part nationalisation. There have been concerns in the market in the past year regarding the risks of such nationalisation in relation to the company and other United Kingdom banks. If economic conditions in the United Kingdom or globally were to deteriorate, or the events described in the following risk factors occur to such an extent that they have a materially adverse impact on the financial condition, perceived or actual credit quality, results of operations or business of any of the relevant entities in the Group, the United Kingdom Government may decide to take similar action in relation to the company under the Banking Act. Given the extent of the Authorities' powers under the Banking Act, it is difficult to predict what effect such actions might have on the Group and any securities issued by the company or Group companies. However, potential impacts may include full nationalisation of the company, the total loss of value in Securities issued by the company and the inability of the company to perform its obligations under the Securities.

If the relevant stabilisation option was effected in respect of the company or the stabilisation options were effected in respect of a relevant entity or its business within the Group, HM Treasury would be required to make certain compensation orders, which will depend on the stabilisation power adopted. For example, in the event that the Bank of England were to transfer some of the business of a relevant entity to a bridge bank, HM Treasury would have to make a resolution fund order including a third party compensation order pursuant to the Banking Act (Third Party Compensation Arrangements for Partial Property Transfers) Regulations 2009. However, there can be no assurance that compensation would be assessed to be payable or that holders of the Securities would recover any compensation promptly and/or equal to any loss actually incurred.

The Group's businesses, earnings and financial condition have been and will continue to be affected by the global economy and instability in the global financial markets.

The performance of the Group has been and will continue to be influenced by the economic conditions of the countries in which it operates, particularly the United Kingdom, the United States and other countries throughout Europe, the Middle East and Asia. The outlook for the global economy over the near to medium term remains challenging, particularly in the United Kingdom, the United States and other European economies. In addition, the global financial system has yet to fully overcome the difficulties which first manifested themselves in August 2007 and financial markets conditions have not yet fully normalised. These conditions led to severe dislocation of financial markets around the world and unprecedented levels of illiquidity in 2008 and 2009, resulting in the development of significant problems at a number of the world's largest corporate institutions operating across a wide range of industry sectors, many of whom are the Group's customers and counterparties in the ordinary course of its business. In response to this economic instability and illiquidity in the market, a number of governments, including the United Kingdom Government, the governments of the other EU member states and the United States Government, have intervened in order to inject liquidity and capital into the financial system, and, in some cases, to prevent the failure of these institutions.

Despite such measures, the volatility and disruption of the capital and credit markets have continued, with many forecasts predicting only modest levels of GDP growth over the course of 2010. Similar conditions are likely to exist in a number of the Group's key markets, including those in the United States and Europe, particularly Ireland. These conditions have exerted, and may continue to exert, downward pressure on asset prices and on availability and cost of credit for financial institutions, including the company, and will continue to impact the credit quality of the Group's customers and counterparties. Such conditions, alone or in combination with regulatory changes or actions of other market participants, may cause the Group to incur losses or to experience further reductions in business activity, increased funding costs and funding pressures, lower share prices, decreased asset values, additional write-downs and impairment charges and lower profitability.

The performance of the Group may be affected by economic conditions impacting euro-zone member states. For example the financial problems experienced by the government of Greece, may lead to Greece issuing significant volumes of debt which may in turn reduce demand for debt issued by financial institutions and corporate borrowers. This could adversely affect the Group's access to the debt capital markets and may increase the Group's funding costs, having a negative impact on the Group's earnings and financial condition. In addition, euro-zone countries in which the Group operates may be required to provide financial assistance to Greece, which may in turn have a negative impact on the financial condition of those EU member states. Should the economic conditions facing Greece be replicated in other euro-zone member states, the risks above would be exacerbated.

In addition, the Group will continue to be exposed to the risk of loss if major corporate borrowers or counterparty financial institutions fail or are otherwise unable to meet their obligations. The Group currently experiences certain business sector and country concentration risk, primarily focused in the United States, the United Kingdom and the rest of Europe and relating to personal and banking and financial institution exposures. The Group's performance may also be affected by future recovery rates on assets and the historical assumptions underlying asset recovery rates, which (as has already occurred in certain instances) may no longer be accurate given the unprecedented market disruption and general economic instability. The precise nature of all the risks and uncertainties the Group faces as a result of current economic conditions cannot be predicted and many of these risks are outside the control of the Group.

The Group was required to obtain State Aid approval, for the aid given to the Group by HM Treasury and for the Group's State Aid restructuring plan, from the European Commission. The Group is subject to a variety of risks as a result of implementing the State Aid restructuring plan. The State Aid restructuring plan includes a prohibition on the making of discretionary dividend or coupon payments on existing hybrid capital instruments (including preference shares and B Shares) for a two-year period commencing no later than 30 April 2010, which may impair the Group's ability to raise new Tier 1 capital through the issuance of ordinary shares and other Securities.
The Group was required to obtain State Aid approval for the aid given to the Group by HM Treasury as part of the placing and open offer undertaken by the company in December 2008 (the "First Placing and Open Offer"), the issuance of £25.5 billion of B shares in the capital of the company which are, subject to certain terms and conditions, convertible into ordinary shares in the share capital of the company (the "B Shares") to HM Treasury, a contingent commitment by HM Treasury to subscribe for up to an additional £8 billion of B Shares if certain conditions are met and the Group's participation in the Asset Protection Scheme (the "APS") (the "State Aid").

As a result of the First Placing and Open Offer (approved as part of the European Commission's approval of a package of measures to the banking industry in the United Kingdom in October 2008), the Group was required to cooperate with HM Treasury to submit a forward plan to the

8

European Commission. This plan was submitted and detailed discussions took place between HM Treasury, the Group and the European Commission. The plan submitted not only had regard to the First Placing and Open Offer, but also the issuance of B Shares to HM Treasury, the commitment by HM Treasury to subscribe for additional B Shares if certain conditions were met and the Group's participation in the APS. As part of its review, the European Commission was required to assess the State Aid and to consider whether the Group's long-term viability would be assured, that the Group makes a sufficient contribution to the costs of its restructuring and that measures are taken to limit any distortions of competition arising from the State Aid provided to the Group by the United Kingdom Government. The Group, together with HM Treasury, agreed in principle with the European Competition Commissioner the terms of the State Aid and the terms of a restructuring plan (the "State Aid restructuring plan"). On 14 December 2009, the European Commission formally approved the Group's participation in the APS, the issuance of £25.5 billion of B Shares to HM Treasury, a contingent commitment by HM Treasury to subscribe for up to an additional £8 billion of B Shares and the State Aid restructuring plan. The prohibition on the making of discretionary dividend (including preference shares and B Shares) or coupon payments on existing hybrid capital instruments for a two-year period commencing no later than 30 April 2010 will prevent the company from paying dividends on its ordinary and preference shares and coupons on other Tier 1 securities for the same duration, and it may impair the Group's ability to raise new Tier 1 capital through the issuance of ordinary shares and other Securities.

It is possible a third party could challenge the approval decision in the European Courts (within specified time limits). The Group does not believe that any such challenge would be likely to succeed but, if it were to succeed, the European Commission would need to reconsider its decision, which might result in an adverse outcome for the Group, including a prohibition or amendment to some or all of the terms of the State Aid. The European Commission could also impose conditions that are more disadvantageous, potentially materially so, to the Group than those in the State Aid restructuring plan.

The Group is subject to a variety of risks as a result of implementing the State Aid restructuring plan. There is no assurance that the price that the Group receives for any assets sold pursuant to the State Aid restructuring plan will be at a level the Group considers adequate or which it could obtain in circumstances in which the Group was not required to sell such assets in order to implement the State Aid restructuring plan or if such sale were not subject to the restrictions (including in relation to potential purchasers of the United Kingdom branch divestment) contained in the terms thereof. Further, should the Group fail to complete any of the required disposals within the agreed timeframes for such disposals, under the terms of the State Aid clearance, a divestiture trustee can be empowered to conduct the disposals, with the mandate to complete the disposal at no minimum price.

Furthermore, if the Group is unable to comply with the terms of the State Aid approval it could constitute a misuse of aid. In circumstances where the European Commission doubts that the Group is complying with the terms of the State Aid approval, it may open a formal investigation. At the conclusion of this investigation, if the European Commission decides that there has been misuse of aid, it can issue a decision requiring HM Treasury to recover the misused aid which could have a material adverse impact on the Group.

In implementing the State Aid restructuring plan, the Group will lose existing customers, deposits and other assets (both directly through the sale and potentially through the impact on the rest of the Group's business arising from implementing the State Aid restructuring plan) and the potential for realising additional associated revenues and margins that it otherwise might have achieved in the absence of such disposals. Further, the loss of such revenues and related income may extend the time period over which the Group may pay any amounts owed to HM Treasury under the APS or otherwise. The implementation of the State Aid restructuring plan may also result in disruption to the retained business and give rise to significant strain on management, employee, operational and financial resources, impacting customers and giving rise to separation costs which could be substantial.

The implementation of the State Aid restructuring plan may result in the emergence of one or more new viable competitors or a material strengthening of one or more of the Group's competitors in the Group's markets. The effect of this on the Group's future competitive position, revenues and margins is uncertain and there could be an adverse effect on the Group's operations and financial condition and its business generally. If any or all of the risks described above, or any other currently unforeseen risks, materialise, there could be a materially negative impact on the Group's business, operations, financial condition, capital position and competitive position.

The Group's ability to implement its strategic plan depends on the success of the Group's refocus on its core strengths and the balance sheet reduction programme arising out of its previously announced non-core restructuring plan and the State Aid restructuring plan.

In light of the changed global economic outlook, the Group has embarked on a financial and core business restructuring which is focused on achieving appropriate risk-adjusted returns under these changed circumstances, reducing reliance on wholesale funding and lowering exposure to capital intensive businesses. A key part of this restructuring is the programme announced in February 2009 to run-down and sell the Group's non-core assets and the continued review of the Group's portfolio to identify further disposals of certain non-core assets. Assets identified for this purpose and allocated to the Group's Non-Core division totalled £252 billion, excluding derivatives, as at 31 December 2008. At 31 December 2009, this total had reduced to £187 billion, excluding the Group's interest in RBS Sempra Commodities LLP ("RBS Sempra Commodities"), which was transferred to the Non-Core division during 2009. This balance sheet reduction programme will continue alongside the disposals under the State Aid restructuring plan approved by the European Commission.

Because the ability to dispose of assets and the price achieved for such disposals will be dependent on prevailing economic and market conditions, which may remain challenging, there is no assurance that the Group will be able to sell or run-down (as applicable) those businesses it is seeking to exit either on favourable economic terms to the Group or at all. Furthermore, where transactions are entered into for the purpose of selling non-core assets and businesses, they may be subject to conditions precedent, including government and regulatory approvals and completion mechanics that in certain cases may entail consent from customers. There is no assurance that such conditions precedent will be satisfied, or consents and approvals obtained, in a timely manner or at all. There is consequently a risk that the Group may fail to complete such disposals by any agreed longstop date.

Furthermore, in the context of implementing the State Aid restructuring plan, the Group is subject to certain timing and other restrictions which may result in the sale of assets at prices below those which the Group would have otherwise agreed had the Group not been required to sell such assets as part of the State Aid restructuring plan or if such sale were not subject to the restrictions contained in the terms of the State Aid conditions.

In addition, the Group may be liable for any deterioration in businesses being sold between the announcement of the disposal and its completion. In certain cases, the period between the announcement of a transaction and its completion may be lengthy and may span many months. Other risks that may arise out of the disposal of the Group’s assets include ongoing liabilities up to completion of the relevant transaction in respect of the assets and businesses disposed of, commercial and other risks associated with meeting covenants to the buyer during the period up to completion, the risk of employee and customer attrition in the period up to completion, substantive indemnity obligations in favour of the buyer, the risk of liability for breach of warranty, the need to continue to provide transitional service arrangements for potentially lengthy periods following completion of the relevant transaction to the businesses being transferred and redundancy and other transaction costs. Further, the Group may be required to enter into covenants agreeing not to compete in certain markets for specific periods of time. In addition, as a result of the disposals, the Group will lose existing customers, deposits and other assets (both directly through the sale and potentially through the impact on the rest of the Group’s business arising from implementing the restructuring plans) and the potential for realising additional associated revenues and margins that it otherwise might have achieved in the absence of such disposals.

Any of the above factors, either in the context of State Aid-related or non-core or other asset disposals, could affect the Group's ability to implement its strategic plan and have a material adverse effect on the Group's business, results of operations, financial condition, capital ratios and liquidity and could result in a loss of value in the Securities.

The extensive organisational restructuring may adversely affect the Group’s business, results of operations and financial condition.

As part of its refocus on core strengths and its disposal programme, the Group has undertaken and continues to undertake extensive organisational restructuring involving the allocation of assets identified as non-core assets to a separate Non-Core Division, and the run-down and sale of those assets over a period of time. In addition, to comply with State Aid clearance, the Group agreed to undertake a series of measures to be implemented over a four-year period from December 2009, which include disposing of RBS Insurance (subject to potentially maintaining a minority interest until the end of 2014). the company will also divest by the end of 2013 Global Merchant Services, subject to the company retaining up to 20 per cent. of each business within Global Merchant Services if required by the purchaser, and its interest in RBS Sempra Commodities, as well as divesting the RBS branch-based business in England and Wales and the NatWest branches in Scotland, along with the direct small and medium-sized enterprise (“SME”) customers and certain mid-corporate customers across the United Kingdom. On 16 February 2010, the company announced that RBS Sempra Commodities had agreed to sell its Metals, Oil and European Energy business lines, subject to certain conditions including regulatory approvals. The Group and its joint venture partner, Sempra Energy, are continuing to consider ownership alternatives for the remaining North American Power and Gas businesses of RBS Sempra Commodities.

In order to implement the restructurings referred to above, various businesses and divisions within the Group will be re-organised, transferred or sold, or potentially merged with other businesses and divisions within the Group. As part of this process, personnel may be reallocated, where permissible, across the Group, new technology may be implemented, and new policies and procedures may be established in order to accommodate the new shape of the Group. As a result, the Group may experience a high degree of business interruption, significant restructuring charges, delays in implementation, and significant strain on management, employee, operational and financial resources. Any of the above factors could affect the Group’s ability to achieve its strategic objectives and have a material adverse effect on its business, results of operations and financial condition or could result in a loss of value in the Securities.

Lack of liquidity is a risk to the Group’s business and its ability to access sources of liquidity has been, and will continue to be, constrained.

Liquidity risk is the risk that a bank will be unable to meet its obligations, including funding commitments, as they fall due. This risk is inherent in banking operations and can be heightened by a number of enterprise specific factors, including an over-reliance on a particular source of funding (including, for example, short-term and overnight funding), changes in credit ratings or market-wide phenomena such as market dislocation and major disasters. During the course of 2008 and 2009, credit markets worldwide experienced a severe reduction in liquidity and term-funding. During this time, perception of counterparty risk between banks also increased significantly. This increase in perceived counterparty risk also led to reductions in inter-bank lending, and hence, in common with many other banking groups, the Group’s access to traditional sources of liquidity has been, and may continue to be, restricted.

The Group’s liquidity management focuses on maintaining a diverse and appropriate funding strategy for its assets, controlling the mismatch of maturities and carefully monitoring its undrawn commitments and contingent liabilities. However, the Group’s ability to access sources of liquidity (for example, through the issue or sale of financial and other instruments or through the use of term loans) during the recent period of liquidity stress has been constrained to the point where it, like other banks, has had to rely on shorter term and overnight funding with a consequent reduction in overall liquidity, and to increase its recourse to liquidity schemes provided by central banks. While during the course of 2009 money market conditions improved, with the Group seeing a material reduction of funding from central banks and the issuance of non-government guaranteed term debt, further tightening of credit markets could have a negative impact on the Group. The Group, in line with other financial institutions, may need to seek funds from alternative sources, potentially at higher costs of funding than has previously been the case.

In addition, there is also a risk that corporate and institutional counterparties with credit exposures may look to reduce all credit exposures to banks, given current risk aversion trends. It is possible that credit market dislocation becomes so severe that overnight funding from non-government sources ceases to be available.

Like many banking groups, the Group relies on customer deposits to meet a considerable portion of its funding. Furthermore, as part of its ongoing strategy to improve its liquidity position, the Group is actively seeking to increase the proportion of its funding represented by customer deposits. However, such deposits are subject to fluctuation due to certain factors outside the Group’s control, such as a loss of confidence, increasing competitive pressures or the encouraged or mandated repatriation of deposits by foreign wholesale or central bank depositors, which could result in a significant outflow of deposits within a short period of time. There is currently heavy competition among United Kingdom banks for retail customer deposits, which has increased the cost of procuring new deposits and impacted the Group’s ability to grow its deposit base. An inability to grow, or any material decrease in, the Group’s deposits could, particularly if accompanied by one of the other factors described above, have a negative impact on the Group’s ability to satisfy its liquidity needs unless corresponding actions were taken to improve the liquidity profile of other deposits or to reduce assets. In particular, the liquidity position of the Group may be negatively impacted if it is unable to achieve the run-off and sale of non-core and other assets as expected. Any significant delay in those plans may require the Group to consider disposal of other assets not previously identified for disposal to achieve its funded balance sheet target level.

The governments of some of the countries in which the Group operates have taken steps to guarantee the liabilities of the banks and branches operating in their respective jurisdiction. Whilst in some instances the operations of the Group are covered by government guarantees alongside other local banks, in other countries this may not necessarily always be the case. This may place the Group's subsidiaries operating in those countries, such as Ulster Bank Ireland Ltd, which did not participate in such government guarantee schemes, at a competitive disadvantage to the other local banks and therefore may require the Group to provide additional funding and liquidity support to these operations.

There can be no assurance that these measures, alongside other available measures, will succeed in improving the funding and liquidity in the markets in which the Group operates, or that these measures, combined with any increased cost of any funding currently available in the market, will not lead to a further increase in the Group's overall cost of funding, which could have an adverse impact on the Group's financial condition and results of operations or result in a loss of value in the Securities.

Governmental support schemes may be subject to cancellation, change or withdrawal or may fail to be renewed, which may have a negative impact on the availability of funding in the markets in which the Group operates.
Governmental support schemes may be subject to cancellation, change or withdrawal (on a general or individual basis, subject to relevant contracts) or may fail to be renewed, based on changing economic and political conditions in the jurisdiction of the relevant scheme. To the extent government support schemes are cancelled, changed or withdrawn in a manner which diminishes their effectiveness, or to the extent such schemes fail to generate additional liquidity or other support in the relevant markets in which such schemes operate, the Group, in common with other banking groups, may continue to face limited access to, have insufficient access to, or incur higher costs associated with, funding alternatives, which could have a material adverse impact on the Group's business, financial condition, results of operations and prospects or result in a loss of value in the Securities.

The financial performance of the Group has been and will be affected by borrower credit quality.
Risks arising from changes in credit quality and the recoverability of loans and amounts due from counterparties are inherent in a wide range of the Group's businesses. Whilst some economies stabilised over the course of 2009, the Group may continue to see adverse changes in the credit quality of its borrowers and counterparties, for example, as a result of their inability to refinance their indebtedness, with increasing delinquencies, defaults and insolvencies across a range of sectors (such as the personal and banking and financial institution sectors) and in a number of geographies (such as the United Kingdom, the United States, the Middle East and the rest of Europe, particularly Ireland). This trend has led and may lead to further and accelerated impairment charges, higher costs, additional write-downs and losses for the Group or result in a loss of value in the Securities.

The actual or perceived failure or worsening credit of the Group's counterparties has adversely affected and could continue to adversely affect the Group.
The Group's ability to engage in routine funding transactions has been and will continue to be adversely affected by the actual or perceived failure or worsening credit of its counterparties, including other financial institutions and corporate borrowers. The Group has exposure to many different industries and counterparties and routinely executes transactions with counterparties in the financial industry, including brokers and dealers, commercial banks, investment banks, mutual and hedge funds and other institutional clients. As a result, defaults by, or even the perceived creditworthiness of or concerns about, one or more corporate borrowers, financial services institutions or the financial services industry generally, have led to market-wide liquidity problems, losses and defaults and could lead to further losses or defaults, by the Group or by other institutions. Many of these transactions expose the Group to credit risk in the event of default of the Group's counterparty or client and the Group does have significant exposures to certain individual counterparties (including counterparties in certain weakened sectors and markets). In addition, the Group's credit risk is exacerbated when the collateral it holds cannot be realised or is liquidated at prices not sufficient to

recover the full amount of the loan or derivative exposure that is due to the Group, which is most likely to occur during periods of illiquidity and depressed asset valuations, such as those recently experienced. Any such losses could have a material adverse effect on the Group's results of operations and financial condition or result in a loss of value in the Securities.

The Group's earnings and financial condition have been, and its future earnings and financial condition may continue to be, affected by depressed asset valuations resulting from poor market conditions.
Financial markets continue to be subject to significant stress conditions, where steep falls in perceived or actual asset values have been accompanied by a severe reduction in market liquidity, as exemplified by recent events affecting asset-backed collateralised debt obligations, residential mortgage-backed securities and the leveraged loan market. In dislocated markets, hedging and other risk management strategies have proven not to be as effective as they are in normal market conditions due in part to the decreasing credit quality of hedge counterparties, including monoline and other insurance companies and credit derivative product companies. Severe market events have resulted in the Group recording large write-downs on its credit market exposures in 2007, 2008 and 2009. Any deterioration in economic and financial market conditions could lead to further impairment charges and write-downs. Moreover, market volatility and illiquidity (and the assumptions, judgements and estimates in relation to such matters that may change over time and may ultimately not turn out to be accurate) make it difficult to value certain of the Group's exposures. Valuations in future periods, reflecting, among other things, then-prevailing market conditions and changes in the credit ratings of certain of the Group's assets, may result in significant changes in the fair values of the Group's exposures, even in respect of exposures, such as credit market exposures, for which the Group has previously recorded write-downs. In addition, the value ultimately realised by the Group may be materially different from the current or estimated fair value. Any of these factors could require the Group to recognise further significant write-downs or realise increased impairment charges, any of which may adversely affect its capital position, its financial condition and its results of operations or result in a loss of value in the Securities.

Further information about the write-downs which the Group has incurred and the assets it has reclassified can be found in the Risk, capital and liquidity management section of the Business review.

The value or effectiveness of any credit protection that the Group has purchased from monoline and other insurers and other market counterparties (including credit derivative product companies) depends on the value of the underlying assets and the financial condition of the insurers and such counterparties.
The Group has credit exposure arising from over-the-counter derivative contracts, mainly credit default swaps ("CDSs"), which are carried at fair value. The fair value of these CDSs, as well as the Group's exposure to the risk of default by the underlying counterparties, depends on the valuation and the perceived credit risk of the instrument against which protection has been bought. Since 2007, monoline and other insurers and other market counterparties (including credit derivative product companies) have been adversely affected by their exposure to residential mortgage linked and corporate credit products, whether synthetic or otherwise, and their actual and perceived creditworthiness has deteriorated

rapidly, which may continue. If the financial condition of these counterparties or their actual or perceived creditworthiness deteriorates further, the Group may record further credit valuation adjustments on the credit protection bought from these counterparties under the CDSs in addition to those already recorded and such adjustments may have a material adverse impact on the Group's financial condition and results of operations.

Changes in interest rates, foreign exchange rates, credit spreads, bond, equity and commodity prices and other market factors have significantly affected and will continue to affect the Group's business.
Some of the most significant market risks the Group faces are interest rate, foreign exchange, credit spread, bond, equity and commodity price risks. Changes in interest rate levels, yield curves and spreads may affect the interest rate margin realised between lending and borrowing costs, the effect of which may be heightened during periods of liquidity stress, such as those experienced in the past year. Changes in currency rates, particularly in the sterling-US dollar and sterling-euro exchange rates, affect the value of assets, liabilities, income and expenses denominated in foreign currencies and the reported earnings of the company's non-United Kingdom subsidiaries (principally Citizens Financial Group, Inc. ("Citizens") and RBS Securities Inc.) and may affect income from foreign exchange dealing. The performance of financial markets may affect bond, equity and commodity prices and, therefore, cause changes in the value of the Group's investment and trading portfolios. This has been the case during the period since August 2007, with market disruptions and volatility resulting in significant reductions in the value of such portfolios. While the Group has implemented risk management methods to mitigate and control these and other market risks to which it is exposed, it is difficult, particularly in the current environment, to predict with accuracy changes in economic or market conditions and to anticipate the effects that such changes could have on the Group's financial performance and business operations.

The Group's borrowing costs and its access to the debt capital markets depend significantly on its and the United Kingdom Government's credit ratings.
The company and other Group members have been subject to a number of downgrades in the recent past. Any future reductions in the long-term or short-term credit ratings of the company or one of its principal subsidiaries (particularly RBS) would further increase its borrowing costs, require the Group to replace funding lost due to the downgrade, which may include the loss of customer deposits, and may also limit the Group's access to capital and money markets and trigger additional collateral requirements in derivatives contracts and other secured funding arrangements. Furthermore, given the extent of the United Kingdom Government ownership and support provided to the Group through HM Treasury's guarantee scheme (announced by the United Kingdom Government on 8 October 2008) (the "Credit Guarantee Scheme"), any downgrade in the United Kingdom Government's credit ratings could adversely affect the Group's own credit ratings and may have the effects noted above. All credit rating agencies have reaffirmed the United Kingdom Government's AAA rating, although S&P changed its outlook to "negative" on 21 May 2009. Fitch reaffirmed the United Kingdom Government's stable outlook on 31 July 2009 and Moody's reiterated the United Kingdom Government's stable outlook on 26 October 2009. Credit ratings of the company, RBS, ABN AMRO Holding N.V. (which was renamed "RBS Holdings N.V." on 1 April 2010) ("ABN AMRO"), The Royal Bank of Scotland N.V. (which was renamed from "ABN AMRO Bank N.V." on 6 February 2010), Ulster Bank and Citizens are also important to the Group when competing in certain markets, such as over-the-counter derivatives. As a result, any further reductions in the company's long-term or short-term credit ratings or those of its principal subsidiaries could adversely affect the Group's access to liquidity and competitive position, increase its funding costs and have a negative impact on the Group's earnings and financial condition or result in a loss of value in the Securities.

The Group's business performance could be adversely affected if its capital is not managed effectively or if there are changes to capital adequacy and liquidity requirements.

Effective management of the Group's capital is critical to its ability to operate its businesses, to grow organically and to pursue its strategy of returning to standalone strength. The Group is required by regulators in the United Kingdom, the United States and in other jurisdictions in which it undertakes regulated activities, to maintain adequate capital resources. The maintenance of adequate capital is also necessary for the Group's financial flexibility in the face of continuing turbulence and uncertainty in the global economy. Accordingly, the purpose of the issuance of the £25.5 billion of B Shares, the grant of the Contingent Subscription (as defined below) and the previous placing and open offers was to allow the Group to strengthen its capital position. The FSA's recent liquidity policy statement articulates that firms must hold sufficient eligible securities to survive a liquidity stress and this will result in banks holding a greater amount of government securities, to ensure that these institutions have adequate liquidity in times of financial stress.

In addition, on 17 December 2009, the Basel Committee on Banking Supervision (the "Basel Committee") proposed a number of fundamental reforms to the regulatory capital framework in its consultative document entitled "Strengthening the resilience of the banking sector". If the proposals made by the Basel Committee are implemented, these could result in the Group being subject to significantly higher capital requirements. The proposals include: (a) the build-up of a counter-cyclical capital buffer in excess of the regulatory minimum capital requirement, which is large enough to enable the Group to remain above the minimum capital requirement in the face of losses expected to be incurred in a feasibly severe downturn; (b) an increase in the capital requirements for counterparty risk exposures arising from derivatives, repo-style transactions and securities financing transactions; (c) the imposition of a leverage ratio as a supplementary measure to the existing Basel II risk-based measure; (d) the phasing out of hybrid capital instruments as Tier 1 capital and the requirement that the predominant form of Tier 1 capital must be common shares and retained earnings; and (e) the imposition of global minimum liquidity standards that include a requirement to hold a stock of unencumbered high quality liquid assets sufficient to cover cumulative net cash outflows over a 30-day period under a prescribed stress scenario. The proposed reforms are subject to a consultative process and an impact assessment and are not likely to be implemented before the end of 2012. The Basel Committee will also consider appropriate transition and grandfathering arrangements.

These and other future changes to capital adequacy and liquidity requirements in the jurisdictions in which it operates may require the Group to raise additional Tier 1, Core Tier 1 and Tier 2 capital by way of further issuances of securities, including in the form of Ordinary Shares or B Shares and could result in existing Tier 1 and Tier 2 securities issued by the Group ceasing to count towards the Group's regulatory capital, either at the same level as present or at all. The requirement to raise additional Core Tier 1 capital could have a number of negative consequences for the company and its shareholders, including impairing the company's ability to pay dividends on or make other distributions in respect of Ordinary Shares and diluting the ownership of existing shareholders of the company. If the Group is unable to raise the requisite Tier 1 and Tier 2 capital, it may be required to further reduce the amount of its risk-weighted assets and engage in the disposition of core and other non-core businesses, which may not occur on a timely basis or achieve prices which would otherwise be attractive to the Group. In addition, pursuant to the State Aid approval, should the Group's Core Tier 1 capital ratio decline to below 5 per cent. at any time before 31 December 2014, or should the Group fall short of its funded balance sheet target level (after adjustments) for 31 December 2013 by £30 billion or more, the Group will be required to reduce its risk-weighted assets by a further £60 billion in excess of its plan through further disposals of identifiable businesses and their associated assets. As provided in the Acquisition and Contingent Capital Agreement (as defined below), the Group would also be subject to restrictions on payments on its hybrid capital instruments should its Core Tier 1 ratio fall below 6 per cent. or if it would fall below 6 per cent. as a result of such payment.

As at 31 December 2009, the Group's Tier 1 and Core Tier 1 capital ratios were 14.1 per cent. and 11.0 per cent., respectively, calculated in accordance with FSA definitions (see page 69). Any change that limits the Group's ability to manage effectively its balance sheet and capital resources going forward (including, for example, reductions in profits and retained earnings as a result of write-downs or otherwise, increases in risk-weighted assets, delays in the disposal of certain assets or the inability to syndicate loans as a result of market conditions, a growth in unfunded pension exposures or otherwise) or to access funding sources, could have a material adverse impact on its financial condition and regulatory capital position or result in a loss of value in the Securities.

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.
Under IFRS, the Group recognises at fair value: (i) financial instruments classified as "held-for-trading" or "designated as at fair value through profit or loss"; (ii) financial assets classified as "available-for-sale"; and (iii) derivatives. Generally, to establish the fair value of these instruments, the Group relies on quoted market prices or, where the market for a financial instrument is not sufficiently active, internal valuation models that utilise observable market data. In certain circumstances, the data for individual financial instruments or classes of financial instruments utilised by such valuation models may not be available or may become unavailable due to changes in market conditions, as has been the case during the recent financial crisis. In such circumstances, the Group's internal valuation models require the Group to make assumptions, judgements and estimates to establish fair value. In common with other financial institutions, these internal valuation models are complex, and the assumptions, judgements and estimates the Group is required to make often relate to matters that are inherently uncertain, such as expected cash flows, the ability of borrowers to service debt, residential and commercial property price appreciation and depreciation, and relative levels of defaults and deficiencies. Such assumptions, judgements and estimates may need to be updated to reflect changing facts, trends and market conditions. The resulting change in the fair values of the financial instruments has had and could continue to have a material adverse effect on the Group's earnings and financial condition. Also, recent market volatility and illiquidity have challenged the factual bases of certain underlying assumptions and have made it difficult to value certain of the Group's financial instruments. Valuations in future periods, reflecting prevailing market conditions, may result in further significant changes in the fair values of these instruments, which could have a negative effect on the Group's results of operations and financial condition or result in a loss of value in the Securities.

The Group operates in markets that are highly competitive and consolidating. If the Group is unable to perform effectively, its business and results of operations will be adversely affected.
Recent consolidation among banking institutions in the United Kingdom, the United States and throughout Europe is changing the competitive landscape for banks and other financial institutions. If financial markets continue to be volatile, more banks may be forced to consolidate. This consolidation, in combination with the introduction of new entrants into the United States and United Kingdom markets from other European and Asian countries, could increase competitive pressures on the Group. In addition, certain competitors may have access to lower cost funding and/or be able to offer retail deposits on more favourable terms than the Group and may have stronger multi-channel and more efficient operations as a result of greater historical investments. Furthermore, the Group's competitors may be better able to attract and retain clients and talent, which may have a negative impact on the Group's relative performance and future prospects.

Furthermore, increased government ownership of, and involvement in, banks generally may have an impact on the competitive landscape in the major markets in which the Group operates. Although, at present, it is difficult to predict what the effects of this increased government ownership and involvement will be or how they will differ from jurisdiction to jurisdiction, such involvement may cause the Group to experience stronger competition for corporate, institutional and retail clients and greater pressure on profit margins. Future disposals and restructurings by the Group and the compensation structure and restrictions imposed on the Group may also have an impact on its ability to compete effectively. Since the markets in which the Group operates are expected to remain highly competitive in all areas, these and other changes to the competitive landscape could adversely affect the Group's business, margins, profitability and financial condition or result in a loss of value in the Securities.

As a condition to HM Treasury support, the company has agreed to certain undertakings which may serve to limit the RBS Group's operations.
Under the terms of the First Placing and Open Offer, the company provided certain undertakings aimed at ensuring that the subscription by HM Treasury of the relevant ordinary shares and preference shares and the RBS Group's participation in the Credit Guarantee Scheme offered by HM Treasury as part of its support for the United Kingdom banking industry are compatible with the common market under EU law. These undertakings include (i) supporting certain initiatives in relation to mortgage lending and lending to SMEs until 2011, (ii) regulating management remuneration and (iii) regulating the rate of growth of the RBS Group's balance sheet. Under the terms of the placing and open offer undertaken by the company in April 2009, the RBS Group's undertakings in relation to mortgage lending and lending to SMEs were extended to larger commercial and industrial companies in the United Kingdom. Pursuant to these arrangements, the company agreed to make available to creditworthy borrowers on commercial terms, £16 billion above the amount the company had budgeted to lend to United Kingdom businesses and £9 billion above the amount the company had budgeted to lend to United Kingdom homeowners in the year commencing 1 March 2009.

In relation to the 2009 commitment period, which ended on 28 February 2010, the RBS Group's net mortgage lending to UK homeowners was £12.7 billion above the amount it had originally budgeted to lend. In relation to its business lending commitment, the RBS Group achieved £60 billion of gross new lending to businesses, including £39 billion to SMEs but, in the economic environment prevailing at the time, many customers were strongly focused on reducing their borrowings and repayments consequently increased. Moreover, the withdrawal of foreign lenders was less pronounced than anticipated, there was a sharp increase in capital market issuance and demand continued to be weak. As a result, the RBS Group's net lending did not reach the £16 billion targeted.

In March 2010, the company agreed with the United Kingdom government certain adjustments to the lending commitments for the 2010 commitment period (the 12 month period commencing 1 March 2010), to reflect expected economic circumstances over the period. As part of the amended lending commitments, the company has committed, among other things, to make available gross new facilities, drawn or undrawn, of £50 billion to UK businesses in the period 1 March 2010 to 28 February 2011. In addition, the company has agreed with the United Kingdom government to make available £8 billion of net mortgage lending in the 2010 commitment period. This is a decrease of £1 billion on the net mortgage lending target that previously applied to the 2010 commitment period which ends on 28 February 2011, to reflect that the mortgage lending commitment for the 2009 commitment period was increased from £9 billion to £10 billion.

The RBS Group has also agreed to certain other commitments, which are material for the structure of the RBS Group and its operations, under the State Aid restructuring plan approved by the European Commission in relation to State Aid.

In addition, the RBS Group, together with HM Treasury, has agreed with the European Commission a prohibition on the making of discretionary dividends (including on preference shares and B Shares) or coupon payments on existing hybrid capital instruments for a two-year period from a date commencing no later than 30 April 2010 (which the RBS Group has subsequently announced shall be 30 April 2010). It is possible that the RBS Group may, in future, be subject to further restrictions on payments on such hybrid capital instruments, whether as a result of undertakings given to regulatory bodies, changes to capital requirements such as the proposals published by the Basel Committee on 17 December 2009 or otherwise. The RBS Group has also agreed to certain other undertakings in the Acquisition and Contingent Capital Agreement.

The undertakings described above may serve to limit the RBS Group's operations. See "HM Treasury (or UKFI on its behalf) may be able to exercise a significant degree of influence over the Group."

The Group could fail to attract or retain senior management, which may include members of the Board, or other key employees, and it may suffer if it does not maintain good employee relations.
The Group's ability to implement its strategy depends on the ability and experience of its senior management, which may include directors, and other key employees. The loss of the services of certain key employees, particularly to competitors, could have a negative impact on the Group's business. The Group's future success will also depend on its ability to attract, retain and remunerate highly skilled and qualified personnel competitively with its peers. This cannot be guaranteed, particularly in light of heightened regulatory oversight of banks and heightened scrutiny of, and (in some cases) restrictions placed upon, management compensation arrangements, in particular those in receipt of Government funding (such as the company). The Group has made a commitment to comply with the FSA Remuneration Code. These rules came into force on 1 January 2010 and are in line with the agreement reached by the G-20, setting global standards for the implementation of the Financial Stability Board's remuneration principles. The Group agreed that it will be at the leading edge of implementing the G-20 principles and granted UK Financial Investments Limited ("UKFI") consent rights over the shape and size of its aggregate bonus pool for the 2009 performance year. The level of the 2009 bonus pool and the deferral and claw-back provisions implemented by the Group may impair the ability of the Group to attract and retain suitably qualified personnel in various parts of the Group's businesses.

The Group is also altering certain of the pension benefits it offers to staff. Some employees continue to participate in defined benefit arrangements. The following two changes have been made to the main defined benefit pension plans: (i) a yearly limit on the amount of any salary increase that will count for pension purposes; and (ii) a reduction in the severance lump sum for those who take an immediate undiscounted pension for redundancy. In addition to the effects of such measures on the Group's ability to retain senior management and other key employees, the marketplace for skilled personnel is becoming more competitive, which means the cost of hiring, training and retaining skilled personnel may continue to increase. The failure to attract or retain a sufficient number of appropriately skilled personnel could place the Group at a significant competitive disadvantage and prevent the Group from successfully implementing its strategy, which could have a material adverse effect on the Group's financial condition and results of operations or result in a loss of value in the Securities.

In addition, certain of the Group's employees in the United Kingdom, continental Europe and other jurisdictions in which the Group operates are represented by employee representative bodies, including trade unions. Engagement with its employees and such bodies is important to the Group and a breakdown of these relationships could adversely affect the Group's business, reputation and results. As the Group implements cost-saving initiatives and disposes of, or runs-down, certain assets or businesses (including as part of its expected restructuring plans), it faces increased risk in this regard and there can be no assurance that the Group will be able to maintain good relations with its employees or employee representative bodies in respect of all matters. As a result, the Group may experience strikes or other industrial action from time to time, which could have a material adverse effect on its business and results of operations and could cause damage to its reputation.

Each of the Group's businesses is subject to substantial regulation and oversight. Any significant regulatory developments could have an effect on how the Group conducts its business and on its results of operations and financial condition.

The Group is subject to financial services laws, regulations, corporate governance requirements, administrative actions and policies in each location in which it operates. All of these are subject to change, particularly in the current market environment, where there have been unprecedented levels of government intervention and changes to the regulations governing financial institutions, including recent nationalisations in the United States, the United Kingdom and other European countries. As a result of these and other ongoing and possible future changes in the financial services regulatory landscape (including requirements imposed by virtue of the Group's participation in government or regulator-led initiatives), the Group expects to face greater regulation in the United Kingdom, the United States and other countries in which it operates, including throughout the rest of Europe. Compliance with such regulations may increase the Group's capital requirements and costs and have an adverse impact on how the Group conducts its business, on the products and services it offers, on the value of its assets and on its results of operations and financial condition or result in a loss of value in the Securities.

Other areas where governmental policies and regulatory changes could have an adverse impact include, but are not limited to:

- the monetary, interest rate, capital adequacy, liquidity, balance sheet leverage and other policies of central banks and regulatory authorities;
- general changes in government or regulatory policy or changes in regulatory regimes that may significantly influence investor decisions in particular markets in which the Group operates, increase the costs of doing business in those markets or result in a reduction in the credit ratings of the company or one of its subsidiaries;
- changes to financial reporting standards;
- changes in regulatory requirements relating to capital and liquidity, such as limitations on the use of deferred tax assets in calculating Core Tier 1 and/or Tier 1 capital, or prudential rules relating to the capital adequacy framework;

- other general changes in the regulatory requirements, such as the imposition of onerous compliance obligations, restrictions on business growth or pricing, new levies or fees, requirements in relation to the structure and organisation of the Group and requirements to operate in a way that prioritises objectives other than shareholder value creation;

- changes in competition and pricing environments;

- further developments in financial reporting, corporate governance, corporate structure, conduct of business and employee compensation;

- differentiation among financial institutions by governments with respect to the extension of guarantees to bank customer deposits and the terms attaching to such guarantees, including requirements for the entire Group to accept exposure to the risk of any individual member of the Group, or even third party participants in guarantee schemes, failing;

- implementation of, or costs related to, local customer or depositor compensation or reimbursement schemes;

- transferability and convertibility of currency risk;

- expropriation, nationalisation and confiscation of assets;

- changes in legislation relating to foreign ownership; and

- other unfavourable political, military or diplomatic developments producing social instability or legal uncertainty which, in turn, may affect demand for the Group’s products and services.

The Group’s results have been and could be further adversely affected in the event of goodwill impairment.
The Group capitalises goodwill, which is calculated as the excess of the cost of an acquisition over the net fair value of the identifiable assets, liabilities and contingent liabilities acquired. Acquired goodwill is recognised initially at cost and subsequently at cost less any accumulated impairment losses. As required by IFRS, the Group tests goodwill for impairment annually or more frequently, at external reporting dates, when events or circumstances indicate that it might be impaired. An impairment test involves comparing the recoverable amount (the higher of value in use and fair value less cost to sell) of an individual cash generating unit with its carrying value. The value in use and fair value of the Group’s cash generating units are affected by market conditions and the performance of the economies in which the Group operates. Where the Group is required to recognise a goodwill impairment, it is recorded in the Group’s income statement, although it has no effect on the Group’s regulatory capital position. For the year ended 31 December 2009, the Group recorded a £363 million accounting write down of goodwill and other intangibles relating to prior year acquisitions (see page 257).

The Group may be required to make further contributions to its pension schemes if the value of pension fund assets is not sufficient to cover potential obligations.
The Group maintains a number of defined benefit pension schemes for past and a number of current employees. Pensions risk is the risk that the liabilities of the Group’s various defined benefit pension schemes which are long term in nature will exceed the schemes’ assets, as a result of which the Group is required or chooses to make additional contributions to the schemes. The schemes’ assets comprise investment portfolios that are held to meet projected

liabilities to the scheme members. Risk arises from the schemes because the value of these asset portfolios and returns from them may be less than expected and because there may be greater than expected increases in the estimated value of the schemes' liabilities. In these circumstances, the Group could be obliged, or may choose, to make additional contributions to the schemes, and during recent periods, the Group has voluntarily made such contributions. Given the current economic and financial market difficulties and the prospect that they may continue over the near and medium term, the Group may experience increasing pension deficits or be required or elect to make further contributions to its pension schemes and such deficits and contributions could be significant and have a negative impact on the Group's capital position, results of operations or financial condition or result in a loss of value in the Securities. The next funding valuation of the Group's major defined benefit pension plan, The Royal Bank of Scotland Group Pension Fund, will take place with an effective date of 31 March 2010.

The Group is and may be subject to litigation and regulatory investigations that may impact its business.
The Group's operations are diverse and complex, and it operates in legal and regulatory environments that expose it to potentially significant litigation, regulatory investigation and other regulatory risk. As a result, the Group is, and may in the future be, involved in various disputes, legal proceedings and regulatory investigations in the United Kingdom, the EU, the United States and other jurisdictions, including class action litigation, anti-money laundering investigations and review by the European Commission under State Aid rules. Furthermore, the Group, like many other financial institutions, has come under greater regulatory scrutiny over the last year and expects that environment to continue for the foreseeable future, particularly as it relates to compliance with new and existing corporate governance, employee compensation, conduct of business, anti-money laundering and anti-terrorism laws and regulations, as well as the provisions of applicable sanctions programmes. Disputes, legal proceedings and regulatory investigations are subject to many uncertainties, and their outcomes are often difficult to predict, particularly in the earlier stages of a case or investigation. Adverse regulatory action or adverse judgments in litigation could result in restrictions or limitations on the Group's operations or result in a material adverse effect on the Group's reputation or results of operations or result in a loss of value in the Securities. For details about certain litigation and regulatory investigations in which the Group is involved, see Note 32 on the Financial statements.

Operational risks are inherent in the Group's operations.
The Group's operations are dependent on the ability to process a very large number of transactions efficiently and accurately while complying with applicable laws and regulations where it does business. The Group has complex and geographically diverse operations and operational risk and losses can result from internal and external fraud, errors by employees or third parties, failure to document transactions properly or to obtain proper authorisation, failure to comply with applicable regulatory requirements and conduct of business rules (including those arising out of anti-money laundering and anti-terrorism legislation, as well as the provisions of applicable sanctions programmes), equipment failures, natural disasters or the inadequacy or failure of systems and controls, including those of the Group's suppliers or counterparties. Although the Group has

implemented risk controls and loss mitigation actions, and substantial resources are devoted to developing efficient procedures, to identify and rectify weaknesses in existing procedures and to train staff, it is not possible to be certain that such actions have been or will be effective in controlling each of the operational risks faced by the Group. Any weakness in these systems or controls, or any breaches or alleged breaches of applicable laws or regulations, could have a materially negative impact on the Group’s business, reputation and results of operations and the price of any Securities. Notwithstanding anything contained in this risk factor, it should not be taken as implying that the company will be unable to comply with its obligations as a company with securities admitted to the Official List of the United Kingdom Listing Authority (the “Official List”) nor that it, or its relevant subsidiaries, will be unable to comply with its or their obligations as supervised firms regulated by the FSA.

The Group is exposed to the risk of changes in tax legislation and its interpretation and to increases in the rate of corporate and other taxes in the jurisdictions in which it operates.
The Group’s activities are subject to tax at various rates around the world computed in accordance with local legislation and practice. Action by governments to increase tax rates or to impose additional taxes or to restrict the tax reliefs currently available to the Group would reduce the Group’s profitability. Revisions to tax legislation or to its interpretation might also affect the Group’s results in the future.

HM Treasury (or UKFI on its behalf) may be able to exercise a significant degree of influence over the Group.
UKFI manages HM Treasury’s shareholder relationship with the company. Although HM Treasury has indicated that it intends to respect the commercial decisions of the Group and that the Group will continue to have its own independent board of directors and management team determining its own strategy, should its current intentions change, HM Treasury's position as a majority shareholder (and UKFI’s position as manager of this shareholding) means that HM Treasury or UKFI may be able to exercise a significant degree of influence over, among other things, the election of directors and the appointment of senior management. In addition, as the provider of the APS, HM Treasury has a range of rights that other shareholders do not have. These include rights under the terms of the APS over the Group's remuneration policy and practice. The manner in which HM Treasury or UKFI exercises HM Treasury’s rights as majority shareholder or in which HM Treasury exercises its rights under the APS could give rise to conflict between the interests of HM Treasury and the interests of other shareholders. The Board has a duty to promote the success of the company for the benefit of its members as a whole.

The Group’s insurance businesses are subject to inherent risks involving claims.
Future claims in the Group’s general and life assurance business may be higher than expected as a result of changing trends in claims experience resulting from catastrophic weather conditions, demographic developments, changes in the nature and seriousness of claims made, changes in mortality, changes in the legal and compensatory landscape and other causes outside the Group’s control. These trends could affect the profitability of current and future insurance products and services. The Group reinsures some of the risks it has assumed and is accordingly exposed to the risk of loss should its reinsurers become unable or unwilling to pay claims made by the Group against them.

The Group’s operations have inherent reputational risk.
Reputational risk, meaning the risk to earnings and capital from negative public opinion, is inherent in the Group’s business. Negative public opinion can result from the actual or perceived manner in which the Group conducts its business activities, from the Group’s financial performance, from the level of direct and indirect government support or from actual or perceived practices in the banking and financial industry. Negative public opinion may adversely affect the Group’s ability to keep and attract customers and, in particular, corporate and retail depositors. The Group cannot ensure that it will be successful in avoiding damage to its business from reputational risk.

In the United Kingdom and in other jurisdictions, the Group is responsible for contributing to compensation schemes in respect of banks and other authorised financial services firms that are unable to meet their obligations to customers. In the United Kingdom, the Financial Services Compensation Scheme (the "Compensation Scheme") was established under the FSMA and is the United Kingdom's statutory fund of last resort for customers of authorised financial services firms. The Compensation Scheme can pay compensation to customers if a firm is unable, or likely to be unable, to pay claims against it and may be required to make payments either in connection with the exercise of a stabilisation power or in exercise of the bank insolvency procedures under the Banking Act. The Compensation Scheme is funded by levies on firms authorised by the FSA, including the Group. In the event that the Compensation Scheme raises funds from the authorised firms, raises those funds more frequently or significantly increases the levies to be paid by such firms, the associated costs to the Group may have a material impact on its results of operations and financial condition. During the financial year ended 31 December 2009, the Group has accrued £135 million for its share of Compensation Scheme management expenses levies for the 2009/10 and 2010/2011 Compensation Scheme years.

In addition, to the extent that other jurisdictions where the Group operates have introduced or plan to introduce similar compensation, contributory or reimbursement schemes (such as in the United States with the Federal Deposit Insurance Corporation), the Group may make further provisions and may incur additional costs and liabilities, which may negatively impact its financial condition and results of operations or result in a loss of value in the Securities.

The Group's business and earnings may be affected by geopolitical conditions.
The performance of the Group is significantly influenced by the geopolitical and economic conditions prevailing at any given time in the countries in which it operates, particularly the United Kingdom, the United States and other countries in Europe and Asia. For example, the Group has a presence in countries where businesses could be exposed to the risk of business interruption and economic slowdown following the outbreak of a pandemic, or the risk of sovereign default following the assumption by governments of the obligations of private sector institutions. Similarly, the Group faces the heightened risk of trade barriers, exchange controls and other measures taken by sovereign governments which may impact a borrower's ability to repay. Terrorist acts and threats and the response to them of governments in any of these countries could also adversely affect levels of economic activity and have an adverse effect upon the Group's business.

The restructuring proposals for ABN AMRO are complex and may not realise the anticipated benefits for the Group.
The restructuring plan in place for the integration and separation of ABN AMRO (called The Royal Bank of Scotland N.V. with effect from 6 February 2010) into and among the businesses and operations of the Consortium Members (as defined below) is complex, involving substantial reorganisation of ABN AMRO's operations and legal structure. The restructuring plan is being implemented and significant elements have been completed within the planned timescales and the integration of the Group's businesses continues. As part of this reorganisation, on 6 February 2010, the majority of the businesses of ABN AMRO acquired by the Dutch State were legally demerged from the ABN AMRO businesses acquired

by the Group and were transferred into a newly established company, ABN AMRO Bank N.V. (formerly named ABN AMRO II N.V.). This company was transferred to ABN AMRO Group N.V., a company wholly owned by the Dutch State, on 1 April 2010. Certain assets and liabilities of ABN AMRO acquired by the Dutch State were not part of the transfer which occurred on 1 April 2010 and remain within ABN AMRO (now The Royal Bank of Scotland N.V.). These will be transferred to the Dutch State as soon as possible. In addition, certain assets within ABN AMRO (The Royal Bank of Scotland N.V.) continue to be under shared ownership by the Consortium Members.

The Group may not realise the benefits of the acquisition or the restructuring when expected or to the extent projected. The occurrence of any of these events, including as a result of staff losses or performance issues, or as a result of further disposals or restructurings by the Group, may have a negative impact on the Group’s financial condition and results of operations.

The recoverability and regulatory capital treatment of certain deferred tax assets recognised by the Group depends on the Group's ability to generate sufficient future taxable profits and there being no adverse changes to tax legislation, regulatory requirements or accounting standards.

In accordance with IFRS, the Group has recognised deferred tax assets on losses available to relieve future profits from tax only to the extent that it is probable that they will be recovered. The deferred tax assets are quantified on the basis of current tax legislation and accounting standards and are subject to change in respect of the future rates of tax or the rules for computing taxable profits and allowable losses. Failure to generate sufficient future taxable profits or changes in tax legislation or accounting standards may reduce the recoverable amount of the recognised deferred tax assets.

There is currently no restriction in respect of deferred tax assets recognised by the Group for regulatory purposes. Changes in regulatory rules may restrict the amount of deferred tax assets that can be recognised and such changes could lead to a reduction in the Group’s Core Tier 1 capital ratio. In particular, on 17 December 2009, the Basel Committee published a consultative document setting out certain proposed changes to capital requirements (see risk factor above headed “The Group’s business performance could be adversely affected if its capital is not managed effectively or if there are changes to capital adequacy and liquidity requirements”). Those proposals included a requirement that deferred tax assets which rely on future profitability of the Group to be realised should be deducted from the common equity component of Tier 1 and therefore not count towards Tier 1 capital.

RBS has entered into a credit derivative and a financial guarantee contract with The Royal Bank of Scotland N.V. which may adversely affect the Issuer Group’s results

RBS has also entered into a credit derivative and a financial guarantee contract with The Royal Bank of Scotland N.V., which is a subsidiary undertaking of RBSG, under which it has sold credit protection over the exposures held by The Royal Bank of Scotland N.V. and its subsidiaries that are subject to the APS. These agreements may adversely affect the Issuer Group's results as: (a) they cover 100% of losses on these assets whilst the APS provides 90% protection if losses on the whole APS portfolio exceed the first loss; and (b) the basis of valuation of the APS and the financial guarantee contract are asymmetrical: the one measured at fair value and the other at the higher of cost less amortisation and the amount determined in accordance with IAS 37 “Provisions, Contingent Liabilities and Contingent Assets”.

Risks relating to the Group’s participation in the Asset Protection Scheme, the B Shares, the Contingent B Shares and the Dividend Access Share

Owing to the complexity, scale and unique nature of the APS and the uncertainty surrounding the duration and severity of the recent economic recession, there may be unforeseen issues and risks that are relevant in the context of the Group's participation in the APS and in the impact of the APS on the Group's business, operations and financial condition. In addition, the assets or exposures to be covered by the APS may not be those with the greatest future losses or with the greatest need for protection.

Since the APS is a unique form of credit protection over a complex range of diversified assets and exposures (the "Covered Assets") in a number of jurisdictions and there is significant uncertainty about the duration and severity of the recent economic recession, there may be unforeseen issues and risks that may arise as a result of the Group's participation in the APS and the impact of the APS on the Group's business, operations and financial condition cannot be predicted with certainty. Such issues or risks may have a material adverse effect on the Group. Moreover, the Group's choice of assets or exposures to be covered by the APS was based on predictions at the time of its accession to the APS regarding the performance of counterparties and assumptions about market dynamics and asset and liability pricing, all or some of which may prove to be inaccurate. There is, therefore, a risk that the Covered Assets will not be those with the greatest future losses or with the greatest need for protection and, as a result, the Group's financial condition, income from operations and the value of any Securities may still suffer due to further impairments and credit write-downs.

There is no assurance that the Group's participation in the APS and the issue of £25.5 billion of B Shares and, if required, the £8 billion Contingent B Shares will achieve the Group's goals of improving and maintaining the Group's capital ratios in the event of further losses. Accordingly, the Group's participation in the APS and the issue of £25.5 billion of B Shares and, if required, the £8 billion Contingent B Shares may not improve market confidence in the Group and the Group may still face the risk of full nationalisation or other resolution procedures under the Banking Act.

The Group's participation in the APS, together with the issue of £25.5 billion of B Shares in December 2009 and, if required, the £8 billion Contingent B Shares (as defined below), has improved its consolidated capital ratios. In the event that the Group's Core Tier 1 capital ratio declines to below 5 per cent., and if certain conditions are met, HM Treasury is committed to subscribe (the "Contingent Subscription") for up to an additional £8 billion of B Shares (the "Contingent B Shares") and, in connection with such subscription, would receive further enhanced dividend rights under the associated series 1 dividend access share in the capital of the company (the "Dividend Access Share"). However, notwithstanding the Group's participation in the APS and the issue of the £25.5 billion of B Shares and, if required, the issue of the £8 billion Contingent B, the Group remains exposed to a substantial first loss amount of £60 billion in respect of the Covered Assets and for 10 per cent. of Covered Assets losses after the first loss amount. In addition, as mentioned in the previous risk factor, the assets or exposures covered by the APS may not be those with the greatest future losses or with the greatest need for protection. Moreover, the Group continues to carry the risk of losses, impairments and write-downs with respect to assets not covered by the APS. Therefore, there can be no assurance that any regulatory capital benefits and the additional Core Tier 1 capital will be sufficient to maintain the Group's capital ratios at the requisite levels in the event of further losses (even with the £8 billion Contingent B Shares). If the Group is unable to improve its capital ratios sufficiently or to maintain its capital ratios in the event of further losses, its business, results of operations and financial condition will suffer, its credit ratings may fall, its ability to lend and access funding will be further limited and its cost of funding may increase. The occurrence of any or all of such events may cause the price of the

Securities to decline substantially and may result in intervention by the Authorities, which could include full nationalisation or other resolution procedures under the Banking Act. Any compensation payable to holders of the Securities would be subject to the provisions of the Banking Act, and investors may receive no value for their Securities.

In the event that the Group's Core Tier 1 capital ratio declines to below 5 per cent., HM Treasury is committed to subscribe for up to an additional £8 billion of Contingent B Shares if certain conditions are met. If such conditions are not met, and the Group is unable to issue the £8 billion Contingent B Shares, the Group may be unable to find alternative methods of obtaining protection for stressed losses against severe or prolonged recessionary periods in the economic cycle and improving its capital ratios, with the result that the Group may face increased risk of full nationalisation or other resolution procedures under the Banking Act.

In the event that the Group's Core Tier 1 capital ratio declines to below 5 per cent., HM Treasury is committed to subscribe for up to an additional £8 billion of Contingent B Shares if certain conditions are met. Such conditions include that the European Commission's decision that the State Aid is compatible with article 87 of the consolidated version of the Treaty establishing the European Community continues to be in force, that the European Commission has not opened a formal investigation under article 88(2) of such Treaty in relation to the possible misuse of State Aid, that there has been no breach by the company of the State Aid Commitment Deed and that no Termination Event has occurred.

If such conditions are not met, and the Group is unable to issue the £8 billion Contingent B Shares, the Group may be unable to find alternative methods of obtaining protection for stressed losses against severe or prolonged recessionary periods in the economic cycle and improving its capital ratios, with the result that the Group may face increased risk of full nationalisation or other resolution procedures under the Banking Act.

In these circumstances, if the Group is unable to issue the £8 billion Contingent B Shares, the Group will need to assess its strategic and operational position and will be required to find alternative methods for achieving the requisite capital ratios. Such methods could include an accelerated reduction in risk-weighted assets, disposals of certain businesses, increased issuance of Tier 1 capital securities, increased reliance on alternative government-supported liquidity schemes and other forms of government assistance. There can be no assurance that any of these alternative methods will be available or would be successful in increasing the Group's capital ratios to the desired or requisite levels. If the Group is unable to issue the £8 billion Contingent B Shares, the Group's business, results of operations, financial condition and capital position and ratios will suffer, its credit ratings may drop, its ability to lend and access funding will be further limited and its cost of funding may increase. The occurrence of any or all of such events may cause the price of the Securities to decline substantially and may result in intervention by the Authorities or other regulatory bodies in the other jurisdictions in which RBS and its subsidiaries operate, which could include full nationalisation, other resolution procedures under the Banking Act or revocation of permits and licences necessary to conduct the Group's businesses. Any compensation payable to holders of Securities would be subject to the provisions of the Banking Act, and investors may receive no value for their Securities (see the risk factor headed "the company and its United Kingdom bank subsidiaries may face the risk of full nationalisation or other resolution procedures under the Banking Act 2009" above).

The Group may have included Covered Assets that are ineligible (or that later become ineligible) for protection under the APS. Protection under the APS may be limited or may cease to be available where Covered Assets are not correctly or sufficiently logged or described, where a Covered Asset is disposed of (in whole or in part) prior to a Trigger, where the terms of the APS do not apply or are uncertain in their application, where the terms of the protection itself potentially give rise to legal uncertainty, where certain criminal conduct has or may have occurred or where a breach of bank secrecy, confidentiality, data protection or similar laws may occur. In addition, certain assets included in the APS do not satisfy the eligibility requirements of the Scheme Documents. In each case this would reduce the anticipated benefits to the Group of the APS.

The Covered Assets comprise a wide variety and a very large number of complex assets and exposures. As a result of the significant volume, variety and complexity of assets and exposures and the resulting complexity of the Scheme Documents, there is a risk that the Group may have included assets or exposures within the Covered Assets that are not eligible for protection under the APS, with the result that such assets or exposures may not be protected by the APS. Furthermore, if Covered Assets are not correctly or sufficiently logged or described for the purposes of the APS, protection under the APS may, in certain circumstances and subject to certain conditions, not be available or may be limited, including by potentially being limited to the terms of the assets "as logged". If a Covered Asset is disposed of prior to the occurrence of a failure to pay, a bankruptcy or a restructuring, as described in the UK Asset Protection Scheme Terms and Conditions (the "Scheme Conditions") (a "Trigger") in respect of that Covered Asset, the Group will also lose protection under the APS in respect of that disposed asset or, if the Covered Asset is disposed of in part, in respect of that disposed part of the Covered Asset or in some circumstances all of the Covered Asset, in each case with no rebate of the fee payable to HM Treasury, unless an agreement otherwise is reached with HM Treasury at the relevant time. Moreover, since the terms of the credit protection available under the APS are broad and general (given the scale and purpose of the APS and the wide variety and very large number of complex assets and exposures intended to be included as Covered Assets) and also very complex and in some instances operationally restrictive, certain Scheme Conditions may not apply to particular assets, exposures or operational scenarios or their applicability may be uncertain (for example, in respect of overdrafts). In addition, many of these provisions apply from 31 December 2008 and therefore may not have been complied with between this date and the date of the Group's accession to the APS on 22 December 2009. In each case this may result in a loss or reduction of protection. There are certain limited terms and conditions of the Scheme Conditions which are framed in such a way that may give rise to lack of legal certainty. Furthermore, if a member of the Group becomes aware after due and reasonable enquiry that there has been any material or systemic criminal conduct on the part of the Group (including its directors, officers and employees) relating to or affecting any of the Covered Assets, some or all of those assets may cease to be protected by the APS. HM Treasury may also require the withdrawal or the company may itself consider it necessary to withdraw Covered Assets held in certain jurisdictions where disclosure of certain information to HM Treasury may result in a breach of banking secrecy, confidentiality, data protection or similar laws. In addition, at the time of accession to the APS, approximately £3 billion of derivative and structured finance assets were identified as having been included in the APS which, for technical reasons, did not or which were anticipated at some stage not to, satisfy the eligibility requirements specified in the Scheme Documents. HM Treasury and the company agreed to negotiate in good faith to establish as soon as practicable whether (and if so, to what extent) coverage should extend to these derivative assets. These negotiations remain ongoing. The £3 billion of derivative and structured finance assets referred to above were in addition to approximately £1.2 billion of Covered Assets across a broad range of asset classes which were withdrawn from the APS at the time of accession.

The effect of (i) failures to be eligible and/or to log or correctly describe Covered Assets, (ii) disposals of Covered Assets prior to a Trigger, (iii) the uncertainty of certain Scheme Conditions and the exclusion of certain assets and exposures from the APS and potential lack of legal certainty, (iv) the occurrence of material or systemic criminal conduct on the part of the company or its representatives relating to or affecting Covered Assets or breach of banking secrecy, confidentiality, data protection or similar laws and (v) failure or potential failure of HM Treasury and the company to reach agreement in respect of whether (and if so, to what extent) cover should extend to certain ineligible assets, may (or, in respect of assets which HM Treasury and the company have agreed are ineligible, will) impact the enforceability and/or level of protection available to the Group and may materially reduce the protection anticipated by the Group for its stressed losses. Further, there is no ability to nominate additional or alternative assets or exposures in place of those which turn out not to be covered under the APS. If the Group is then unable to find alternative methods for improving and maintaining its capital ratios, its business, results of operations and financial condition will suffer, its credit ratings may drop, its ability to lend and access funding will be further limited and its cost of funding may increase. The occurrence of any or all of such events may cause the price of the Securities to decline substantially and may result in intervention by the Authorities, which could include full nationalisation or other resolution procedures under the Banking Act. Any compensation payable to holders of Securities would be subject to the provisions of the Banking Act, and investors may receive no value for their Securities.

During the life of the APS, certain or all of the Covered Assets may cease to be protected due to a failure to comply with continuing obligations under the APS, reducing the benefit of the APS to the Group.
The Group is subject to limitations on actions it can take in respect of the Covered Assets and certain related assets and to extensive continuing obligations under the Scheme Conditions relating to governance, asset management, audit and reporting. The Group's compliance with the Scheme Conditions is dependent on its ability to (i) implement efficiently and accurately new approval processes and reporting, governance and management systems in accordance with the Scheme Conditions and (ii) comply with applicable laws and regulations where it does business. The Group has complex and geographically diverse operations, and operational risk in the context of the APS may result from errors by employees or third-parties, failure to document transactions or procedures properly or to obtain proper authorisations in accordance with the Scheme Conditions, equipment failures or the inadequacy or failure of systems and controls. Although the Group has devoted substantial financial and operational resources, and intends to devote further substantial resources, to developing efficient procedures to deal with the requirements of the APS and to training staff, it is not possible to be certain that such actions will be effective to control each of the operational risks faced by the Group or to provide the necessary information in the necessary time periods in the context of the APS. Since the Group's operational systems were not originally designed to facilitate compliance with these extensive continuing obligations, there is a risk that the Group will fail to comply with a number of these obligations. This risk is particularly acute in the period immediately following the APS becoming effective. Certain of the reporting requirements, in particular, are broad in their required scope and challenging in their required timing. There is, as a result, a real possibility that the Group, at least initially, will not be able to achieve full compliance. Where the Group is in breach of its continuing obligations under the Scheme Conditions in respect of any of the Covered Assets, related assets or other obligations, or otherwise unable to provide or verify information required under the APS within the requisite time periods, recovery of losses under the APS may be adversely impacted, may lead to an indemnity claim and HM Treasury may in addition have the right to exercise certain step-in rights, including the right to require the Group to appoint a step-in manager who may exercise oversight, direct management rights and certain other rights including the right to modify certain of the Group's strategies, policies or systems. Therefore, there is a risk that Covered Assets in relation to which the Group has failed to comply with its continuing obligations under the Scheme Conditions, will not be protected or fully protected by the APS. As there is no ability to nominate additional or alternative assets or exposures for cover under the APS, the effect of such failures will impact the level of protection available to the Group and may reduce or eliminate in its entirety the protection anticipated by the Group for its stressed losses, in which case its business, results of operations and financial condition will suffer, its credit ratings may drop, its ability to lend and access funding will be further limited and its cost of funding may increase. The occurrence of any or all of such events may cause the price of the Securities to decline substantially and may result in intervention by the Authorities, which could include full nationalisation or other resolution procedures under the

Banking Act. Any compensation payable to holders of Securities would be subject to the provisions of the Banking Act, and investors may receive no value for their Securities.

The Scheme Conditions may be modified by HM Treasury in certain prescribed circumstances, which could result in a loss or reduction in the protection provided under the APS in relation to certain Covered Assets, increased costs to the Group in respect of the APS or limitations on the Group's operations.
HM Treasury may, following consultation with the Group, modify or replace certain of the Scheme Conditions in such a manner as it considers necessary (acting reasonably) to:

- remove or reduce (or remedy the effects of) any conflict between: (i) the operation, interpretation or application of certain Scheme Conditions; and (ii) any of the overarching principles governing the APS;

- correct any manifest error contained in certain Scheme Conditions; or

- take account of any change in law.

HM Treasury can only effect a modification or replacement of a Scheme Condition if (i) it is consistent with each of the Scheme Principles, (ii) there has been no formal notification from the FSA that such modification would result in any protection provided to the Group under the APS ceasing to satisfy certain requirements for eligible credit risk mitigation and (iii) HM Treasury has considered in good faith and had regard to any submissions, communications or representations of or made by the Group regarding the anticipated impact of the proposed modification under any non-United Kingdom capital adequacy regime which is binding on the company or a Covered Entity.

Such modifications or replacements may be retrospective and may result in a loss of or reduction in the protection expected by the Group under the APS in relation to certain Covered Assets, an increase in the risk weightings of the Covered Assets (either in the United Kingdom or overseas), a material increase in the continuing reporting obligations or asset management conditions applicable to the Group under the Scheme Conditions or a material increase in the expenses incurred or costs payable by the Group under the APS. Modifications by HM Treasury of the Scheme Conditions could result in restrictions or limitations on the Group's operations. The consequences of any such modifications by HM Treasury are impossible to quantify and are difficult to predict and may have a material adverse effect on the Group's financial condition and results of operations.

Owing to the complexity of the APS and possible regulatory capital developments, the operation of the APS and the issue of £25.5 billion of B Shares and, if required, the £8 billion Contingent B Shares may fail to achieve the desired effect on the Group's regulatory capital position. This may mean the Group's participation in the APS and the issuance of £25.5 billion of B Shares and, if required, the £8 billion Contingent B Shares does not improve market confidence in the Group sufficiently or at all. This may result in the Group facing the risk of full nationalisation or other resolution procedures under the Banking Act.

One of the key objectives of the APS and the issuance of £25.5 billion of B Shares in December 2009 and, if required, the £8 billion Contingent B Shares was to improve capital ratios at a consolidated level for the Group and at an individual level for certain relevant Group members. The Group has entered and may in the future enter into further back-to-back arrangements with Group members holding assets or exposures to be covered by the APS in order to ensure the capital ratios of these entities are also improved by virtue of the APS. As the APS and certain of the associated back-to-back arrangements are a unique form of credit protection over a complex range of diversified Covered Assets in a number of jurisdictions, there is a risk that the interpretation of the relevant regulatory capital requirements by one or more of the relevant regulatory authorities may differ from that assumed by the Group, with the result that the anticipated improvement to the Group's capital ratios will not be fully achieved. There is a further risk that, given that the current regulatory capital requirements and the regulatory bodies governing these requirements are subject to unprecedented levels of review and scrutiny both globally and locally, regulatory capital treatment that differs from that assumed by the Group in respect of the APS, the treatment of the B Share issuance or the back-to-back arrangement may also occur because of changes in law or regulation, regulatory bodies or interpretation of the regulatory capital regimes applicable to the Group and/or the APS and/or the B Shares and/or the back-to-back arrangements described above. If participation in the APS and the issuance of £25.5 billion of B Shares and, if required, the £8 billion Contingent B Shares are not sufficient to maintain the Group's capital ratios, this could cause the Group's business, results of operations and financial condition to suffer, its credit rating to drop, its ability to lend and access to funding to be further limited and its cost of funding to increase. The occurrence of any or all of such events may cause the price of the Securities to decline substantially and may result in intervention by the Authorities, which could include full nationalisation or other resolution procedures under the Banking Act. Any compensation payable to holders of Securities would be subject to the provisions of the Banking Act and investors may receive no value for their Securities.

The costs of the Group's participation in the APS may be greater than the amounts received thereunder.
The costs of participating in the APS incurred by the Group to HM Treasury include a fee of £700 million per annum, payable in advance for the first three years of the APS and £500 million per annum thereafter until the earlier of (i) the date of termination of the APS and (ii) 31 December 2099. The fee may be paid in cash or, subject to HM Treasury consent, by the waiver of certain United Kingdom tax reliefs that are treated as deferred tax assets (pursuant to three agreements which provide the right, at the company's option, subject to HM Treasury consent, to satisfy all or part of the annual fee in respect of the APS and £8 billion of Contingent B Shares, and the exit fee payable in connection with any termination of the Group's participation in the APS, by waiving the right to certain United Kingdom tax reliefs that are treated as deferred tax assets ("Tax Loss Waiver")) or be funded by a further issue of B Shares to HM Treasury. The Group has paid in cash the fee of £1.4 billion in respect of 2009 and 2010. On termination of the Group's participation in the APS, the fees described in the risk factor below headed "The Group may have to repay any net pay-outs made by HM Treasury under the APS in order to terminate its participation in the APS" will apply. Furthermore, the Group may be subject to additional liabilities in connection with the associated intra group arrangements. Significant costs either have been or will also be incurred in (i) establishing the APS (including a portion of HM Treasury's costs attributed to the Group by HM Treasury), (ii) implementing the APS, including the Group's internal systems building and as a consequence of its on-going management and administration obligations under the Scheme Conditions, such as complying with (a) the extensive governance, reporting, auditing and other continuing obligations of the APS and (b) the asset management objective which is generally applied at all times to the Covered Assets and will require increased lending in certain circumstances and (iii) paying the five-year annual fee for the £8 billion of Contingent B Shares of £320 million less 4 per cent. of: (a) the value of any B Shares subscribed for under the Contingent Subscription; and (b) the amount by which the Contingent Subscription has been reduced pursuant to any exercise by the company of a partial termination of the Contingent Subscription (payable in cash or, with HM Treasury's consent,

by waiving certain United Kingdom tax reliefs that are treated as deferred tax assets (pursuant to the Tax Loss Waiver), or funded by a further issue of B Shares to HM Treasury). In addition, there will be ongoing expenses associated with compliance with the Scheme Conditions, including the company's and HM Treasury's professional advisers' costs and expenses. These expenses are expected to be significant due to the complexity of the APS, the need to enhance the Group's existing systems in order to comply with reporting obligations required by the APS and the Group's obligations under the Scheme Conditions to pay HM Treasury's and its advisers' costs in relation to the APS. In addition, the Group has certain other financial exposures in connection with the APS including (i) an obligation to indemnify HM Treasury, any governmental entity or their representatives and (ii) for the minimum two-year period from a Trigger until payment is made by HM Treasury under the APS, exposure to the funding costs of retaining assets and exposures on its balance sheet whilst receiving interest based on the "Sterling General Collateral Repo Rate" as displayed on the Bloomberg service, or such other rate as may be notified by HM Treasury from time to time as reflecting its costs of funds. The aggregate effect of the joining, establishment and operational costs of the APS and the on-going costs and expenses, including professional advisers' costs, may significantly reduce or even eliminate the anticipated amounts to be received by the Group under the APS.

The amounts received under the APS (which amounts are difficult to quantify precisely) may be less than the costs of participation, as described above. There are other, non-cash, anticipated benefits of the Group's participation, which include the regulatory capital benefits referred to above and the potential protection from future losses, which are themselves also difficult to quantify.

The Group may have to repay any net pay-outs made by HM Treasury under the APS in order to terminate its participation in the APS.
During its participation in the APS, RBS will pay an annual participation fee to HM Treasury. The annual fee, which is payable in advance, is £700 million per annum for the first three years of the Group's participation in the APS and £500 million per annum thereafter until the earlier of (i) the date of termination of the APS and (ii) 31 December 2099. The Group has paid in cash the fee of £1.4 billion in respect of 2009 and 2010. Pursuant to the Accession Agreement and the Tax Loss Waiver, subject to HM Treasury consent, all or part of the exit fee (but not the refund of the net payments the Group has received from HM Treasury under the APS) may be paid by the waiver of certain United Kingdom tax reliefs that are treated as deferred tax assets (pursuant to the Tax Loss Waiver). The directors of the company may, in the future, conclude that the cost of this annual fee, in combination with the other costs of the Group's participation in the APS, outweighs the benefits of the Group's continued participation and therefore that the Group's participation in the APS should be terminated. However, in order to terminate the Group's participation in the APS, the Group must have FSA approval and pay an exit fee which is an amount equal to (a) the larger of (i) the cumulative aggregate fee of £2.5 billion and (ii) 10 per cent. of the annual aggregate reduction in Pillar I capital requirements in respect of the assets covered by the APS up to the time of exit less (b) the aggregate of the annual fees paid up to the date of exit. In the event that the Group has received payments from HM Treasury under the APS in respect of losses on any Covered Assets in respect of which a Trigger occurs ("Triggered Assets"), it must either negotiate a satisfactory exit payment to exit the APS, or absent such agreement, refund to HM Treasury any net payments made by HM Treasury under the APS in respect of losses on the Triggered Assets.

The effect of the payment of the exit fee and potentially the refund of the net pay-outs it has received from HM Treasury under the APS may significantly reduce or even eliminate the anticipated further regulatory capital benefits to the Group of its participation in the APS or if FSA approval for the proposed termination is not obtained and could have an adverse impact on the Group's financial condition and results of operation or result in a loss of value in the Securities. Alternatively, if the Group is unable to repay to HM Treasury in full the exit fee and potentially the net pay-outs it has received under the APS and, therefore, unable to terminate its participation in the APS, the Group will be required under the Scheme Conditions to continue to pay the annual fee to HM Treasury until 31 December 2099, which could have an adverse impact on the Group's financial condition and results of operation or result in a loss of value in the Securities.

Under certain circumstances, the Group cannot be assured that assets of ABN AMRO (and certain other entities) will continue to be covered under the APS, either as a result of a withdrawal of such assets or as a result of a breach of the relevant obligations.
If HM Treasury seeks to exercise its right to appoint one or more step-in managers in relation to the management and administration of Covered Assets held by ABN AMRO or its wholly-owned subsidiaries, ABN AMRO will, in certain circumstances, need to seek consent from the Dutch Central Bank to allow it to comply with such step-in. If this consent is not obtained by the date (which will fall no less than 10 business days after the notice from HM Treasury) on which the step-in rights must be effective, and other options to effect compliance are not possible (at all or because the costs involved prove prohibitive), those assets would need to be withdrawn by the Group from the APS where permissible under the Scheme Conditions or, otherwise, with HM Treasury consent. If the Group cannot withdraw such Covered Assets from the APS, it would be likely to lose protection in respect of these assets under the APS and/or may be liable under its indemnity to HM Treasury. If the Group loses cover under the APS in respect of any Covered Asset held by ABN AMRO or its wholly-owned subsidiaries, any losses incurred on such asset will continue to be borne fully by the Group and may have a material adverse impact on its financial condition, profitability and capital ratios. Similar issues apply in certain other jurisdictions but the relevant Covered Assets are of a lower quantum.

The extensive governance, asset management and information requirements under the Scheme Conditions and HM Treasury's step-in rights may serve to limit materially the Group's operations. In addition, the market's reaction to such controls and limitations may have an adverse impact on the price of the Securities.
Under the Scheme Conditions, the Group has extensive governance, asset management, audit and information obligations aimed at ensuring (amongst other things) that (i) there is no prejudice to, discrimination against, or disproportionate adverse effect on the management and administration of Covered Assets when compared with the management and administration of other assets of the Group that are outside of the APS and (ii) HM Treasury is able to manage and assess its exposure under the APS, perform any other functions within HM Treasury's responsibilities or protect or enhance the stability of the United Kingdom financial system. Any information obtained by HM Treasury through its information rights under the APS may be further disclosed by HM Treasury to other government agencies, the United Kingdom Parliament, the European Commission, and more widely if HM Treasury determines that doing so is required, for example, to protect the stability of the United Kingdom financial system.

Moreover, HM Treasury has the right under the Scheme Conditions to appoint one or more step-in managers (identified or agreed to by HM Treasury) to exercise certain step-in rights upon the occurrence of certain specified events. The step-in rights are extensive and include certain oversight, investigation, approval and other rights, the right to require the modification or replacement of any of the systems, controls, processes and practices of the Group and extensive rights in relation to the direct management and administration of the Covered Assets. For further information on these rights. If the Group does not comply with the instructions of the step-in manager, once appointed, the Group may lose protection under the APS in respect of all or some of the Covered Assets. The step-in manager may be a person identified by HM Treasury and not by the company.

The payment obligations of HM Treasury under the Scheme Documents are capable of being transferred to any third party (provided the transfer does not affect the risk weightings the Group is entitled to apply to its exposures to Covered Assets). The step-in rights, together with all other monitoring, administration and enforcement rights, powers and discretions of HM Treasury under the Scheme Documents, are capable of being transferred to any government entity.

The obligations of the Group and the rights of HM Treasury may, individually or in the aggregate, impact the way the Group runs its business and may serve to limit the Group's operations with the result that the Group's business, results of operations and financial condition will suffer.

Any conversion of the B Shares, in combination with any future purchase by HM Treasury of Ordinary Shares, would increase HM Treasury's ownership interest in the company, and could result in the delisting of the company's Securities.
On 22 December 2009, the company issued £25.5 billion of B Shares to HM Treasury. The B Shares are convertible, at the option of the holder at any time, into Ordinary Shares at an initial conversion price of £0.50 per Ordinary Share. Although HM Treasury has agreed not to convert any B Shares it holds if, as a result of such conversion, it would hold more than 75 per cent. of the Ordinary Shares, if HM Treasury were to acquire additional ordinary shares otherwise than through the conversion of the B Shares, such additional acquisitions could significantly increase HM Treasury's ownership interest in the company to above 75 per cent. of the company's ordinary issued share capital, which would put the company in breach of the FSA's Listing Rules requirement that at least 25 per cent. of its issued ordinary share capital must be in public hands. Although the company may apply to the UK Listing Authority for a waiver in such circumstances, there is no guarantee that such a waiver would be granted, the result of which could be the delisting of the company from the Official List and potentially other exchanges where its Securities are currently listed and traded. In addition, HM Treasury will not be entitled to vote in respect of the B Shares or in respect of the Dividend Access Share to the extent, but only to the extent, that votes cast on such B Shares and/or on such Dividend Access Share, together with any other votes which HM Treasury is entitled to cast in respect of any other Ordinary Shares held by or on behalf of HM Treasury, would exceed 75 per cent. of the total votes eligible to be cast on a resolution presented at a general meeting of the company. In addition, holders of the B Shares will only be entitled to receive notice of and to attend any general meeting of the company and to speak to or vote upon any resolution proposed at such meeting if a resolution is proposed which either varies or abrogates any of the rights and restrictions attached to the B Shares or proposes the winding up of the company (and then in each such case only to speak and vote upon any such resolution).

A significant proportion of senior management's time and resources will have to be committed to the APS, which may have a material adverse effect on the rest of the Group's business.
The Group expects that significant senior management and key employee time and resources will have to be committed to the ongoing operation of the APS, including governance, asset management and reporting and generally to ensure compliance with the Scheme Conditions. The time and resources required to be committed to the APS by the Group's senior management and other key employees is likely to place significant additional demands on senior management in addition to the time and resources required to be dedicated to the rest of the Group's business. In addition, and separately from the Group's participation in the APS, significant headcount reductions are being introduced at all levels of

management in the context of a restructuring of the Group. The Group's ability to implement its overall strategy depends on the availability of its senior management and other key employees. If the Group is unable to dedicate sufficient senior management resources to the Group's business outside the APS, its business, results of operations and financial condition will suffer.

The cost of the Tax Loss Waiver and related undertakings is uncertain and the Group may be subject to additional tax liabilities in connection with the APS.
It is difficult to value accurately the cost to the Group if it opts, subject to HM Treasury consent, to satisfy the annual fee in respect of both the APS and the Contingent Subscription and any exit fee (payable to terminate the Group's participation in the APS) by waiving certain United Kingdom tax reliefs that are treated as deferred tax assets pursuant to the Tax Loss Waiver. The cost will depend on unascertainable factors including the extent of future losses, the extent to which the Group regains profitability and any changes in tax law. In addition to suffering greater tax liabilities in future years as a result of the Tax Loss Waiver, the Group may also be subject to further tax liabilities in the United Kingdom and overseas in connection with the APS and the associated intra-group arrangements which would not otherwise have arisen. The Tax Loss Waiver provides that the Group will not be permitted to enter into arrangements which have a main purpose of reducing the net cost of the Tax Loss Waiver. It is unclear precisely how these restrictions will apply, but it is possible that they may limit the operations and future post-tax profitability of the Group.

In order to fulfil its disclosure obligations under the APS, the Group may incur the risk of civil suits, criminal liability or regulatory actions.
The Scheme Conditions require that certain information in relation to the Covered Assets be disclosed to HM Treasury to enable HM Treasury to quantify, manage and assess its exposure under the APS. The FSA has issued notices to the Group requiring the information that HM Treasury required under the Scheme Documents prior to the Group's accession to and participation in the APS (and certain other information which HM Treasury requires under the Scheme Documents following the Group's accession), be provided to it through its powers under the FSMA and the Banking Act. To the extent regulated by the FSA, the Group has a legal obligation to comply with these disclosure requests from the FSA. However, in complying with these disclosure obligations and providing such information to the FSA, the Group may, in certain jurisdictions, incur the risk of civil suits or regulatory action (which could include fines) to the extent that disclosing information related to the Covered Assets results in the Group breaching common law or statutory confidentiality laws, contractual undertakings, data protection laws, banking secrecy and other laws restricting disclosure. There can be no guarantee that future requests for information will not be made by the FSA in the same manner. Requests made directly by HM Treasury pursuant to the terms of the APS are likely to expose the Group to a greater risk of such suits or regulatory action. Adverse regulatory action or adverse judgments in litigation could result in a material adverse effect on the Group's reputation or results of operations or result in a loss of value in the Securities. Alternatively, in order to avoid the risk of such civil suits or regulatory actions or to avoid the risk of criminal liability, the Group may choose to or (in the case of criminal liability) be required to remove Covered Assets from the APS so as not to be required to disclose to HM Treasury, such information, with the result that such assets will not be protected by the APS. The effect of the removal of such Covered Assets will impact the level of protection available to the Group and may materially reduce the protection anticipated by the Group for its stressed losses, in which case its business, results of operations and financial condition will suffer.

Where the Group discloses information to HM Treasury as set out above, HM Treasury may disclose that information to a number of third parties for certain specified purposes. Such disclosures by HM Treasury may put the Group in breach of common law or statutory confidentiality laws, contractual undertakings, data protection laws, banking secrecy or other laws restricting disclosure.

Key financials

For year ended 31 December 2009	Restated 2009 £m	2008 £m	2007 £m
Total income	33,026	20,730	29,472
Operating (loss)/profit before tax	(2,647)	(25,691)	9,636
(Loss)/profit attributable to ordinary and B shareholders	(3,607)	(24,306)	7,303
Cost:income ratio	52.7%	169.2%	45.4%
Basic (loss)/earnings per ordinary and B share from continuing operations (pence)	(6.3p)	(146.2p)	64.0p

At 31 December 2009	2009 £m	2008 £m	2007 £m
Total assets	1,696,486	2,401,652	1,840,829
Loans and advances to customers	728,393	874,722	828,538
Deposits	756,346	897,556	994,657
Owners' equity	77,736	58,879	53,038
Risk asset ratio			
– Core Tier 1	11.0%	6.6%	4.5%
– Tier 1	14.1%	10.0%	7.3%
– Total	16.1%	14.1%	11.2%

Overview of Results

The results of 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 minority interests. Legal separation of ABN AMRO Bank N.V. took place on 1 April 2010. As a result, RBS no longer consolidates the interests in ABN AMRO of its consortium partners in its results. Consortium partners results are classified as discontinued operations and all periods have been restated accordingly.

For a discussion of the events that led to the presentation of ABN AMRO Bank N.V. as a discontinued operation refer to 'Recent Developments' on page 6.

Summary consolidated income statement for the year ended 31 December 2009

	Restated 2009 £m	2008 £m	2007 £m
Net interest income	13,388	15,482	11,550
Fees and commissions receivable	8,738	8,855	8,097
Fees and commissions payable	(2,790)	(2,444)	(2,207)
Other non-interest income	8,424	(6,872)	6,050
Insurance net premium income	5,266	5,709	5,982
Non-interest income	19,638	5,248	17,922
Total income	33,026	20,730	29,472
Operating expenses	(17,417)	(35,065)	(13,383)
Profit/(loss) before other operating charges and impairment losses	15,609	(14,335)	16,089
Insurance net claims	(4,357)	(3,917)	(4,528)
Impairment losses	(13,899)	(7,439)	(1,925)
Operating (loss)/profit before tax	(2,647)	(25,691)	9,636
Tax credit/(charge)	429	2,167	(2,011)
(Loss)/profit from continuing operations	(2,218)	(23,524)	7,625
(Loss)/profit from discontinued operations, net of tax	(105)	(11,018)	87
(Loss)/profit for the year	(2,323)	(34,542)	7,712
Minority interests	(349)	10,832	(163)
Preference shares and other dividends	(935)	(596)	(246)
(Loss)/profit attributable to ordinary and B shareholders	(3,607)	(24,306)	7,303
Basic (loss)/earnings per ordinary and B share from continuing operations	(6.3p)	(146.2p)	64.0p

2009 compared with 2008

Operating loss before tax

Operating loss before tax for the year was £2,647 million compared with a loss of £25,691 million in 2008. The reduction in the loss is primarily a result of a substantial increase in non-interest income and a substantial fall in the write-down of goodwill and other intangible assets partially offset by a significant increase in impairment losses and lower net interest income.

After tax, minority interests and preference share and other dividends, the loss attributable to ordinary and B shareholders was £3,607 million, compared with an attributable loss of £24,306 million in 2008.

Total income

Total income increased 59% to £33,026 million in 2009 primarily reflecting a significant reduction in credit and other market losses and a gain on redemption of own debt. Increased market volatility and strong customer demand in a positive trading environment also contributed to this improvement. While income was down marginally in UK Corporate and held steady in Retail & Commercial Banking and RBS Insurance, a significant improvement occurred in Global Banking & Markets, reflecting the reduced credit and other market losses and a more buoyant trading market during the year compared to 2008.

Net interest income

Net interest income fell by 14% to £13,388 million, with average loans and advances to customers stable and average customer deposits down 1%. Group net interest margin fell from 2.12% to 1.83% largely reflecting the pressure on liability margins, given rates on many deposit products already at floors in the low interest rate environment, and strong competition, particularly for longer-term deposits and the build up of the Group's liquidity portfolio.

Non-interest income

Non-interest income increased to £19,638 million from £5,248 million in 2008, largely reflecting the sharp improvement in income from trading activities, as improved asset valuations led to lower credit market losses and GBM benefited from the restructuring of its business to focus on core customer franchises. The Group also recorded a gain of £3,790 million on a liability management exercise to redeem a number of Tier 1 and upper Tier 2 securities. However, fees and commissions fell as a result of the withdrawal of the single premium payment protection insurance product and the restructuring of UK current account overdraft fees, offset by higher fees in businesses attributable to RFS Holdings minority interest.

Operating expenses

Total operating expenses decreased from £35,065 million in 2008 to £17,417 million, largely resulting from the substantial decrease in the write-down of goodwill and other intangible assets, down to £363 million compared with £16,911 million in 2008. Staff costs, excluding curtailment gains, were up 12% with most of the movement relating to adverse movements in foreign exchange rates and some salary inflation. Changes in incentive compensation, primarily in Global Banking & Markets, represented most of the remaining change. This was offset by a gain of £2,148 million arising from the curtailment of prospective pension benefits in the defined benefit scheme and certain other subsidiary schemes. The Group cost:income ratio improved to 53%, compared with 169% in 2008.

Net insurance claims

Bancassurance and general insurance claims, after reinsurance, increased by 11% to £4,357 million.

Impairment losses

Impairment losses increased to £13,899 million from £7,439 million in 2008, with Core bank impairments rising by £2,182 million, Non-Core by £4,285 million off set by a decrease in RFS Holdings minority interest of £7 million. Signs that impairments might be plateauing appear to have been borne out in the latter part of the year, and there are indications that the pace of downwards credit rating migration for corporates is slowing. Nonetheless, the financial circumstances of many consumers and businesses remain fragile, and rising refinancing costs, whether as a result of monetary tightening or of increased regulatory capital requirements, could expose some customers to further difficulty.

Impairments represented 1.9% of gross loans and advances, excluding reverse repos, in 2009 compared with 0.8% in 2008.

Risk elements in lending and potential problem loans at 31 December 2009 represented 5.4% of loans and advances, excluding reverse repos, compared with 2.5% a year earlier. Provision coverage was 45%, compared with 51% at 31 December 2008 as a consequence of the growth in risk elements in lending being concentrated in secured, property-related loans. These loans require relatively lower provisions in view of their collateralised nature.

Taxation

The effective tax rate for 2009 was 16.2% compared with 8.4% in 2008.

Earnings

Basic earnings per ordinary and B share, including discontinued operations, improved from a loss of 146.7p to a loss of 6.4p.

Balance Sheet

Total assets of £1,696.5 billion at 31 December 2009 were down £705.2 billion, 29%, compared with 31 December 2008, principally reflecting substantial repayments of customer loans and advances, as corporate customer demand fell and corporates looked to deleverage their balance sheets. Lending to banks also fell in line with significantly reduced wholesale funding activity. There were also significant falls in the value of derivative assets, with a corresponding reduction in derivative liabilities.

Loans and advances to banks decreased by £46.4 billion, 34%, to £91.8 billion with reverse repurchase agreements and stock borrowing (‘reverse repos’) down by £23.7 billion, 40% to £35.1 billion and lower bank placings, down £22.7 billion, 29%, to £56.7 billion, largely as a result of reduced wholesale funding activity in Global Banking & Markets.

Loans and advances to customers were down £146.3 billion, 17%, to £728.4 billion. Within this, reverse repos increased by 4%, £1.7 billion to £41.0 billion. Excluding reverse repos, lending decreased by £148.0 billion to £687.4 billion or by £141.8 billion, 17%, before impairment provisions.

Capital

Capital ratios at 31 December 2009 were 11.0% (Core Tier 1), 14.1% (Tier 1) and 16.1% (Total).

2008 compared with 2007

Operating loss before tax

Operating loss before tax was £25,691 million compared with an operating profit before tax of £9,636 million in 2007. The results have been adversely affected by the write-down of goodwill and other assets, a substantial decline in non-interest income, a number of specific losses such as counterparty failures, and a marked increase in the credit impairment charge, reflecting weakness in financial markets and a deteriorating global economy.

Losses from credit market exposures increased to £7,781 million, compared with £1,410 million in 2007, with the great majority incurred in the first half of the year. Write-down of goodwill and other assets was £16,911 million. Other one-off items amounted to a credit of £1,674 million, 25% higher than in 2007, principally as a result of a £1,232 million increase in the carrying value of own debt carried at fair value.

Loss attributable to ordinary shareholders was £24,306 million, compared with an attributable profit of £7,303 million in 2007.

Total income

Total income declined by 30% to £20,730 million, with a significant deterioration experienced during the second half of the year principally as a result of £5.8 billion of trading asset write-downs, counterparty failure and incremental reserving within GBM and Non-Core. While income increased in 2008 in Global Transaction Services, UK Corporate, Ulster Bank and US Retail & Commercial, a significant reduction occurred in UK Retail, and in Global Banking & Markets and Non-Core, where a strong performance in rates, currencies and commodities was offset by marked deterioration in credit markets and equities.

Net interest income

Net interest income increased by 34% to £15,482 million, with average loans and advances to customers up 61% and average customer deposits up 53%. Group net interest margin fell from 2.32% to 2.12% largely reflecting tightened margins within UK Retail as market interest rates fell, with deposit markets remaining competitive and price adjustments on lending taking some time to feed through to the back book.

Non-interest income

Non-interest income was severely affected by the weakness in financial markets experienced over the course of the year, particularly in the fourth quarter. Non-interest income decreased to £5,248 million principally due to the credit market write-downs of £7,781 million offset by a movement in the fair value of own debt of £1,232 million. While the decline was particularly marked in GBM and Non-Core credit markets and equities businesses, with reduced business volumes and mounting mark-to-market trading losses, UK Retail also saw non-interest income fall in the latter part of the year as declining consumer confidence led to lower demand for credit and other financial products.

Operating expenses
Total operating expenses rose to £35,065 million, with cost growth in the Group's core retail and commercial banking franchises offset by efficiency programmes. Integration and restructuring costs were £1,357 million compared with £108 million in 2007. Write-down of goodwill and other assets was £16,911 million.

Net insurance claims
Bancassurance and general insurance claims, after reinsurance, decreased by 13% to £3,917 million, reflecting improved risk selection, better claims management and the non-recurrence of the severe floods experienced in 2007 and as a result of movements in financial market values.

Impairment losses
Impairment losses increased to £7,439 million in 2008, compared with £1,925 million in 2007. The Group experienced a pronounced deterioration in impairments in the second half of the year, as financial stress spread to a broad range of customers. The greatest increase in impairments occurred in GBM and Non-Core, where fourth quarter impairments included a loss of approximately £900 million on the Group's exposure to LyondellBasell. However businesses in all geographies also experienced a noticeable increase in impairments in the second half, particularly in the UK and Irish corporate and US personal segments.

Impairments represented 0.44% of gross loans and advances, excluding reverse repos, in the first half but reached 1.27% in the second half. For 2008 as a whole, impairments amounted to 0.82% of loans and advances, excluding reverse repos, compared with 0.28% in 2007. Risk elements in lending and potential problem loans at 31 December 2008 represented 2.5% of gross loans and advances to customers, excluding reverse repos, compared with 1.6% a year earlier. Provision coverage was 51%, compared with 57% at 31 December 2007 reflecting the higher proportion of secured loans included in risk elements in lending and potential problem loans.

Credit market losses
Losses for 2008 relating to the Group's previously identified credit market exposures totalled £7,781 million, net of hedging gains of £1,642 million. This includes impairment losses of £466 million incurred on credit market assets reclassified out of the 'held-for-trading' category in line with the amendments to IAS 39 'Financial Instruments: Recognition and Measurement' issued in October 2008. While the majority of these write-downs were incurred in the first half of 2008, the severity of the financial market dislocation intensified in the fourth quarter, resulting in further losses in particular on the Group's structured credit portfolios.

Write-down of goodwill and other intangible assets

After reviewing the carrying value of goodwill and other purchased intangible assets, the Group recorded an impairment charge of £16,911 million. Of this charge, £7,678 million relates to part of the goodwill in respect of the acquisition of ABN AMRO, while other significant impairments have been recorded on part of the Citizens/Charter One goodwill of £4,382 million, part of the NatWest goodwill (principally allocated to Global Banking & Markets) of £2,742 million and other goodwill of £720 million. Other intangible asset impairments of £1,389 million principally relate to the write down in the value of customer relationships recognised on the acquisition of ABN AMRO.

These impairments have no cash impact, and minimal impact on the Group's capital ratios.

Other non-operating items

Integration and restructuring costs totalled £1,357 million, primarily reflecting the integration of ABN AMRO into the Group, while the amortisation of purchased intangibles increased to £582 million from £124 million.

Taxation

The Group recorded a tax credit of £2,167 million in 2008, compared with a tax charge of £2,011 million in 2007. The effective tax rate for 2008 was 8.4% compared with 20.9% in 2007.

Earnings

Basic earnings per ordinary share, including discontinued operations, decreased from 64.0p to (146.7p).

The number of shares in issue increased to 39,456 million at 31 December 2008, compared with 10,006 million in issue at 31 December 2007, reflecting the Group's capital raisings in June and December and the capitalisation issue in lieu of the interim dividend for 2008.

Analysis of results

Net interest income

	Restated 2009 £m	2008 £m	2007 £m
Continuing			
Interest receivable	26,311	42,190	31,360
Interest payable	(12,923)	(26,708)	(19,810)
Net interest income	13,388	15,482	11,550
Discontinued			
Interest receivable	7,525	7,332	892
Interest payable	(4,409)	(4,139)	(373)
Net interest income	3,116	3,193	519
Total			
Interest receivable	33,836	49,522	32,252
Interest payable	(17,332)	(30,847)	(20,183)
Net interest income	16,504	18,675	12,069

	%	%	%
Gross yield on interest-earning assets of the banking business (1)	3.76	5.61	6.19
Cost of interest-bearing liabilities of the banking business	(2.18)	(3.79)	(4.36)
Interest spread of the banking business (2)	1.58	1.82	1.83
Benefit from interest-free funds	0.25	0.30	0.49
Net interest margin of the banking business (3)	1.83	2.12	2.32

Yields, spreads and margins of the banking business	%	%	%
Gross yield (1)			
Group	3.76	5.61	6.19
UK	3.35	5.72	6.69
Overseas	4.09	5.54	5.52
Interest spread (2)			
Group	1.58	1.82	1.83
UK	1.50	1.92	2.30
Overseas	1.67	1.76	1.20
Net interest margin (3)			
Group	1.83	2.12	2.32
UK	1.81	2.39	2.55
Overseas	1.85	1.91	1.99

The Royal Bank of Scotland plc base rate (average)	0.64	4.67	5.51
London inter-bank three month offered rates (average):			
Sterling	1.21	5.51	6.00
Eurodollar	0.69	2.92	5.29
Euro	1.21	4.63	4.28

Notes:

(1) Gross yield is the interest rate earned on average interest-earning assets of the banking business.

(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.

Business review
continued

Average balance sheet and related interest

		2009			2008		
		Average Balance £m	Interest £m	Rate %	Average Balance £m	Interest £m	Rate %
Assets							
Loans and advances to banks	– UK	21,616	310	1.43	19,039	939	4.93
	– Overseas	32,367	613	1.89	31,388	1,417	4.51
Loans and advances to customers	– UK	333,230	11,940	3.58	319,696	19,046	5.96
	– Overseas	376,382	16,339	4.34	393,405	22,766	5.79
Debt securities	– UK	52,470	1,414	2.69	33,206	1,276	3.84
	– Overseas	84,822	3,220	3.80	85,625	4,078	4.76
Total interest-earning assets	– banking business (2, 3)	900,887	33,836	3.76	882,359	49,522	5.61
	– trading business (4)	291,092			425,454		
Total interest-earning assets		1,191,979			1,307,813		
Non-interest-earning assets (2, 3)		831,501			732,872		
Total assets		2,023,480			2,040,685		
Percentage of assets applicable to overseas operations		47.4%			48.6%		
Liabilities and owners' equity							
Deposits by banks	– UK	24,837	679	2.73	46,217	1,804	3.90
	– Overseas	104,396	2,362	2.26	113,592	4,772	4.20
Customer accounts: demand deposits	– UK	110,294	569	0.52	99,852	2,829	2.83
	– Overseas	82,177	1,330	1.62	70,399	1,512	2.15
Customer accounts: savings deposits	– UK	54,270	780	1.44	42,870	1,708	3.98
	– Overseas	83,388	2,114	2.54	72,473	2,203	3.04
Customer accounts: other time deposits	– UK	68,625	932	1.36	94,365	4,011	4.25
	– Overseas	71,315	2,255	3.16	105,660	4,097	3.88
Debt securities in issue	– UK	116,536	2,830	2.43	101,520	4,095	4.03
	– Overseas	117,428	2,500	2.13	132,699	5,846	4.41
Subordinated liabilities	– UK	26,053	834	3.20	26,300	1,356	5.16

	– Overseas	12,468	656	5.26	12,385	788	6.36
Internal funding of trading business	– UK	(60,284)	(317)	0.53	(85,664)	(3,445)	4.02
	– Overseas	(14,845)	(192)	1.29	(18,090)	(729)	4.03
Total interest-bearing liabilities	– banking business (2, 3)	796,658	17,332	2.18	814,578	30,847	3.79
	– trading business (4)	331,380			466,610		
Total interest-bearing liabilities		1,128,038			1,281,188		
Non-interest-bearing liabilities:							
Demand deposits	– UK	38,220			37,568		
	– Overseas	27,149			17,625		
Other liabilities (3, 4)		772,770			645,760		
Owners' equity		57,303			58,544		
Total liabilities and owners' equity		2,023,480			2,040,685		
Percentage of liabilities applicable to overseas operations		45.8%			47.2%		

Notes:

(1) The analysis into UK and Overseas has been compiled on the basis of location of office.

(2) Interest-earning assets and interest-bearing liabilities include the Retail bancassurance assets and liabilities attributable to policyholders.

(3) Interest income and interest expense do not include interest on financial assets and liabilities designated as at fair value through profit or loss.

(4) Interest receivable and interest payable on trading assets and liabilities are included in income from trading activities.

Average balance sheet and related interest

		2007		
		Average Balance £m	Interest £m	Rate %
Assets				
Loans and advances to banks	– UK	21,133	1,024	4.85
	– Overseas	12,654	546	4.31
Loans and advances to customers	– UK	268,911	18,506	6.88
	– Overseas	175,301	10,062	5.74
Debt securities	– UK	10,883	600	5.51
	– Overseas	31,792	1,514	4.76
Total interest-earning assets	– banking business (2, 3)	520,674	32,252	6.19
	– trading business (4)	313,110		
Total interest-earning assets		833,784		
Non-interest-earning assets (2, 3)		289,188		
Total assets		1,122,972		
Percentage of assets applicable to overseas operations		38.0%		
Liabilities and owners' equity				
Deposits by banks	– UK	52,951	2,234	4.22
	– Overseas	31,073	1,172	3.77
Customer accounts: demand deposits	– UK	93,764	3,296	3.52
	– Overseas	30,739	1,031	3.35
Customer accounts: savings deposits	– UK	36,334	1,658	4.56
	– Overseas	27,645	902	3.26
Customer accounts: other time deposits	– UK	88,089	4,201	4.77
	– Overseas	43,141	2,100	4.87
Debt securities in issue	– UK	57,140	3,060	5.36
	– Overseas	49,848	2,627	5.27
Subordinated liabilities	– UK	23,502	1,300	5.53
	– Overseas	4,509	230	5.10
Internal funding of trading business	– UK	(68,395)	(3,307)	4.84
	– Overseas	(7,454)	(321)	4.31
Total interest-bearing liabilities	– banking business (2, 3)	462,886	20,183	4.36
	– trading business (4)	316,453		
Total interest-bearing liabilities		779,339		
Non-interest-bearing liabilities:				
Demand deposits	– UK	18,416		
	– Overseas	14,455		
Other liabilities (3, 4)		267,403		
Owners' equity		43,359		
Total liabilities and owners' equity		1,122,972		

Percentage of liabilities applicable to overseas operations	35.9%

Notes:

(1) The analysis into UK and Overseas has been compiled on the basis of location of office.

(2) Interest-earning assets and interest-bearing liabilities include the Retail bancassurance assets and liabilities attributable to policyholders.

(3) Interest income and interest expense do not include interest on financial assets and liabilities designated as at fair value through profit or loss.

(4) Interest receivable and interest payable on trading assets and liabilities are included in income from trading activities.

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.

	2009 over 2008 Increase/(decrease) due to changes in:			2008 over 2007 Increase/(decrease) due to changes in:		
	Average volume £m	Average rate £m	Net change £m	Average volume £m	Average rate £m	Net change £m
Interest-earning assets						
Loans and advances to banks						
UK	113	(742)	(629)	(103)	18	(85)
Overseas	43	(847)	(804)	845	26	871
Loans and advances to customers						
UK	775	(7,881)	(7,106)	3,221	(2,681)	540
Overseas	(949)	(5,478)	(6,427)	12,621	83	12,704
Debt securities						
UK	594	(456)	138	906	(230)	676
Overseas	(38)	(820)	(858)	2,564	—	2,564
Total interest receivable of the banking business						
UK	1,482	(9,079)	(7,597)	4,024	(2,893)	1,131
Overseas	(944)	(7,145)	(8,089)	16,030	109	16,139
	538	(16,224)	(15,686)	20,054	(2,784)	17,270
Interest-bearing liabilities						
Deposits by banks						
UK	683	442	1,125	481	(51)	430
Overseas	360	2,050	2,410	(3,708)	108	(3,600)
Customer accounts: demand deposits						
UK	(268)	2,528	2,260	117	350	467
Overseas	(228)	410	182	(376)	(105)	(481)
Customer accounts: savings deposits						
UK	(369)	1,297	928	(29)	(21)	(50)
Overseas	(306)	395	89	(1,248)	(53)	(1,301)
Customer accounts: other time deposits						
UK	881	2,198	3,079	75	115	190
Overseas	1,175	667	1,842	(1,751)	(246)	(1,997)
Debt securities in issue						
UK	(540)	1,805	1,265	(785)	(250)	(1,035)
Overseas	609	2,737	3,346	(2,930)	(289)	(3,219)
Subordinated liabilities						
UK	13	509	522	(36)	(20)	(56)

Overseas	(5)	137	132	(588)	30	(558)
Internal funding of trading business						
UK	(795)	(2,333)	(3,128)	83	55	138
Overseas	(112)	(425)	(537)	390	18	408
Total interest payable of the banking business						
UK	(395)	6,446	6,051	(94)	178	84
Overseas	1,493	5,971	7,464	(10,211)	(537)	(10,748)
	1,098	12,417	13,515	(10,305)	(359)	(10,664)
Movement in net interest income						
UK	1,087	(2,633)	(1,546)	3,930	(2,715)	1,215
Overseas	549	(1,174)	(625)	5,819	(428)	5,391
	1,636	(3,807)	(2,171)	9,749	(3,143)	6,606

Note:
(1) The analysis into UK and Overseas has been compiled on the basis of location of office.

Business review
continued

Non-interest income

	Restated 2009 £m	2008 £m	2007 £m
Fees and commissions receivable	8,738	8,855	8,097
Fees and commissions payable	(2,790)	(2,444)	(2,207)
Income/(loss) from trading activities	3,761	(9,025)	1,272
Gain on redemption of own debt	3,790	—	—
Other operating income (excluding insurance net premium income)	873	2,153	4,778
	14,372	(461)	11,940
Insurance premium income	5,529	6,009	6,271
Reinsurers' share	(263)	(300)	(289)
	5,266	5,709	5,982
	19,638	5,248	17,922

2009 compared with 2008

Net fees and commissions fell by £463 million primarily due to the withdrawal of the single premium payment protection insurance product and the restructuring of current account overdraft fees within UK Retail during the year, as well as to reduced fees received in Non-Core. This was partially offset by improved performance in GBM (£112 million) and US Retail & Commercial (£50 million).

Income from trading activities rose substantially during the year by £12,786 million, principally due to lower credit market losses reflecting improved underlying asset prices compared with 2008. Increased market volatility and strong customer demand in a positive trading environment also contributed to this improvement.

In the second quarter of 2009 the Group recorded a gain of £3,790 million on a liability management exercise to redeem a number of Tier 1 and upper Tier 2 securities.

Other operating income fell by £1,280 million. Adjusting for changes in the fair value of own debt of £926 million and a gain of £600 million on the sale of Angel Trains in 2008, other operating income increased by £246 million. This improvement reflected a small gain in the fair value of securities and other assets and liabilities compared with a loss of £1.3 billion in 2008 partially offset by a loss on sales of securities and properties of £0.1 billion, compared with a profit of £0.9 billion in 2008, and reduced dividend income.

Insurance net premium income fell by £443 million principally reflecting lower bancassurance fees, and lower general insurance premiums.

2008 compared with 2007

Non-interest income, decreased by 71%, £12,674 million to £5,248 million. Non-interest income was severely affected by the weakness in financial markets experienced over the course of the year. While the decline was particularly marked in Global Banking & Markets and Non-Core credit markets and equities businesses, with reduced business volumes and mounting mark-to-market trading losses, UK Retail also saw non-interest income fall in the latter part of the year as declining consumer confidence led to lower demand for credit and other financial products.

Excluding general insurance premium income, non-interest income fell by £12,401 million to a loss of £461 million.

Within non-interest income, fees and commissions receivable increased by 9% or £758 million, to £8,855 million, while fees and commissions payable increased by 11%, £237 million to £2,444 million.

Income from trading activities was down from £1,272 million to a loss of £9,025 million. Currency trading activities benefited from increased volatility in the markets. However, this improvement was more than offset by substantial credit market write downs during the year.

Other operating income also decreased, falling by 55%, £2,625 million to £2,153 million. This was principally due to a fall in the fair value of securities and other financial assets and liabilities partially offset by profits from the sale of subsidiaries and associates.

Insurance premium income, after reinsurance, decreased by 5% to £5,709 million primarily reflecting the discontinuation of less profitable partnership contracts.

Operating expenses

	Restated		
	2009 £m	2008 £m	2007 £m
Administrative expenses:			
Staff costs			
– excluding gains on pensions curtailment	9,993	8,898	7,106
– gains on pensions curtailment	(2,148)	—	—
Premises and equipment	2,594	2,163	1,615
Other administrative expenses	4,449	4,716	2,859
Total administrative expenses	14,888	15,777	11,580
Depreciation and amortisation	2,166	2,377	1,803
Write-down of goodwill and other intangible assets	363	16,911	—
	17,417	35,065	13,383

2009 compared with 2008

Staff costs, excluding pension schemes curtailment gains, were up £1,095 million with most of the movement relating to adverse movements in foreign exchange rates and some salary inflation. Changes in incentive compensation, primarily in Global Banking & Markets, represented most of the remaining change.

Pension curtailment gains of £2,148 million were recognised in 2009 arising from changes to prospective pension benefits in the defined benefit scheme and certain other subsidiary schemes.

Premises and equipment costs rose by £431 million primarily due to the impact of expanded Group premises in London and the US.

Other expenses fell by £267 million due to integration benefits in GBM partially offset by increased deposit insurance levies in the US.

2008 compared with 2007

Operating expenses increased by £21,682 million to £35,065 million, primarily reflecting the write-down of goodwill and other assets of £16,911 million following a review of the carrying value of goodwill and other assets. Cost growth in the Group’s core retail and commercial banking franchises was offset by efficiency programmes.

Integration costs

	2009	2008	2007
	£m	£m	£m
Staff costs	365	503	18
Premises and equipment	78	25	4
Other administrative expenses	398	486	26
Depreciation and amortisation	18	36	60
	859	1,050	108

2009 compared with 2008
Integration costs in 2009 were £859 million compared with £1,050 million in 2008. Integration and restructuring costs decreased primarily due to restructuring activity resulting from the strategic review undertaken earlier in the year. This was more than offset by lower ABN AMRO integration activity during the year.

2008 compared with 2007
Integration costs in 2008 were £1,050 million compared with £108 million in 2007. The significant increase reflects a full year of integration costs being incurred in respect of the ABN AMRO acquisition, compared to 76 days in 2007.

Accruals in relation to integration costs are set out below.

	At 31 December 2007	At 31 December 2008	Currency translation adjustments	Charge to income statement	Utilised .during the year	At 31 December 2009
	£m	£m	£m	£m	£m	£m
Staff costs – redundancy	—	—	—	158	(158)	—
Staff costs – other	4	5	—	207	(212)	—
Premises and equipment	2	1	—	78	(39)	40
Other	1	3	—	416	(418)	1
	7	9	—	859	(827)	41

Restructuring costs

	2009	2008	2007
	£m	£m	£m
Staff costs	328	251	—
Premises and equipment	48	15	—
Other administrative expenses	51	41	—
	427	307	—

Accruals in relation to restructuring costs are set out below.

	At 31 December 2007	At 31 December 2008	Currency translation adjustments	Charge to income statement	Utilised during the year	At 31 December 2009
	£m	£m	£m	£m	£m	£m

Staff costs – redundancy	—	284	(13)	299	(315)	255
Staff costs – other	—	—	—	29	(25)	4
Premises and equipment	—	15	—	48	(26)	37
Other	—	51	(4)	51	(63)	35
	—	350	(17)	427	(429)	331

34

Impairment losses

	Restated 2009 £m	2008 £m	2007 £m
New impairment losses	14,224	7,700	2,169
less: recoveries of amounts previously written-off	(325)	(261)	(244)
Charge to income statement	13,899	7,439	1,925
Comprising:			
Loan impairment losses	13,090	6,478	1,903
Impairment of available-for-sale securities	809	961	22
Charge to income statement	13,899	7,439	1,925

Refer to pages 98 to 101 for additional analysis.

2009 compared with 2008
Impairment losses were £13,899 million compared with £7,439 million. Impairment losses in the Core divisions increased by £2,182 million, Non-Core losses increased by £4,285 million off set by a decrease in RFS Holdings minority interest of £7 million.

In the Core business, the biggest increases were in UK Retail, UK Corporate and Ulster Bank, reflecting the difficult economic environment.

Non-Core losses also increased substantially, particularly across the corporate and property sectors.

2008 compared with 2007
Credit impairment losses increased to £7,439 million in 2008, compared with £1,925 million in 2007. The Group experienced a pronounced deterioration in impairments during the year, as financial stress spread to a broad range of customers. The greatest increase in impairments occurred in Non-Core and Global Banking & Markets. However, businesses in all geographies also experienced a noticeable increase in impairments during the year, particularly in the UK SME and US personal segments.

Total balance sheet provisions for impairment amounted to £11,016 million compared with £6,452 million in 2007.

Total provision coverage (the ratio of total balance sheet provisions for impairment to total risk elements in lending) decreased from 60% to 52%. The ratio of total balance sheet provisions for impairment to total risk elements in lending and potential problem loans also decreased to 51% compared with 57% in 2007.

Credit market exposures

Credit and other market losses (1)	2009 £m	2008 £m
Monoline exposures	2,387	3,093
CDPCs	957	615
Asset-backed products (2)	288	4,778
Other credit exotics	558	947
Equities	47	948
Leveraged finance	—	1,088
Banking book hedges	1,727	(1,642)
Other	188	268
Group	6,152	10,095

Notes:
(1) Included in 'Income/(loss) from trading activities'.
(2) Includes super senior asset-backed structures and other asset-backed products.

2009 compared with 2008

Losses relating to monoline exposures were £2,387 million in 2009 compared with £3,093 million in 2008.

- The credit quality of the monolines has continued to deteriorate and the level of CVA held against exposures to monoline counterparties has increased from 52% to 62% during the year. This was driven by a combination of wider credit spreads and lower recovery rates.

- The gross exposure to monoline counterparties has decreased primarily due to a combination of higher prices of underlying reference instruments and restructuring certain exposures.

- The increase in CVA resulting from the credit quality deterioration was partially offset by the decrease in CVA requirement following the reduction in gross exposure due to higher prices of underlying reference instruments. Consequently the net losses incurred in this regard were lower than in 2008 when there was both an increase in gross exposure and deterioration in credit quality.

Losses relating to CDPC exposures were £957 million in 2009 compared with £615 million in 2008.

- The credit quality of the CDPCs has continued to deteriorate and the level of CVA held against exposures to CDPC counterparties has increased from 27% to 39% during the year.

- The gross exposure to CDPC counterparties has reduced primarily due to a combination of tighter credit spreads of the underlying reference loans and bonds, and a decrease in the relative value of senior tranches compared with the underlying reference portfolios.

- The decrease in CVA requirement following the reduction in gross exposure was partially offset by the increase in CVA requirement resulting from the credit quality deterioration. Consequently there were net gains in this regard in 2009 compared with losses in 2008 when there was both an increase in gross exposure and deterioration in credit quality.

- Net losses were incurred in 2009 due to hedges put in place at the end of 2008 and during 2009 which effectively cap the exposure to certain CDPCs. As the exposure to these CDPCs has reduced, losses have been incurred on the hedges.

Losses relating to asset-backed products were £288 million in 2009 compared with £4,778 million in 2008.

- Losses reported in 2009 primarily relate to super senior CDOs. The significant price declines of the underlying predominantly mortgage-backed securities seen in 2008 were not repeated in 2009.

- Losses on other mortgage backed securities were greatly reduced in 2009 as many of these positions were sold or substantially written down in 2008 resulting in reduced net exposure in 2009.

Losses relating to credit exotics were £558 million in 2009 compared with £947 million in 2008. These losses were reduced in 2009 as hedges were put in place to mitigate the risk.

Leveraged finance assets were reclassified on 1 July 2009. Changes in the fair value of these assets are only recognised in the income statement to the extent that they are considered impairments.

Losses relating to banking book hedges were £1,727 million in 2009 compared with profits of £1,642 million in 2008. These trades hedge counterparty risk that arises from loans and bonds on the regulatory banking book. As credit spreads have generally tightened in 2009 the value of these hedges has decreased resulting in losses. These hedges gave rise to gains in 2008 due to credit spreads generally widening.

Business review
continued

Additional disclosures on these and other related exposures can be found in the following sections:

Disclosure	Section	Sub-section	Page
Further analysis of credit market exposures	Risk and capital management	Market turmoil exposures	137
Valuation aspects	Financial statements	Note 11 Financial instruments	234
	Financial statements	Critical accounting policies	211
Reclassification of financial instruments	Financial statements	Note 11 Financial instruments	231

Taxation

	2009 £m	Restated 2008 £m	2007 £m
Tax credit/(charge)	429	2,167	(2,011)
	%	%	%
UK corporation tax rate	28.0	28.5	30.0
Effective tax rate	16.2	8.4	20.9

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

	2009 £m	Restated 2008 £m	2007 £m
Expected tax credit/(charge)	741	7,322	(2,891)
Non-deductible goodwill impairment	(102)	(3,826)	(12)
Unrecognised timing differences	274	(274)	(29)
Other non-deductible items	(508)	(378)	(222)
Non-taxable items:			
– gain on redemption of own debt	693	—	—
– other	410	491	595
Taxable foreign exchange movements	1	(80)	(16)
Reduction in deferred tax liability following change in the rate of UK corporation tax	—	—	189
Foreign profits taxed at other rates	(276)	(509)	(1)
Losses in year not recognised	(780)	(942)	(2)
Losses brought forward and utilised	94	11	11
Adjustments in respect of prior periods	(118)	352	367
Actual tax credit/(charge)	429	2,167	(2,011)

The effective tax rate for the year was 16.2% (2008 – 8.4%; 2007 – 20.9%). The tax credit is lower than that arising from applying the standard rate of UK corporation tax of 28% to the loss for the period, principally due to certain carried forward losses on which no tax relief has been recognised.

Divisional performance
The results of each division are set out below. The results are stated before amortisation of purchased intangible assets, write-down of goodwill and other intangible assets, integration and restructuring costs, gain on redemption of own debt, strategic disposals, gains on pensions curtailment and bonus tax.

Business Services directly attributable costs have been allocated to the operating divisions, based on their service usage. Where services span more than one division an appropriate measure is used to allocate the costs on a basis which management considers reasonable. Business Services costs are fully allocated and there are no residual unallocated costs.

Group Centre directly attributable costs have been allocated to the operating divisions, based on their service usage. Where services span more than one division, the costs are allocated on a basis management considers reasonable. The residual unallocated costs remaining in the Group centre relate to volatile corporate items that do not naturally reside within a division.

Treasury costs are allocated to operating divisions as follows: term funding costs are allocated or rewarded based on long term funding gap or surplus; liquidity buffer funding costs are allocated based on share of overall liquidity buffer derived from divisional stresses; and capital cost or benefit is allocated based on share of divisional risk-adjusted RWAs.

	2009 £m	Restated 2008 £m	2007 £m
UK Retail	229	723	1,232
UK Corporate	1,125	1,781	1,803
Wealth	420	348	491
Global Banking & Markets	5,709	(1,796)	1,024
Global Transaction Services	973	1,002	895
Ulster Bank	(368)	218	317
US Retail & Commercial	(113)	528	743
RBS Insurance	58	584	542
Central items	292	1,025	845
Core	8,325	4,413	7,892
Non-Core	(14,557)	(11,351)	2,147
	(6,232)	(6,938)	10,039
Reconciling items			
RFS Holdings minority interest	(356)	(484)	(33)
Amortisation of purchased intangible assets	(272)	(443)	(262)
Write-down of goodwill and other intangible assets	(363)	(16,911)	—
Integration and restructuring costs	(1,286)	(1,357)	(108)
Gain on redemption of own debt	3,790	—	—
Strategic disposals	132	442	—
Gains on pensions curtailment	2,148	—	—
Bonus tax	(208)	—	—

Group operating (loss)/profit before tax	(2,647)	(25,691)	9,636

The performance of each of the divisions is reviewed on pages 40 to 64.

	Restated		
	2009	2008	2007
Impairment losses by division	£m	£m	£m
UK Retail	1,679	1,019	975
UK Corporate	927	319	178
Wealth	33	16	3
Global Banking & Markets	640	522	66
Global Transaction Services	39	54	14
Ulster Bank	649	106	46
US Retail & Commercial	702	437	246
RBS Insurance	8	42	—
Central items	1	(19)	3
Core	4,678	2,496	1,531
Non-Core	9,221	4,936	399
	13,899	7,432	1,930
Reconciling item			
RFS Holdings minority interest	—	7	(5)
Group impairment losses	13,899	7,439	1,925

Net interest margin by division	2009 %	2008 %	2007(1) %
UK Retail	3.59	3.58	
UK Corporate	2.22	2.40	
Wealth	4.38	4.51	
Global Banking & Markets	1.38	1.34	
Global Transaction Services	9.22	8.25	
Ulster Bank	1.87	1.89	
US Retail & Commercial	2.37	2.68	
Non-Core	0.69	0.87	
Group	1.83	2.12	2.32

Risk-weighted assets by division	2009 £bn	2008 £bn	2007(1) £bn
UK Retail	51.3	45.7	
UK Corporate	90.2	85.7	
Wealth	11.2	10.8	
Global Banking & Markets	123.7	151.8	
Global Transaction Services	19.1	17.4	
Ulster Bank	29.9	24.5	
US Retail & Commercial	59.7	63.9	
Other	9.4	7.1	
Core	394.5	406.9	
Non-Core	171.3	170.9	
Group before benefit of APS	565.8	577.8	490.0
Benefit of APS	(127.6)		—
Group before RFS Holdings minority interest	438.2	577.8	490.0
RFS Holdings minority interest	102.8	118.0	119.0
Total	541.0	695.8	609.0

Note

(1) As noted on page 5, following a comprehensive strategic review, changes have been made to the Group's operating segments in 2009. The company has also improved the granularity of certain segment information resulting in the provision of supplementary disclosures. However, it is not possible to source certain elements of these supplementary disclosures for 2007 without undue cost.

UK Retail

	2009	2008	2007(2)
	£m	£m	£m
Net interest income	3,452	3,187	3,230
Net fees and commissions	1,320	1,577	1,754
Other non-interest income	309	358	754
Non–interest income	1,629	1,935	2,508
Total income	5,081	5,122	5,738
Direct expenses			
– staff	(845)	(924)	(936)
– other	(421)	(421)	(424)
Indirect expenses	(1,773)	(1,851)	(1,653)
	(3,039)	(3,196)	(3,013)
Insurance net claims	(134)	(184)	(518)
Impairment losses	(1,679)	(1,019)	(975)
Operating profit before tax	229	723	1,232
Analysis of income by product			
Personal advances	1,192	1,244	
Personal deposits	1,349	2,037	
Mortgages	1,214	500	
Bancassurance	380	401	
Cards	869	831	
Other	77	109	
Total income	5,081	5,122	5,738
Analysis of impairment by sector			
Mortgages	124	31	
Personal	1,023	568	
Cards	532	420	
Total impairment	1,679	1,019	975
Loan impairment charge as % of gross customer loans and advances by sector			
Mortgages	0.15%	0.04%	
Personal	7.52%	3.71%	
Cards	8.58%	6.67%	
	1.63%	1.09%	
Performance ratios			
Return on equity (1)	4.2%	13.1%	
Net interest margin	3.59%	3.58%	
Cost:income ratio	59.8%	62.4%	52.5%

	£bn	£bn	£bn
Capital and balance sheet			
Loans and advances to customers – gross			86.6
– mortgages	83.2	72.2	
– personal	13.6	15.3	
– cards	6.2	6.3	
Customer deposits (excluding bancassurance)	87.2	78.9	76.1
Assets under management (excluding deposits)	5.3	5.7	7.0
Risk elements in lending	4.6	3.8	
Loan:deposit ratio (excluding repos)	115%	116%	
Risk-weighted assets	51.3	45.7	

Notes

(1) Return on equity is based on divisional operating profit after tax, divided by divisional notional equity (based on 7% of divisional risk-weighted assets, adjusted for capital deductions).

(2) As noted on page 5, following a comprehensive strategic review, changes have been made to the Group's operating segments in 2009. The company has also improved the granularity of certain segment information resulting in the provision of supplementary disclosures. However, it is not possible to source certain elements of these supplementary disclosures for 2007 without undue cost.

2009 compared with 2008
Operating profit before tax of £229 million was £494 million lower than in 2008. Profit before impairments was up £166 million or 10%, but impairments rose by £660 million as the economic environment deteriorated, albeit with signs of conditions stabilising in the second half of the year.

The division has focused in 2009 on growing secured lending to meet its Government targets while at the same time building customer deposits, thereby reducing the Group's reliance on wholesale funding. Loans and advances to customers grew 10%, with a change in mix from unsecured to secured as the Group sought actively to reduce its risk profile, with 15% growth in mortgage lending and an 8% reduction in unsecured lending.

- Mortgage growth was due to good retention of existing customers and new business sourced predominantly from the existing customer base. Gross mortgage lending market share increased to 12% from 7% in 2008, with the Group on track to exceed its Government targets on net lending by £3 billion.

- Customer deposits grew 11% on 2008 reflecting the strength of the UK Retail customer franchise, which outperformed the market in an increasingly competitive environment. Savings balances grew by £6 billion or 11% and account acquisition saw a 20% increase, with 2.2 million accounts opened. Personal current account balances increased by 12% on 2008 with a 3% growth in accounts to 12.8 million.

Net interest income increased significantly by 8% to £3,452 million, driven by strong balance sheet growth. Net interest margin was flat at 3.59%, with decreasing liability margins in the face of stiff competition for deposits offsetting wider asset margins. The growth in mortgages and the reduction in higher margin unsecured balances also had a negative impact on the blended net interest margin.

Non-interest income declined 16% to £1,629 million, principally reflecting the withdrawal of the single premium payment protection insurance product and the restructuring of current account overdraft fees in the final quarter of 2009, with the annualised impact of the overdraft fee restructuring further affecting income in 2010. The weak economic environment presented little opportunity in 2009 to grow credit card, private banking and bancassurance fees.

Expenses decreased by 5%, with the cost:income ratio improving from 62% to 60%.

- Direct staff costs declined by 9%, as the division benefited from strong cost control, a focus on process re-engineering and a 10% reduction in headcount.

- RBS continues to progress towards a more convenient, lower cost operating model, with over 4 million active users of online banking and a record share of new sales achieved through direct channels. More than 5.5 million accounts have switched to paperless statements and 254 branches now utilise automated cash deposit machines.

Impairment losses increased 65% to £1,679 million reflecting the deterioration in the economic environment, and its impact on customer finances.

- The mortgage impairment charge was £124 million (2008 – £31 million) on a total book of £83.2 billion. Mortgage arrears rates stabilised in the second half of 2009 and remain well below the industry average, as reported by the Council of Mortgage Lenders. Repossessions show only a small increase on 2008, as the Group continues to support customers facing financial difficulties.

- The unsecured lending impairment charge was £1,555 million (2008 – £988 million) on a book of £19.8 billion. Industry benchmarks for cards arrears showed a slightly improving trend in the final quarter of 2009, which is consistent with the Group's experience. RBS continues to perform better than the market on arrears.

Risk weighted assets increased by 12% to £51.3 billion due to higher lending and the upward pressure from procyclicality, more than offsetting the adoption of a through-the-cycle loss given default approach for mortgages.

2008 compared with 2007

Due to an economic environment which became markedly weaker in the second half of the year, UK Retail Banking saw an 11% decrease in total income to £5,122 million, whilst direct costs remained in line with 2007. However the deterioration in the macroeconomic environment resulted in a 5% increase in impairment losses. Consequently, operating profit before tax decreased 41%, to £723 million. In the personal segment, RBS retained top position and NatWest was again joint second for customer satisfaction amongst main high street banks. UK Retail continues to maintain availability of lending while managing risk exposure and focusing on supporting customers through a difficult economic environment.

Net interest income decreased 1% to £3,187 million. There was good volume growth coupled with improving new lending margins. Spot loans and advances to customers increased 8% and average deposits were up 4%. Despite increasing competitive pressure in a slowing market, at year end deposit balances were £3 billion higher than in 2007. Net interest margin reduced to 3.58%, reflecting increased funding and liquidity costs.

UK Retail mortgage balances grew 12% despite more muted demand in the second half, and net mortgage lending market share increased to 18% (2007 – 2%). Personal unsecured lending slowed, however, particularly in the second half of the year.

Non-interest income declined 23% to £1,935 million. Bancassurance sales grew 3% to £353 million annual premium equivalent in the year, however the negative performance of debt and equity markets reduced investment income by £48 million. Excluding BBU, non-interest income declined 20% reflecting reduced demand for unsecured lending and lower sales of payment protection insurance.

Direct expenses remained in line with 2007. Direct staff costs reduced 1% reflecting increased efficiency. Other direct costs rose by 2% as a result of increased investment in selected business lines. During 2008 the division almost doubled the number of branches open on a Saturday and introduced 1,000 MoneySense advisers into branches to provide impartial advice to customers on managing their money.

Impairment losses increased 5% to £1,019 million, reflecting the changed economic environment, particularly in the second half. The increase in impairments has been driven by mortgage impairment charges of £33 million (2007 – £21 million) on a total book of £72.3 billion, and a slight increase in unsecured personal lending impairments to £986 million (2007 – £954 million). Higher Loan-to-Value ratio mortgages have been restricted and affordability criteria tightened. The average LTV for new business was 67% (2007 – 63%). Repossessions represented 0.06% of outstanding mortgage balances at 31 December 2008, compared with a Council of Mortgage Lenders' average at December 2008 of 0.21%.

Risk weighted assets totalled £45.7 billion at year end.

UK Corporate

	2009	2008	2007(2)
	£m	£m	£m
Net interest income	2,292	2,448	2,252
Net fees and commissions	858	829	518
Other non-interest income	432	460	709
Non–interest income	1,290	1,289	1,227
Total income	3,582	3,737	3,479
Direct expenses			
– staff	(753)	(801)	(721)
– other	(268)	(318)	(295)
Indirect expenses	(509)	(518)	(482)
	(1,530)	(1,637)	(1,498)
Impairment losses	(927)	(319)	(178)
Operating profit before tax	1,125	1,781	1,803
Analysis of income by business			
Corporate and commercial lending	2,401	2,166	
Asset and invoice finance	232	241	
Corporate deposits	985	1,266	
Other	(36)	64	
Total income	3,582	3,737	3,479
Analysis of impairment by sector			
Banks and financial institutions	15	9	
Hotels and restaurants	98	25	
Housebuilding and construction	106	42	
Manufacturing	51	14	
Other	150	53	
Private sector education, health, social work, recreational and community services	59	15	
Property	259	24	
Wholesale and retail trade, repairs	76	37	
Asset and invoice finance	113	100	
Total impairment	927	319	178
Loan impairment charge as % of gross customer loans and advances (excluding reverse repurchase agreements) by sector			
Banks and financial institutions	0.29%	0.17%	
Hotels and restaurants	1.75%	0.41%	
Housebuilding and construction	3.12%	0.81%	
Manufacturing	1.38%	0.26%	
Other	0.36%	0.14%	
Private sector education, health, social work, recreational and community services	0.80%	0.20%	

Property	0.93%	0.08%	
Wholesale and retail trade, repairs	0.97%	0.41%	
Asset and invoice finance	1.33%	1.18%	
	0.83%	0.27%	
Performance ratios			
Return on equity (1)	10.3%	18.0%	
Net interest margin	2.22%	2.40%	
Cost:income ratio	42.7%	43.8%	43.1%

Notes:

(1) Return on equity is based on divisional operating profit after tax, divided by divisional notional equity (based on 8% of divisional risk-weighted assets, adjusted for capital deductions).

(2) As noted on page 5, following a comprehensive strategic review, changes have been made to the Group's operating segments in 2009. The company has also improved the granularity of certain segment information resulting in the provision of supplementary disclosures. However, it is not possible to source certain elements of these supplementary disclosures for 2007 without undue cost.

	2009 £bn	2008 £bn	2007(2) £bn
Capital and balance sheet			
Total assets	114.9	121.0	
Loans and advances to customers – gross			101.5
– Banks and financial institutions	5.2	5.4	
– Hotels and restaurants	5.6	6.1	
– Housebuilding and construction	3.4	5.2	
– Manufacturing	3.7	5.3	
– Other	42.0	38.1	
– Private sector education, health, social work, recreational and community services	7.4	7.4	
– Property	28.0	31.8	
– Wholesale and retail trade, repairs	7.8	9.1	
– Asset and invoice finance	8.5	8.5	
Customer deposits	87.8	82.0	83.4
Risk elements in lending	2.3	1.3	
Loan:deposit ratio	126%	142%	
Risk-weighted assets	90.2	85.7	

Notes:
(1) Return on equity is based on divisional operating profit after tax, divided by divisional notional equity (based on 8% of divisional risk-weighted assets, adjusted for capital deductions).
(2) As noted on page 5, following a comprehensive strategic review, changes have been made to the Group's operating segments in 2009. The company has also improved the granularity of certain segment information resulting in the provision of supplementary disclosures. However, it is not possible to source certain elements of these supplementary disclosures for 2007 without undue cost.

2009 compared with 2008
Operating profit before tax of £1,125 million was £656 million lower than in 2008, largely due to an increase of £608 million in impairments.

Net interest margin levels were rebuilt during the second half as asset pricing was amended to reflect increased funding and credit costs. For the year as a whole net interest margin was 18 basis points lower than in 2008, reflecting higher funding costs and continued competitive pricing for deposits.

Gross new lending to customers remained resilient in 2009, with a noticeable acceleration of lending activity in the second half of the year. However, as customers have deleveraged and turned increasingly to capital markets, repayments have accelerated even more sharply. Loans and advances to customers, therefore, declined by 5% to £111.5 billion.

Initiatives aimed at increasing customer deposits have been successful, with balance growth of 7%, although margins declined as a result of increased competition for balances.

Non-interest income was flat, with stable fee income from refinancing and structuring activity.

A reduction in costs of 7% was driven by lower staff expenses as a result of the Group’s restructuring programme, together with restraint on discretionary spending levels.

Impairment losses increased substantially reflecting both a rise in the number of corporate delinquencies requiring a specific impairment and a higher charge to recognise losses not yet specifically identified.

Risk-weighted assets grew 5% despite the fall in customer lending, reflecting the impact of procyclicality, which was most pronounced in the first half of 2009.

2008 compared with 2007
UK Corporate experienced a solid performance in the first half of 2008, with the second half of 2008 being impacted by the marked deterioration in economic conditions. Total income increased by 7% to £3,737 million. However, growth in impairments, especially in the second half of the year, resulted in a 1% fall in operating profit before tax to £1,781 million.

Net interest income rose 9% to £2,448 million. Loans and advances were 6% higher than 2007, reflecting the Group’s continuing support for the UK economy. New business margins widened in the second half to reflect increasing risk premia, however, higher funding costs on the back book impacted net interest income.

Non interest income increased 5% to £1,289 million. 2007 benefited from the profit on disposal of the Securities Services Group business. Year on year growth reflects increased sales of interest rate and currency risk management products.

Direct expenses increased by 10% to £1,119 million, reflecting the recruitment of additional front line staff in the second half of 2008.

Impairment losses totalled £319 million, a sharp increase from the low levels seen in 2007. Losses were concentrated in the smaller end of the corporate sector, although a number of specific exposures in the larger corporate sector have also impacted the charge.

Wealth

	2009	2008	2007(1)
	£m	£m	£m
Net interest income	663	578	653
Net fees and commissions	363	405	410
Other non-interest income	83	76	55
Non-interest income	446	481	465
Total income	1,109	1,059	1,118
Direct expenses			
– staff	(357)	(377)	(346)
– other	(139)	(156)	(139)
Indirect expenses	(160)	(162)	(139)
	(656)	(695)	(624)
Impairment losses	(33)	(16)	(3)
Operating profit before tax	420	348	491
Analysis of income			
Private Banking	916	819	
Investments	193	240	
Total income	1,109	1,059	1,118
Performance ratios			
Net interest margin	4.38%	4.51%	
Cost:income ratio	59.2%	65.6%	55.8%

	£bn	£bn	£bn
Capital and balance sheet			
Loans and advances to customers – gross			10.2
– mortgages	6.5	5.3	
– personal	4.9	5.0	
– other	2.3	2.1	
Customer deposits	35.7	34.1	33.6
Assets under management (excluding deposits)	30.7	34.7	35.0
Risk elements in lending	0.2	0.1	
Loan:deposit ratio	38%	36%	
Risk-weighted assets	11.2	10.8	

Note:

(1) As noted on page 5, following a comprehensive strategic review, changes have been made to the Group’s operating segments in 2009. The company has also improved the granularity of certain segment information resulting in the provision of supplementary disclosures. However, it is not possible to source certain elements of these supplementary disclosures for 2007 without undue cost.

2009 compared with 2008

Wealth produced strong growth in operating profit before tax, up 21% to £420 million, reflecting the increased value of the division's healthy deposit base in an increasingly competitive market for funding. Deposit balances increased by 5% from 2008, though the deposit market remains highly competitive.

Total income was up 5%, with strong growth in net interest income, reflecting the increased internal pricing applied to Wealth's deposit base. This was offset by a marked decrease in investment income year on year as assets under management decreased by 12% during 2009, with investors turning to more liquid assets and away from longer term investments.

Loans and advances increased by 10% over 2008, primarily in the UK. Lending margins improved, particularly for mortgages, and credit metrics for new business remain satisfactory.

Expenses were down 6%, reflecting a rigorous focus on cost management, with staff costs decreasing by 5% as a result of planned headcount reduction. The cost:income ratio improved from 65.6% to 59.2%.

Impairments increased by £17 million over 2008 reflecting some isolated difficulties in the UK and offshore mortgage books (representing mortgages for second properties for expatriates). Provisions as a percentage of lending to customers increased slightly to 0.25%.

2008 compared with 2007
Total income decreased by 5% to £1,059 million despite an increase in underlying business which was more than offset by a movement in the Group's funds transfer pricing mechanism. Operating profit before tax decreased by 29% to £348 million.

Average loans and advances to customers rose by 22% but average customer deposits by only 1%. Deposit growth, which had been strong up to the end of Q4 2008 ceased and a deposit outflow occurred during the most volatile parts of Q4 2008. Deposit margins were also adversely affected by the deep falls in base rates in Q4 2008.

Non interest income grew by 3% to £481 million as higher fee income was offset by lower investment income. Average assets under management were 1% lower than in 2007, as investor risk appetite dropped sharply in Q4 2008.

Direct expenses rose by 10% to £533 million partly due to increased headcount and higher deposit protection scheme contributions.

Impairments rose from £3 million in 2007 to £16 million and represented approximately 0.1% of the total Wealth lending book.

Global Banking & Markets

	2009 £m	2008 £m	2007(2) £m
Net interest income from banking activities	2,424	2,390	467
Funding costs of rental assets	(49)	(64)	(49)
Net interest income	2,375	2,326	418
Net fees and commissions receivable	1,144	973	960
Income/(loss) from trading activities	7,954	(493)	2,486
Other operating income	(464)	(92)	(17)
Non-interest income	8,634	388	3,429
Total income	11,009	2,714	3,847
Direct expenses			
– staff	(2,930)	(2,056)	(1,802)
– other	(965)	(1,269)	(552)
Indirect expenses	(765)	(663)	(403)
	(4,660)	(3,988)	(2,757)
Impairment losses	(640)	(522)	(66)
Operating profit/(loss) before tax	5,709	(1,796)	1,024
Analysis of income by product			
Rates – money markets	1,714	1,641	
Rates – flow	3,142	1,386	
Currencies & commodities	1,277	1,539	
Equities	1,474	368	
Credit markets	2,255	(3,435)	
Portfolio management and origination	1,196	858	
Fair value of own debt	(49)	357	
Total income	11,009	2,714	3,847
Analysis of impairment by sector			
Manufacturing and infrastructure	91	39	
Property and construction	49	12	
Transport	3	—	
Banks and financial institutions	348	186	
Other	149	285	
Total impairment	640	522	66
Loan impairment charge as % of gross customer loans and advances (excluding reverse repurchase agreements)	0.59%	0.29%	
Performance ratios			
Return on equity (1)	30.7%	(8.4%)	
Net interest margin	1.38%	1.34%	
Cost:income ratio	42.3%	146.9%	71.7%

Notes:

(1) Return on equity is based on divisional operating profit after tax, divided by divisional notional equity (based on 10% of divisional risk-weighted assets, adjusted for capital deductions).

(2) As noted on page 5, following a comprehensive strategic review, changes have been made to the Group's operating segments in 2009. The company has also improved the granularity of certain segment information resulting in the provision of supplementary disclosures. However, it is not possible to source certain elements of these supplementary disclosures for 2007 without undue cost.

Business review
continued

	2009 £bn	2008 £bn	2007(1) £bn
Capital and balance sheet			
Loans and advances (including banks)	127.8	224.2	188.0
Reverse repos	73.3	88.8	278.4
Securities	106.0	127.5	205.7
Cash and eligible bills	74.0	20.2	22.7
Other assets	31.1	38.0	38.7
Total third party assets (excluding derivatives mark to market)	412.2	498.7	733.5
Net derivative assets (after netting)	68.0	121.0	49.4
Customer deposits (excluding repos)	46.9	87.8	93.3
Risk elements in lending	1.8	0.9	
Loan:deposit ratio	194%	192%	
Risk-weighted assets	123.7	151.8	

Note:
(1) As noted on page 5, following a comprehensive strategic review, changes have been made to the Group's operating segments in 2009. The company has also improved the granularity of certain segment information resulting in the provision of supplementary disclosures. However, it is not possible to source certain elements of these supplementary disclosures for 2007 without undue cost.

2009 compared with 2008

Operating profit before tax improved to £5,709 million in 2009, compared with an operating loss before tax of £1,796 million in 2008. Although the buoyant market conditions experienced in the first quarter levelled off over the course of the year, the refocusing of the business on its core franchises was successful. Global Banking & Markets (GBM) has tightened its balance sheet management over the course of the year, with disciplined deployment of capital to support its targeted client base.

In an often volatile market environment, GBM responded quickly to its clients' needs to strengthen their balance sheets and to take advantage of the attractive environment for debt and equity issues. RBS participated in the five largest equity issues worldwide in 2009, and in six out of the ten largest debt capital markets transactions.

Income grew significantly, reflecting a very strong first quarter benefiting from market volatility, client activity and a marked improvement from Credit Markets. Rates flow business, up 127%, benefited from good client activity, while strong equity capital markets drove a fourfold increase in Equities.

Portfolio management and origination grew 39% as financial institutions and corporate clients refinanced through the debt capital markets. The refocused Credit Markets delivered a much improved result from greater liquidity and a more positive trading environment.

Despite quarterly movement in the Group's credit spreads, overall spreads remained broadly flat over the year resulting in a small loss from movements in the fair value of own debt compared with a £357 million gain in 2008.

Expenses increased 17%, reflecting higher performance-related costs and the impact of adverse exchange rate movements, partly offset by restructuring and efficiency benefits. Less than half of the change in staff costs related to increases in 2009 bonus awards.

Staff costs represented 27% of income. The Group introduced new deferral policies in 2009, which have led to changes in accrual patterns. Adjusting for both 2008 and 2009 deferrals, GBM's compensation ratio in 2009 would have been 28%.

Higher impairments principally reflected a large individual failure recognised in the third quarter. Impairments represented 0.59% of loans and advances to customers compared with 0.29% in the prior year, reflecting the marked reduction in loans and advances.

Total third party assets, excluding derivatives, were down 17% compared with 31 December 2008, driven by a 43% reduction in loans and advances as customers took advantage of favourable capital market conditions to raise alternative forms of finance to bank debt. This reduction was partially offset by an increase in liquid assets.

Risk-weighted assets decreased 19%, reflecting the fall in third party assets and the Group's continued focus on reducing its risk profile and balance sheet usage.

2008 compared with 2007

GBM's operating profit before tax fell from £1,024 million in 2007 to a loss of £1,796 million. This decline reflected the effect of the market turmoil which adversely affected the division's results in 2008. GBM incurred losses from counterparty failures (notably Lehman), write-downs of our subprime mortgage related positions and higher credit impairments as the effects of the down-turn widened. These were only partly offset by good performances in a number of businesses, most notably in rates and currencies, the inclusion of the ABN AMRO businesses for a full twelve months and gains on the fair value of own debt.

Costs were up by 45%, with the inclusion of the acquired businesses of ABN AMRO for a full year outweighing reduced bonus payments. Credit impairments rose sharply from a very low level, £66 million, to £522 million, resulting in a 2008 operating loss before tax of £1,796 million.

Net interest income grew by £1,908 million to £2,326 million, with the rates business benefiting from the declining interest rate environment. Non-interest income reduced by £3,041 million to £388 million. Fees and commissions increased mainly as a result of the inclusion of the ABN AMRO businesses for a full twelve months partially offset by a decline in origination volumes. Income from trading activities fell from £2,486 million to a loss of £493 million, primarily as a result of counterparty failures and mortgage trading asset write-downs. Other operating income was a loss of £92 million, reflecting losses incurred on European loan sales.

By business line, the rates and currencies business achieved a particularly strong performance in 2008, with high volumes of customer activity and flow trading. The Sempra Commodities joint venture performed ahead of expectations in the nine months since its formation. Equities improved slightly primarily as a result of the inclusion of a full year of ABN AMRO related businesses.

In a reduced market for debt origination, credit markets improved its market positions in a number of key areas such as international bond issuance. Results, however, were severely affected by the continuing market weakness, particularly in the second half of the year.

Portfolio management income remained resilient, but some losses were incurred, including on capital and credit exposure management.

Credit impairments increased sharply to £522 million primarily reflecting higher IAS latent provisions.

GBM’s total third party assets including derivatives were reduced by £165.8 billion to £619.7 billion at 31 December 2008, a reduction of 18% from a year earlier. Within this total, loans and advances were £224.2 billion, an increase of 18%. This increase was more than offset by significant reductions in reverse repos and securities holdings, both of which have been managed down over the course of the year. Net derivative assets totalled £121.0 billion, compared with £49.4 billion at the end of 2007.

Global Transaction Services

	2009	2008	2007(1)
	£m	£m	£m
Net interest income	912	937	647
Non-interest income	1,575	1,494	1,150
Total income	2,487	2,431	1,797
Direct expenses			
– staff	(371)	(362)	(251)
– other	(161)	(149)	(127)
Indirect expenses	(943)	(864)	(510)
	(1,475)	(1,375)	(888)
Impairment losses	(39)	(54)	(14)
Operating profit before tax	973	1,002	895
Analysis of income by product			
Domestic cash management	805	795	
International cash management	734	722	
Trade finance	290	241	
Merchant acquiring	528	554	
Commercial cards	130	119	
Total income	2,487	2,431	1,797
Performance ratios			
Net interest margin	9.22%	8.25%	
Cost:income ratio	59.3%	56.6%	49.4%
	£bn	£bn	£bn
Capital and balance sheet			
Total third party assets	18.4	22.2	21.8
Loans and advances	12.7	14.8	17.7
Customer deposits	61.8	61.8	55.7
Risk elements in lending	0.2	0.1	
Loan:deposit ratio	21%	25%	
Risk-weighted assets	19.1	17.4	

Note:

(1) As noted on page 5, following a comprehensive strategic review, changes have been made to the Group's operating segments in 2009. The company has also improved the granularity of certain segment information resulting in the provision of supplementary disclosures. However, it is not possible to source certain elements of these supplementary disclosures for 2007 without undue cost.

2009 compared with 2008

Operating profit before tax declined by 3%, largely reflecting pressure on deposit income. The attrition of deposit balances experienced in the first half was reversed in the second, but margins remain compressed due to both a very competitive deposit market as well as the low rate environment.

Customer deposit balances at £61.8 billion were flat on the previous year, with growth in the UK and international business offset by weaker US domestic balances. Loans and advances were down 14% due to reduced overdraft utilisation and lower trade volumes.

International payment fees increased by 2%, while trade finance income increased by 20%, with improved penetration in the Asia-Pacific region. Merchant acquiring income, however, declined by 5%, as consumers continued to switch to lower margin debit card transactions in preference to using credit cards.

Expenses were up 7%, as cost savings and efficiencies that helped to mitigate the impact of investment in infrastructure were offset by movements in foreign exchange rates. Staff expenses were up 2%, primarily as a result of movements in foreign exchange rates, with headcount down 5%. The cost:income ratio was 59.3%, a deterioration of 2.7 percentage points.

Impairment losses were £39 million, down £15 million versus 2008. Overall defaults remain modest at 0.3% of loans and advances.

2008 compared with 2007

Global Transaction Services (GTS) grew income by 35% to £2,431 million and operating profit before tax by 12% to £1,002 million for the full year 2008, reflecting the full year income of ABN AMRO business and the strength and enhanced international capability of the cash management, trade finance and merchant acquiring platforms. The income growth rate was maintained in the second half of the year, despite difficult market conditions.

Growth was driven by a strong performance in cash management, in particular international cash management in ABN AMRO. Steady growth was achieved in the RBS UK and US domestic markets. Average customer deposits were higher mitigating the impact of lower interest rates. International overdrafts have been re-priced, reflecting the increased cost of funds and higher risk premia during the second half of the year. Fee income from payment transactions increased strongly, particularly in the US and internationally. The division was successful throughout the year in winning new international cash management mandates from existing RBS Group clients due to the strength of the international payments platform and network.

Trade finance made good progress, with income continuing to grow strongly as the ABN AMRO platform enabled GTS to substantially improve its penetration into the Asia-Pacific market, and has expanded its supply chain finance activities with an enhanced product suite. Margins improved throughout the year reflecting the additional risk premium in the market conditions.

Merchant services and commercial cards delivered growth despite the worsening economic climate. Acquiring transaction volumes were up in the year driven by good growth in online volumes, but weaker consumer confidence in the latter part of the year meant that average transaction values decreased, slowing income growth. Commercial cards income saw strong growth for the full year, driven by higher interchange income the small and middle markets.

Direct expenses rose by 35% to £511 million, reflecting the full year costs of the ABN AMRO business. The full year cost growth reflected investment in staffing and infrastructure to support GTS's development.

Impairment losses were £54 million, up from £14 million in 2007, reflecting in particular the downturn in the global economy and some growth in defaults amongst mid-corporates and SMEs.

Ulster Bank

	2009	2008	2007(2)
	£m	£m	£m
Net interest income	780	708	659
Net fees and commissions	228	238	163
Other non-interest income	26	93	165
Non-interest income	254	331	328
Total income	1,034	1,039	987
Direct expenses			
– staff	(325)	(330)	(258)
– other	(85)	(93)	(101)
Indirect expenses	(343)	(292)	(265)
	(753)	(715)	(624)
Impairment losses	(649)	(106)	(46)
Operating (loss)/profit before tax	(368)	218	317
Analysis of income by business			
Corporate	580	618	
Retail	412	396	
Other	42	25	
Total income	1,034	1,039	987
Analysis of impairment by sector			
Mortgages	74	17	
Corporate			
– property	306	37	
– other	203	7	
Other	66	45	
Total impairment	649	106	46
Loan impairment charge as % of gross customer loans and advances (excluding reverse repurchase agreements) by sector			
Mortgages	0.46%	0.09%	
Corporate			
– property	3.03%	0.34%	
– other	1.85%	0.05%	
Other	2.75%	2.14%	
	1.63%	0.24%	
Performance ratios			
Return on equity (1)	(13.3%)	10.1%	
Net interest margin	1.87%	1.89%	
Cost:income ratio	72.8%	68.8%	63.2%
	£bn	£bn	£bn
Capital and balance sheet			

Loans and advances to customers – gross			33.9
– mortgages	16.2	18.1	
– corporate			
– property	10.1	10.9	
– other	11.0	12.9	
– other	2.4	2.1	
Customer deposits	21.9	24.3	21.8
Risk elements in lending			
– mortgages	0.6	0.3	
– corporate			
– property	0.7	0.5	
– other	0.8	0.3	
– other	0.2	0.1	
Loan: deposit ratio	177%	179%	
Risk-weighted assets	29.9	24.5	

Notes:

(1) Return on equity is based on divisional operating profit after tax, divided by divisional notional equity (based on 7% of divisional risk-weighted assets, adjusted for capital deductions).

(2) As noted on page 5, following a comprehensive strategic review, changes have been made to the Group's operating segments in 2009. The company has also improved the granularity of certain segment information resulting in the provision of supplementary disclosures. However, it is not possible to source certain elements of these supplementary disclosures for 2007 without undue cost.

2009 compared with 2008
Operating results were in line with expectations but deteriorated during 2009 as economic conditions across the island of Ireland worsened, with an operating loss before tax for the year of £368 million.

Net interest income increased by 10% reflecting movements in foreign exchange rates and asset repricing initiatives, largely offset by the tightening of deposit margins in an increasingly competitive market. Net interest margin for the year at 1.87% remained broadly stable despite the challenging market conditions.

Loans to customers decreased by 10% from the prior year as new business demand weakened. Customer deposits reduced by 10% in 2009, reflecting an increasingly competitive Irish deposit market and reductions in wholesale funding during the first quarter. During the second half of the year the market stabilised and the division recorded strong growth in customer balances resulting in an improved funding profile.

Non-interest income declined by 23% due to lower fee income driven by reduced activity levels across all business lines.

Total costs for the year increased by 5%. Direct expenses were down 3% during 2009, driven by the bank’s restructuring programme, which incorporates the merger of the First Active and Ulster Bank businesses. The rollout of the programme has resulted in a downward trend in direct expenses throughout 2009. The reduction in direct expenses has been offset by a 17% increase in indirect expenses primarily reflecting provisions relating to the bank’s own property recognised in the fourth quarter.

Impairment losses increased to £649 million from £106 million driven by the continued deterioration in the Irish economic environment and resultant impact on loan performance across the retail and wholesale portfolios.

Necessary fiscal budgetary action allied to the well-entrenched downturn in property markets in Ireland has fed through to higher loan losses. Mortgage impairments have been driven by rising unemployment and lower incomes. Loans to the property sector experienced a substantial rise in defaults as the Irish property market declined, reflecting the difficult economic backdrop and the uncertainty surrounding the possible effect of the Irish Government's National Asset Management Agency on asset values. Sectors driven by consumer spending have been affected by the double digit decline in 2009 with rising default rates evident.

Customer account numbers increased by 3% during 2009, with growth fuelled by strong current account activity and new-to-bank savings customers.

2008 compared with 2007
The significant deterioration in global and local market conditions has impacted the main Ulster Bank Group markets, with operating profit before tax falling to £218 million, 31% lower than in 2007. A significant driver of this reduction has been an increase of £60 million in impairments, albeit from a low base, reflecting deterioration in credit quality as economic conditions have slowed.

Total income was up 5% at £1,039 million benefiting from movements in exchange rates, net interest income increased by 7%, with average loans and advances to customers up 30% in the year. The benefit from growth in lending, particularly in the first half of the year has been offset by increased funding costs associated with the wholesale funding market dislocation. Non-interest income rose 1%, reflecting a slowdown in particular in the bancassurance and wealth businesses.

Mortgage balances were 13% higher than 2007. New mortgage volumes in the second half of the year were significantly lower than in the first six months, although levels of redemptions have also fallen.

Deposit flows were strong in the latter part of the year and into the early months of 2009. During 2008, we opened 119,000 new current accounts driven by particularly successful current account switcher and student campaigns.

Direct expenses rose by 18% to £423 million, reflecting the impact of the movement in exchange rates and the full year impact of the now completed investment programme in Ulster Bank's footprint and operations. Cost growth in the second half of 2008 was significantly lower, reflecting disciplined management of the cost base.

Impairment losses rose to £106 million, reflecting the impact on credit quality of the slowdown in the Irish economy, with the final quarter showing the most notable decline in both activity and sentiment. This was reflected in a significantly increased flow of cases into the problem debt management process.

In January 2009, Ulster Bank announced its intention to adopt a single brand strategy under the Ulster Bank brand. This will see the merger of the operations of Ulster Bank and First Active in the Republic of Ireland ("RI") by the end of 2009. This action is being taken to strengthen the Ulster Bank Group franchise by positioning it to deal with the prevailing local and global market conditions. A number of cost management initiatives have also commenced across the business.

Ulster Bank has launched a series of initiatives to support its customers in this difficult economic period. We announced in February 2009 that we will be making significant funds available to the Northern Ireland ("NI") SME market. A similar announcement will be made in the coming weeks regarding the RI SME market. Ulster Bank has also indicated that it is adopting the RBS Group pledge regarding certainty of overdraft limits for this sector.

The Momentum and Secure Step mortgages have been launched in NI and RI respectively to support First Time Buyers and the Bank has confirmed its pledge of a six-month moratorium to mortgage customers facing potential repossession. In support of our retail customers across the island of Ireland the Group's MoneySense programme is being rolled out, with trained advisers being introduced to all Ulster Bank branches.

US Retail & Commercial

	2009 £m	2008 £m	2007(2) £m	2009 $m	2008 $m	2007(2) $m
Net interest income	1,775	1,726	1,613	2,777	3,200	3,227
Net fees and commissions	714	664	648	1,119	1,231	1,296
Other non-interest income	235	197	153	368	362	305
Non-interest income	949	861	801	1,487	1,593	1,601
Total income	2,724	2,587	2,414	4,264	4,793	4,828
Direct expenses						
– staff	(776)	(645)	(563)	(1,214)	(1,194)	(1,126)
– other	(593)	(354)	(291)	(929)	(654)	(582)
Indirect expenses	(766)	(623)	(571)	(1,196)	(1,157)	(1,142)
	(2,135)	(1,622)	(1,425)	(3,339)	(3,005)	(2,850)
Impairment losses	(702)	(437)	(246)	(1,099)	(811)	(491)
Operating (loss)/profit before tax	(113)	528	743	(174)	977	1,487
Analysis of income by product						
Mortgages and home equity	499	375		781	695	
Personal lending and cards	451	333		706	617	
Retail deposits	828	1,000		1,296	1,853	
Commercial lending	542	405		848	751	
Commercial deposits	398	377		624	698	
Other	6	97		9	179	
Total income	2,724	2,587	2,414	4,264	4,793	4,828
Average exchange rate – US$/£	1.566	1.853	2.001			
Analysis of impairment by sector						
Residential mortgages	72	41		113	76	
Home equity	167	67		261	125	
Corporate & Commercial	326	181		510	335	
Other consumer	137	148		215	275	
Total impairment	702	437	246	1,099	811	491
Loan impairment charge as % of gross customer loans and advances (excluding reverse repurchase agreements) by sector						
Residential mortgages	1.11%	0.43%		1.07%	0.55%	
Home equity	1.08%	0.36%		1.04%	0.46%	
Corporate & Commercial	1.67%	0.76%		1.61%	0.97%	
Other consumer	1.84%	1.51%		1.77%	1.92%	
	1.44%	0.71%		1.39%	0.90%	
Performance ratios						
Return on equity (1)	(1.8%)	7.7%		(1.7%)	9.7%	

Net interest margin	2.37%	2.68%		2.37%	2.68%	
Cost:income ratio	78.3%	62.7%	59.0%	78.3%	62.7%	59.0%
	£bn	£bn	£bn	US$bn	US$bn	US$bn
Capital and balance sheet						
Total assets	74.8	87.5	67.1	121.3	127.8	134.1
Loans and advances to customers – gross			44.8			89.9
– residential mortgages	6.5	9.5		10.6	13.9	
– home equity	15.4	18.7		25.0	27.2	
– corporate and commercial	19.5	23.7		31.6	34.7	
– other consumer	7.5	9.8		12.1	14.3	
Customer deposits	60.1	63.9	52.6	97.4	93.4	105.4
Risk elements in lending						
– retail	0.4	0.2		0.6	0.3	
– commercial	0.2	0.2		0.4	0.2	
Loan: deposit ratio	80%	96%		80%	96%	
Risk-weighted assets	59.7	63.9		96.9	93.2	
Spot exchange rate – US$/£	1.622	1.460	2.004			

Notes:

(1) Excluding reverse repurchase agreements by sector.

(2) As noted on page 5, following a comprehensive strategic review, changes have been made to the Group's operating segments in 2009. The company has also improved the granularity of certain segment information resulting in the provision of supplementary disclosures. However, it is not possible to source certain elements of these supplementary disclosures for 2007 without undue cost.

55

2009 compared with 2008
The recessionary economic environment, historically low interest rates and deteriorating credit conditions resulted in an operating loss before tax of £113 million. However, the business has now successfully refocused on its core customer franchises in New England, the Mid-Atlantic region and the Midwest. In dollar terms, an operating loss before tax of $174 million was recorded.

The division achieved very strong growth in mortgage origination volumes, with significantly higher penetration through the branch network and improved profitability, particularly on recent origination vintages. Cross-selling of card, deposit and checking account products has increased substantially, with over 65% of new mortgage customers also taking out a checking account. The division has also increased commercial banking market penetration, with lead bank share within its footprint increasing, in dollar terms, from 6% to 7% in the $5 million to $25 million segment and from 6% to 8% in the $25 million to $500 million segment.

Net interest income was up 3%, principally as a result of movements in exchange rates. However, net interest margin was down 31bps for the full year, reflecting the decline in deposit margins resulting from the low interest rate environment, though margins have been partially rebuilt in the second half from the lows experienced in the first half, as the business repriced lending rates and aggressively reduced pricing on term and time deposits.

Expenses increased by 32%, reflecting increased FDIC deposit insurance levies, higher employee benefit costs as well as increased costs relating to loan workout and collection activity. In dollar terms, expenses increased by 11%. Successful execution of restructuring activities resulted in approximately $75 million of cost savings.

Impairment losses increased to £702 million ($1,099 million) as charge-offs climbed to 0.90% of loans, an increase of 34bps compared with 2008.

Loans and advances were down 21%, reflecting subdued customer demand.

Customer deposits decreased 6% from the prior year. In dollar terms, customer deposits increased 4% as the deposit mix improved significantly, with strong growth in checking balances combined with migration away from higher priced term and time deposits as the division adjusted its pricing strategies. Over 58,000 consumer checking accounts were added over the course of the year, and more than 13,000 small business checking accounts. Consumer checking balances grew by 8% and small business balances by 12%.

2008 compared with 2007
US Retail & Commercial Banking increased income by 7% to £2,587 million, primarily as a result of movements in exchange rates, but experienced a sharp increase in impairment losses as economic conditions progressively worsened over the course of the year. As a result, operating profit before tax declined to £528 million, down 29%. In dollar terms, total income was down 1% at $4,793 million while operating profit before tax declined by 34% to $977 million.

Net interest income grew by 7% to £1,726 million. Average loans and advances to retail customers decreased as a result of the slowing economy and tighter underwriting standards, but this decline was offset by continued strong growth in corporate and commercial lending. Core customer deposits declined by 5% and the division further reduced its reliance on brokered deposits by 80%, leading to an overall decline of 11% in total customer deposits. Net interest margin was held steady at 2.82%, reflecting widening asset margins and management of savings rates in a competitive deposit market.

Direct expenses increased by 17% to £999 million, reflecting increased costs from the expansion of the commercial banking relationship management teams, write-downs on mortgage servicing rights, and higher costs related to loan work-out and collection activity together with movements in exchange rates. In dollar terms, direct expenses increased by 8% to $1,848 million.

Credit conditions worsened significantly over the course of the year as the housing market continued to deteriorate and unemployment rose, exacerbating already challenging conditions. Impairment losses totalled £437 million, up from £246 million in 2007 reflecting the deterioration in economic conditions. In dollar terms, impairment losses totalled $811 million, up 65% from 2007. Stress has emerged in all consumer segments during the second half of the year: non-performing loans represented 0.36% of home equity balances, 0.35% of auto balances and 1.04% of residential mortgage balances. Commercial non-performing loans represented 0.41% of loans. US Retail & Commercial does not originate negative amortization mortgages or option adjustable rate mortgages. Closing provision balances for the portfolio were £588 million ($859 million) compared with £275 million ($552 million) at the end of 2007.

The US business has continued to evaluate opportunities to optimise capital allocation by exiting or reducing exposure to lower growth or sub-scale segments. In the fourth quarter, 18 rural branches in the Adirondacks region were sold to Community Bank System. An agreement has also been announced to sell the Indiana retail branch banking network, consisting of 65 branches, and the business banking and regional banking activities, to Old National Bank.

RBS Insurance

	2009	2008	2007
	£m	£m	£m
Earned premiums	4,519	4,512	4,615
Reinsurers' share	(165)	(206)	(190)
Insurance net premium income	4,354	4,306	4,425
Net fees and commissions	(366)	(396)	(465)
Other income	472	520	614
Total income	4,460	4,430	4,574
Direct expenses			
– staff	(267)	(286)	(282)
– other	(222)	(225)	(228)
Indirect expenses	(270)	(261)	(239)
	(759)	(772)	(749)
Gross claims	(3,690)	(3,136)	(3,358)
Reinsurers' share	55	104	75
Net claims	(3,635)	(3,032)	(3,283)
Operating profit before impairment losses	66	626	542
Impairment losses	(8)	(42)	—
Operating profit before tax	58	584	542
Analysis of income by product			
Motor own-brand	2,005	1,942	1,931
Household and Life own-brands	849	806	525
Motor partnerships and broker	577	686	827
Household and Life, partnerships and broker	330	354	625
Other (international, commercial and central)	699	642	666
Total income	4,460	4,430	4,574
Performance ratios			
Return on equity (1)	1.6%	18.3%	17.2%
Cost:income ratio	17.0%	17.4%	16.4%
Adjusted cost:income ratio (2)	92.0%	55.2%	58.0%
In-force policies (000's)			
– Motor own-brand	4,858	4,492	4,445
– Own-brand non-motor (home, rescue, pet, HR24)	6,307	5,560	3,752
– Partnerships and broker (motor, home, rescue, pet, HR24)	5,328	5,898	6,765
– Other (International, commercial and central)	1,217	1,206	1,068
General insurance reserves – total (£m)	7,030	6,672	6,707

Notes:
(1) Based on divisional operating profit after tax, divided by divisional notional equity (based on regulatory capital).
(2) Based on total income and operating expenses above and after netting insurance claims against income.

57

2009 compared with 2008
Operating profit before tax was severely affected by the rising costs of bodily injury claims, declining to £58 million. Significant price increases were implemented in the latter part of the year to mitigate the industry trend of rising claims costs.

Income grew by 1%, with premium income stable but lower reinsurance costs. Investment income was 16% lower, reflecting the impact of low interest rates and returns on the investment portfolio partially offset by gains realised on the sale of equity investments.

In-force policies grew by 3%, driven by the success of own brands, up 11%. Churchill and Privilege have benefited from deployment on selected price comparison websites, with motor policy numbers up 19% and 3% respectively, and home policies up 32% and 109% respectively, compared with prior year. Direct Line motor and home policies grew by 4% and 2% respectively. The partnerships and broker segment declined by 10% in line with business strategy.

Expenses fell by 2% in 2009, with wage inflation, higher industry levies and professional fees offset by cost efficiencies, reduction in headcount and lower marketing expenditure.

Net claims were 20% higher than in 2008 driven by a £448 million increase in bodily injury claims as well as by adverse weather experienced in the fourth quarter. Significant price increases were implemented in the latter part of the year to mitigate the industry trend of rising claims costs, and additional significant initiatives have also been undertaken to adapt pricing models and enhance claims management.

The UK combined operating ratio, including business services costs, was 105.9% compared with 93.6% in the previous year, with the impact of the increase in reserves for bodily injury claims and the bad weather experience only partially mitigated by commission and expense ratio improvement.

2008 compared with 2007
RBS Insurance made good progress in 2008, with operating profit before tax rising by £42 million, an increase of 8%. Total income was £144 million lower at £4,430 million, reflecting a fall in insurance premium income following the continuation of the strategic decision to exit less profitable partnership contracts and the effect of financial market conditions.

Own-brand businesses increased income by 2% and contribution before impairments and excluding indirect expenses by 12%. In the UK motor market the Group increased premium rates to offset claims inflation and continued to target lower risk drivers, with price increases concentrated in higher risk categories in order to improve profitability. During 2008 selected brands were successfully deployed on a limited number of aggregator web sites. Our international businesses in Italy and Germany performed well, with income up 25% and contribution up 74%. Over the last year own-brand motor policy numbers have again begun to increase, and rose by 1% to 4.5 million.

In own-brand non-motor insurance we have continued to achieve good sales through the RBS Group, where home insurance policies in force have increased by 33%. In addition, Privilege and Churchill have grown home policies by 90% and 13% respectively compared with 2007, mainly due to an increase in online sales as a result of successful marketing campaigns. A new commercial insurance offering, Direct Line for Business, was launched, and has grown rapidly over the year with particularly strong performances in Residential Property and Tradesman policies. Overall own-brand non-motor policies in force have grown by 48% to 5.6 million, benefiting from the addition of rescue cover to RBS and NatWest current account package customers.

Results from partnerships and broker business confirmed the Group's strategy of refocusing on the more profitable opportunities in this segment, where we provide underwriting and processing services to third parties. The Group did not renew a number of rescue contracts and pulled back from some less profitable segments of the broker market. As a result partnership and broker in-force policies have fallen by 13% over the last year with a corresponding 12% reduction in income, yet contribution grew by 30%.

For RBS Insurance as a whole, insurance premium income, net of fees and commissions, was broadly maintained at £4 billion, reflecting 6% growth in the Group's own brands offset by a 14% decline in the partnerships and broker segment. Investment income was maintained at £367 million. Other income decreased by 15% to £520 million.

Direct expenses increased by less than 1% to £511 million, despite accelerated marketing development in own brands, including the launch of Direct Line for Business.

Net claims fell by 8% to £3,032 million, benefiting from ongoing claims containment and more benign weather conditions. Impairments of £42 million reflect impairments recognised in corporate bond and equities investment portfolios.

The UK combined operating ratio for 2008, including manufacturing costs, decreased to 93.6% from 98.8%

Central items

	2009	2008	2007
	£m	£m	£m
Fair value of own debt	(93)	875	152
Other	385	150	693
Operating profit before tax	292	1,025	845

2009 compared with 2008
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.

Items not allocated during the year amounted to a net credit of £292 million. The Group's credit spreads have fluctuated over the course of the year, but ended the year slightly tighter, resulting in an increase in the carrying value of own debt. This was offset by a net credit on unallocated Group treasury items, including the impact of economic hedges that do not qualify for IFRS hedge accounting. 2008's results included some significant disposal gains.

2008 compared with 2007
Items not allocated during the year amounted to a net credit of £1,025 million reflecting the benefit from a decrease in the carrying value of own debt, profit on the sale of Tesco Personal Finance offset by a net debit on economic hedges which do not qualify for IFRS hedge accounting.

Non-Core

	2009	2008	2007(4)
	£m	£m	£m
Net interest income from banking activities	1,504	2,028	1,365
Funding costs of rental assets	(256)	(380)	(324)
Net interest income	1,248	1,648	1,041
Net fees and commissions receivable	472	889	834
Loss from trading activities	(5,123)	(7,716)	(804)
Insurance net premium income	784	986	962
Other operating income	318	1,161	2,994
Non-interest income	(3,549)	(4,680)	3,986
Total income	(2,301)	(3,032)	5,027
Direct expenses			
– staff	(851)	(988)	(508)
– other	(1,044)	(1,156)	(1,004)
Indirect expenses	(552)	(539)	(242)
	(2,447)	(2,683)	(1,754)
Insurance net claims	(588)	(700)	(727)
Impairment losses	(9,221)	(4,936)	(399)
Operating (loss)/profit before tax	(14,557)	(11,351)	2,147
Analysis of income			
Banking & Portfolio	(1,338)	2,324	
International Businesses & Portfolios	2,262	2,980	
Markets	(3,225)	(8,336)	
	(2,301)	(3,032)	5,027
Performance ratios			
Net interest margin	0.69%	0.87%	
Cost:income ratio	(106.3%)	(88.5%)	34.9%

	£bn	£bn	£bn
Capital and balance sheet (1)			
Total third party assets (including derivatives (2))	220.9	342.9	256.4
Loans and advances to customers – gross	149.5	191.4	161.4
Customer deposits	12.6	27.4	27.2
Risk elements in lending	22.9	11.1	
Loan:deposit ratio	1,121%	683%	
Risk-weighted assets (3)	171.3	170.9	

Notes:

(1) Includes disposal groups.

(2) Derivatives were £19.9 billion at 31 December 2009 (31 December 2008 – £85.0 billion).

(3) Includes Sempra: 31 December 2009 Third Party Assets (TPAs) £14.2 billion, RWAs £10.2 billion (31 December 2008 – TPAs £17.8 billion, RWAs £10.6 billion).

(4) As noted on page 5, following a comprehensive strategic review, changes have been made to the Group's operating segments in 2009. The company has also improved the granularity of certain segment information resulting in the provision of supplementary disclosures. However, it is not possible to source certain elements of these supplementary disclosures for 2007 without undue cost.

Business review
continued

	2009	2008	2007(4)
	£m	£m	£m
Credit and other market write-downs (1)			
Monoline exposures	2,387	3,121	
CDPCs	947	615	
Asset backed products (2)	288	3,220	
Other credit exotics	558	935	
Equities	47	947	
Leveraged finance	—	1,088	
Banking book hedges	1,613	(1,690)	
Other	(679)	(497)	
	5,161	7,739	
Impairment losses			
Banking & Portfolio	4,215	938	
International Businesses & Portfolios	4,494	1,832	
Markets	512	2,166	
	9,221	4,936	399
Loan impairment charge as % of gross customer loans and advances (3)			
Banking & Portfolio	4.91%	0.90%	
International Businesses & Portfolios	6.56%	2.28%	
Markets	5.34%	13.32%	
Total	5.66%	2.18%	
	£bn	£bn	
Gross customer loans and advances			
Banking & Portfolio	82.0	97.0	
International Businesses & Portfolios	65.6	79.9	
Markets	1.9	14.5	
	149.5	191.4	161.4
Risk-weighted assets			
Banking & Portfolio	58.2	63.1	
International Businesses & Portfolios	43.8	50.1	
Markets	69.3	57.7	
	171.3	170.9	

Notes:

(1) Included in 'Loss from trading activities' on page 60.

(2) Asset backed products include super senior asset backed structures and other asset backed products.

(3) Includes disposal groups.

(4) As noted on page 5, following a comprehensive strategic review, changes have been made to the Group's operating segments in 2009. The company has also improved the granularity of certain segment information resulting in the provision of supplementary disclosures. However, it is not possible to source certain elements of

these supplementary disclosures for 2007 without undue cost.

Loan impairment losses by donating division and sector

	2009 £m	2008 £m	2007(1) £m
UK Retail			
Mortgages	5	1	
Personal	48	42	
Other	—	62	
Total UK Retail	53	105	
UK Corporate			
Manufacturing & infrastructure	87	42	
Property & construction	637	281	
Transport	10	(3)	
Banks & financials	101	4	
Lombard	122	61	
Invoice finance	3	—	
Other	717	142	
Total UK Corporate	1,677	527	
Global Banking & Markets			
Manufacturing & infrastructure	1,405	1,280	
Property & construction	1,413	710	
Transport	178	12	
Telecoms, media & technology	545	55	
Banks & financials	567	870	
Other	619	177	
Total Global Banking & Markets	4,727	3,104	
Ulster Bank			
Mortgages	42	6	
Commercial investment & development	302	9	
Residential investment & development	716	229	
Other	217	60	
Other EMEA	107	116	
Total Ulster Bank	1,384	420	
US Retail & Commercial			
Auto & consumer	136	140	
Cards	130	63	
SBO/home equity	445	321	
Residential mortgages	55	6	
Commercial real estate	228	54	
Commercial & other	85	20	
Total US Retail & Commercial	1,079	604	
Other			

Wealth	251	174	
Global Transaction Services	49	(2)	
Central items	1	4	
Total Other	301	176	
Total impairment losses	9,221	4,936	399

Note:

(1) As noted on page 5, following a comprehensive strategic review, changes have been made to the Group's operating segments in 2009. The company has also improved the granularity of certain segment information resulting in the provision of supplementary disclosures. However, it is not possible to source certain elements of these supplementary disclosures for 2007 without undue cost.

Gross loans and advances to customers by donating division and sector (excluding reverse repurchase agreements)

	2009	2008	2007(1)
	£bn	£bn	£bn
UK Retail			
Mortgages	1.9	2.2	
Personal	0.7	1.1	
Total UK Retail	2.6	3.3	
UK Corporate			
Manufacturing & infrastructure	0.3	0.3	
Property & construction	10.8	11.3	
Lombard	2.7	3.7	
Invoice finance	0.4	0.7	
Other	20.7	22.1	
Total UK Corporate	34.9	38.1	
Global Banking & Markets			
Manufacturing & infrastructure	17.5		
Property & construction	25.7		
Transport	5.8		
Telecoms, media & technology	3.2		
Banks & financials	16.0		
Other	13.5		
Total Global Banking & Markets	81.7	104.8	
Ulster Bank			
Mortgages	6.0	6.5	
Commercial investment & development	3.0	2.9	
Residential investment & development	5.6	5.9	
Other	1.1	1.1	
Other EMEA	1.0	1.3	
Total Ulster Bank	16.7	17.7	
US Retail & Commercial			
Auto & consumer	3.2	4.2	
Cards	0.5	0.7	
SBO/home equity	3.7	5.2	
Residential mortgages	0.8	1.1	
Commercial real estate	1.9	3.0	
Commercial & other	0.9	1.4	
Total US Retail & Commercial	11.0	15.6	
Other			
Wealth	2.6	3.6	
Global Transaction Services	0.8	1.4	
RBS Insurance	0.2	0.2	

Central items	(3.2)	—
Total Other	0.4	5.2
Total loans and advances to customers	147.3	184.7

Note:

(1) As noted on page 5, following a comprehensive strategic review, changes have been made to the Group's operating segments in 2009. The company has also improved the granularity of certain segment information resulting in the provision of supplementary disclosures. However, it is not possible to source certain elements of these supplementary disclosures for 2007 without undue cost.

2009 compared with 2008
Losses from trading activities have declined significantly as underlying asset prices rallied. Mark to market values for exposures such as monolines, super senior high grade collateralised debt obligations, and many negative basis trade asset classes have risen over the course of 2009. However, the £1.6 billion gain recorded on banking book hedging in 2008 unwound over the course of the year to a loss of £1.6 billion in 2009, as spreads continued to tighten throughout the year, ending almost in line with origination levels.

Impairment losses increased to £9.2 billion, reflecting continued weakness in the economic environment, particularly across the corporate and property sectors. There were signs of a slowdown in the rate of provisioning towards the end of the year.

Staff costs decreased by 14% over the year, due to headcount reductions and business divestments, notably Linea Directa and Tesco Personal Finance. Lower depreciation charges followed the 2008 sale of the Angel Trains business.

Third party assets, excluding derivatives, decreased by £56.9 billion in the year as the division has run down exposures and pursued opportunities to dispose of loan portfolios. Sales of equity stakes, including Bank of China, were concluded while further disposals announced in 2009, including Asian retail and commercial operations, are moving towards completion in 2010.

Risk weighted assets increased by 0.2% in 2009. The reduction of 15% since 30 September 2009, reflects active management to reduce trading book exposures, largely offset by the impact of procyclicality, monoline downgrades and adverse market risk.

2008 compared with 2007
Overall results for 2008 deteriorated significantly due to the worsening of global economies and credit markets resulting in large increases in impairment losses and credit and other market write downs on trading activities. In addition 2008 included a full year of results from the acquisition of ABN AMRO compared with 76 days in the previous year.

Net interest income increased to £1,648 million and net fees and commissions increased to £889 million principally due to the inclusion of a full year of income for ABN AMRO. In 2008, losses from trading activities totalled £7,716 million compared with a loss of £804 million in 2007 including £10,172 million of credit and other market write downs, partially offset by £1,690 million gain on credit default swaps, particularly in the fourth quarter of 2008.

Other operating income reduced significantly due to the sale of a number of our private equity portfolios including Southern Water in 2007 which was not repeated in 2008.

The increase in operating expenses mainly reflects the inclusion of a full year of the ABN AMRO cost base partially offset by a reduction in bonus related expenses in 2008.

Insurance premiums and claims including Linea Directa were relatively stable.

Impairment losses increased to £4,936 million from £399 million, of which £3,105 million related to global corporate clients previously managed in our Global Banking & Markets division.

Third party assets had small increases in most areas. Loans and advances increased by £31 billion or 19%. Global clients saw increases of £15 billion, with steady, but smaller increases in the retail & commercial markets of UK, EME, Asia and the US.

Customer deposits remained largely unchanged.

Employee numbers at 31 December in Continuing Operations
(full time equivalents rounded to the nearest hundred)

	Restated 2009	2008	2007
UK Retail	25,500	28,400	28,400
UK Corporate	12,300	13,400	12,500
Wealth	4,600	5,200	5,100
Global Banking & Markets	16,800	16,500	22,000
Global Transaction Services	3,500	3,900	3,100
Ulster Bank	4,500	5,400	5,400
US Retail & Commercial	15,500	16,200	16,300
RBS Insurance	13,900	14,500	15,700
Central items	4,200	4,300	4,300
Core	100,800	107,800	112,800
Non-Core	15,100	19,000	16,300
	115,900	126,800	129,100
Business services	44,200	47,600	44,700
Integration	500	900	—
RFS Holdings minority interest	300	200	2,900
Group total	160,900	175,500	176,700

Consolidated balance sheet at 31 December 2009

	2009 £m	2008 £m	2007 £m
Assets			
Cash and balances at central banks	52,261	12,400	17,866
Net loans and advances to banks	56,656	79,426	43,519
Reverse repurchase agreements and stock borrowing	35,097	58,771	175,941
Loans and advances to banks	91,753	138,197	219,460
Net loans and advances to customers	687,353	835,409	686,181
Reverse repurchase agreements and stock borrowing	41,040	39,313	142,357
Loans and advances to customers	728,393	874,722	828,538
Debt securities	267,254	267,549	294,656
Equity shares	19,528	26,330	53,026
Settlement balances	12,033	17,832	16,589
Derivatives	441,454	992,559	277,402
Intangible assets	17,847	20,049	49,916
Property, plant and equipment	19,397	18,949	18,745
Deferred taxation	7,039	7,082	3,119
Prepayments, accrued income and other assets	20,985	24,402	15,662
Assets of disposal groups	18,542	1,581	45,850
Total assets	1,696,486	2,401,652	1,840,829
Liabilities			
Bank deposits	104,138	174,378	149,256
Repurchase agreements and stock lending	38,006	83,666	163,038
Deposits by banks	142,144	258,044	312,294
Customers deposits	545,849	581,369	547,447
Repurchase agreements and stock lending	68,353	58,143	134,916
Customer accounts	614,202	639,512	682,363
Debt securities in issue	267,568	300,289	274,172
Settlement balances and short positions	50,876	54,277	91,021
Derivatives	424,141	971,364	272,052
Accruals, deferred income and other liabilities	30,327	31,482	34,208
Retirement benefit liabilities	2,963	2,032	460
Deferred taxation	2,811	4,165	5,400
Insurance liabilities	10,281	9,976	10,162
Subordinated liabilities	37,652	49,154	38,043
Liabilities of disposal groups	18,890	859	29,228
Total liabilities	1,601,855	2,321,154	1,749,403
Minority interests	16,895	21,619	38,388
Owners' equity	77,736	58,879	53,038
Total equity	94,631	80,498	91,426
Total liabilities and equity	1,696,486	2,401,652	1,840,829

Commentary on consolidated balance sheet: 2009 compared with 2008

Total assets of £1,696.5 billion at 31 December 2009 were down £705.2 billion, 29%, compared with 31 December 2008, principally reflecting substantial repayments of customer loans and advances as corporate customer demand fell and corporates looked to deleverage their balance sheets. Lending to banks also fell in line with significantly reduced wholesale funding activity. There were also significant falls in the value of derivative assets, with a corresponding fall in derivative liabilities.

Cash and balances at central banks were up £39.9 billion to £52.3 billion due to the placing of short-term cash surpluses, including the proceeds from the issue of B shares in December, with central banks.

Loans and advances to banks decreased by £46.4 billion, 34%, to £91.8 billion with reverse repurchase agreements and stock borrowing (‘reverse repos’) down by £23.7 billion, 40% to £35.1 billion and lower bank placings, down £22.7 billion, 29%, to £56.7 billion largely as a result of reduced wholesale funding activity in Global Banking & Markets.

Loans and advances to customers were down £146.3 billion, 17%, at £728.4 billion. Within this, reverse repos increased by 4%, £1.7 billion to £41.0 billion. Excluding reverse repos, lending decreased by £148.0 billion, 18%, to £687.4 billion or by £141.8 billion, 17%, before impairment provisions. This reflected reductions in Global Banking & Markets of £71.4 billion, and planned reductions in Non-Core of £30.1 billion, including a £3.2 billion transfer to disposal groups in respect of RBS Sempra Commodities and the Asian and Latin American businesses. Reductions were also experienced in US Retail & Commercial, £7.4 billion; UK Corporate & Commercial, £5.4 billion; Ulster Bank, £1.8 billion; and the effect of exchange rate movements, £33.1 billion, following the strengthening of sterling during the year, partially offset by growth in UK Retail of £9.2 billion, and in Wealth of £1.4 billion.

Debt securities were flat at £267.3 billion and equity shares decreased by £6.8 billion, 26%, to £19.5 billion, principally due to the sale of the Bank of China investment and lower holdings in Global Banking & Markets and Non-Core, largely offset by growth in Group Treasury, in part reflecting an £18.0 billion increase in the gilt liquidity portfolio, and in the RFS Holdings minority interest.

Settlement balances were down £5.8 billion, 33%, at £12.0 billion as a result of lower customer activity.

Movements in the value of derivative assets, down £551.1 billion, 56%, to £441.5 billion, and liabilities, down £547.2 billion, 56%, to £424.1 billion, reflect the easing of market volatility, the strengthening of sterling and significant tightening in credit spreads in the continuing low interest rate environment.

Increases in assets and liabilities of disposal groups reflect the inclusion of the RBS Sempra Commodities business and the planned sale of a number of the Group’s retail and commercial activities in Asia and Latin America.

Deposits by banks declined by £115.9 billion, 45%, to £142.1 billion due to a decrease in repurchase agreements and stock lending (‘repos’), down £45.7 billion, 55%, to £38.0 billion and reduced inter-bank deposits, down £70.2 billion, 40% to £104.1 billion principally in Global Banking & Markets, reflecting reduced reliance on wholesale funding, and in the RFS Holdings minority interest.

Customer accounts were down £25.3 billion, 4%, to £614.2 billion. Within this, repos increased £10.2 billion, 18%, to £68.4 billion. Excluding repos, deposits were down £35.5 billion, 6%, to £545.8 billion, primarily due to; reductions in Global Banking & Markets, down £43.6 billion; Non-Core, £13.0 billion; including the transfer of £8.9 billion to disposal groups; and Ulster Bank, £1.2 billion; together with exchange rate movements, £21.3 billion, offset in part by growth across all other divisions, up £23.0 billion, and in the RFS Holdings minority interest, up £20.6 billion.

Debt securities in issue were down £32.7 billion, 11% to £267.6 billion mainly as a result of movements in exchange rates, together with reductions in Global Banking & Markets, Non-Core and the RFS Holdings minority interest.

Retirement benefit liabilities increased by £0.9 billion, 46%, to £3.0 billion, with net actuarial losses of £3.7 billion, arising from lower discount rates and higher assumed inflation, partially offset by curtailment gains of £2.1 billion due to changes in prospective pension benefits.

Subordinated liabilities were down £11.5 billion, 23% to £37.7 billion, reflecting the redemption of £5.0 billion undated loan capital, £1.5 billion trust preferred securities and £2.7 billion dated loan capital, together with the effect of exchange rate movements and other adjustments, £2.9 billion, partly offset by the issue of £2.3 billion undated loan capital within the RFS Holdings minority interest.

Equity minority interests decreased by £4.7 billion, 22%, to £16.9 billion. Equity withdrawals of £3.1 billion, due to the disposal of the investment in the Bank of China attributable to minority shareholders and the redemption, in part, of certain trust preferred securities, exchange rate movements of £1.4 billion, the recycling of related available-for-sale reserves to income, £0.5 billion, and dividends paid of £0.3 billion, were partially offset by attributable profits of £0.3 billion.

Owners' equity increased by £18.9 billion, 32% to £77.7 billion. The issue of B shares to HM Treasury in December 2009 raised £25.1 billion, net of expenses, and was offset in part by the creation of a £1.2 billion reserve in respect of contingent capital B shares. The placing and open offer in April 2009 raised £5.3 billion to fund the redemption of the £5.0 billion preference shares issued to HM Treasury in December 2008. Actuarial losses, net of tax, of £2.7 billion; the attributable loss for the period, £2.7 billion; exchange rate movements of £1.9 billion; the payment of other owners dividends of £0.9 billion including £0.3 billion to HM Treasury on the redemption of preference shares, and partial redemption of paid-in equity £0.3 billion were partly offset by increases in available-for-sale reserves, £1.8 billion; cash flow hedging reserves, £0.6 billion; and the equity owners gain on withdrawal of minority interests, net of tax, of

£0.5 billion arising from the redemption of trust preferred securities.

Commentary on consolidated balance sheet: 2008 compared with 2007

Total assets of £2,401.7 billion at 31 December 2008 were up £560.8 billion, 30%, compared with 31 December 2007.

Loans and advances to banks decreased by £81.3 billion, 37%, to £138.2 billion. Reverse repurchase agreements and stock borrowing ('reverse repos') were down by £117.2 billion, 67% to £58.8 billion. Excluding reverse repos, bank placings increased by £35.9 billion, 83%, to £79.4 billion.

Loans and advances to customers were up £46.2 billion, 6%, at £874.7 billion or £68.0 billion, 8% following the disposal of the Banco Real and other businesses to Santander and Tesco Personal Finance. Within this, reverse repos decreased by 72%, £103.0 billion to £39.3 billion. Excluding reverse repos, lending rose by £149.2 billion, 22% to £835.4 billion reflecting both organic growth and the effect of exchange rate movements following the weakening of sterling during the second half of 2008.

Debt securities decreased by £27.1 billion, 9%, to £267.5 billion and equity shares decreased by £26.7 billion, 50%, to £26.3 billion principally due to lower holdings in Global Banking & Markets.

Movements in the value of derivatives, assets and liabilities, primarily reflect changes in interest and exchange rates, together with growth in trading volumes.

Intangible assets declined by £29.9 billion, 60% to £20.0 billion, reflecting impairment of £32.6 billion and the disposals of the Asset Management business of ABN AMRO, Banca Antonveneta and the Banco Real and other businesses of ABN AMRO acquired by Santander, £7.2 billion. This was offset by exchange rate movements of £11.8 billion, goodwill of £0.2 billion arising on the Sempra joint venture and £0.3 billion on the buyout of the outstanding ABN AMRO shareholdings not previously owned by the Group.

Deferred tax assets increased £4.0 billion to £7.1 billion principally due to carried forward trading losses.

Prepayments, accrued income and other assets were up £8.7 billion, 56% to £24.4 billion.

Assets and liabilities of disposal groups decreased following completion of the sales of the Asset Management business of ABN AMRO to Fortis, Banca Antonveneta to Monte dei Paschi di Sienna and the majority of ABN AMRO's Private Equity business to third parties.

Deposits by banks declined by £54.3 billion, 17% to £258.0 billion. This reflected decreased repurchase agreements and stock lending ('repos'), down £79.4 billion, 49% to £83.7 billion partly offset by increased inter-bank deposits, up £25.1 billion, 17% to £174.4 billion.

Customer accounts were down £42.9 billion, 6% to £639.5 billion or £21.6 billion, 3% excluding disposals of subsidiaries. Within this, repos decreased £76.8 billion, 57% to £58.1 billion. Excluding repos, deposits rose by £33.9 billion, 6%, to £581.4 billion.

Debt securities in issue were up £26.1 billion, 10% to £300.3 billion mainly resulting from the effect of exchange rate movements.

Settlement balances and short positions were down £36.7 billion, 40%, to £54.3 billion reflecting reduced customer activity.

Accruals, deferred income and other liabilities decreased £2.7 billion, 8%, to £31.5 billion primarily as a result of disposals.

Retirement benefit liabilities increased by £1.6 billion to £2.0 billion due to reduced asset values only partly offset by the effect of increased discount rates.

Deferred taxation liabilities decreased by £1.2 billion, 23% to £4.2 billion due in part to the sale of Angel Trains.

Subordinated liabilities were up £11.1 billion, 29% to £49.2 billion. The issue of £2.4 billion dated loan capital and the effect of exchange rate and other adjustments, £11.3 billion, were partially offset by the redemption of £1.6 billion of dated loan capital, £0.1 billion undated loan capital and £0.9 billion in respect of the disposal of the Banco Real and other businesses of ABN AMRO to Santander.

Equity minority interests decreased by £16.8 billion, 44% to £21.6 billion. Attributable losses of £ 10.8 billion, including £15.7 billion of write downs of goodwill and other intangible assets in respect of the State of the

Netherlands investment in RFS Holdings, equity withdrawals of £13.6 billion, including £12.3 billion by Santander following the disposals of Banca Antonveneta and Banco Real, reductions in the market value of available-for-sale securities of £1.4 billion, mainly the investment in Bank of China attributable to minority shareholders, movements in cash flow hedging reserves, £0.8 billion, actuarial losses on defined benefit pension schemes net of tax of £0.5 billion and dividends paid of £0.3 billion, were partially offset by effect of exchange rate movements of £9.1 billion of which £8.0 billion related to the State of the Netherlands and Santander investments in RFS Holdings, the £0.8 billion equity raised as part of the Sempra joint venture and £0.4 billion additional equity in respect of the buy-out of the ABN AMRO minority shareholders.

Owners' equity increased by £5.8 billion, 11% to £58.9 billion. Proceeds of £12.0 billion from the rights issue, net of £246 million expenses, and £19.7 billion from the placing and open offer, net of expenses of £265 million, together with exchange rate movements of £6.8 billion and other movements of £0.2 billion were partially offset by the attributable loss for the period of £23.7 billion, a £4.6 billion decrease in available-for-sale reserves, net of tax, reflecting £1.0 billion in the Group's share in the investment in Bank of China and £3.6 billion in other securities, the majority of which related to Global Banking & Markets, actuarial losses net of tax of £1.3 billion, the payment of the 2007 final ordinary dividend of £2.3 billion and other dividends of £0.6 billion, and a reduction in the cash flow hedging reserve of £0.3 billion.

Cash flow

	2009 £m	2008 £m	2007 £m
Net cash flows from operating activities	(992)	(75,338)	25,604
Net cash flows from investing activities	54	16,997	15,999
Net cash flows from financing activities	18,791	15,102	29,691
Effects of exchange rate changes on cash and cash equivalents	(8,592)	29,209	6,010
Net increase/(decrease) in cash and cash equivalents	9,261	(14,030)	77,304

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.

2008

The major factors contributing to the net cash outflow from operating activities of £75,338 million were the net operating loss before tax of £36,628 million from continuing and discontinued operations, the decrease of £42,219 million in operating liabilities less operating assets, and the elimination of foreign exchange differences of £41,874 million, partly offset by the write down of goodwill and other intangible assets, £32,581 million and other non-cash items, £8,772 million.

Proceeds on disposal of discontinued activities of £20,113 million was the largest element giving rise to net cash flows of investing activities of £16,997 million. Outflow from net purchases of securities of £1,839 million and net disposals of property, plant and equipment, £3,529 million less the net cash inflow of £2,252 million in respect of other acquisitions and disposals represented the other principal factors.

Net cash flows from financing activities of £15,102 million primarily arose from the capital raised from the placing and open offer of £19,741 million and the rights issue of £12,000 million, the issue of subordinated liabilities of £2,413 million and proceeds of minority interests, £1,427 million. This was offset in part by the cash outflow on redemption of minority interests of £13,579 million, repayment of subordinated liabilities of £1,727 million, dividends paid of £3,193 million and interest paid on subordinated liabilities of £1,967 million.

2007

The major factors contributing to the net cash inflow from operating activities of £25,604 million were the increase of £28,261 million in operating liabilities less operating assets and the profit before tax of £9,900 million, partly offset by the elimination of foreign exchange differences of £10,282 million and income taxes paid of £2,442 million.

The acquisition of ABN AMRO, included within net investment in business interests and intangible assets of £13,640 million, was the largest element giving rise to net cash flows from investing activities of £15,999 million, with cash and cash equivalents acquired of £60,093 million more than offsetting the cash consideration paid of £45,856 million. Net sales and maturities of securities of £1,987 million and net disposals of property, plant and equipment, £706 million less the net cash outflow of £597 million in respect of other acquisitions and disposals represented the other principle factors.

Net cash flows from financing activities of £29,691 million primarily relate to the cash injection of £31,019 million from the consortium partners in relation to the acquisition of ABN AMRO, together with the issue of £4,829 million of equity securities and £1,018 million of subordinated liabilities, offset in part by dividend payments of £3,411 million, the repayment of £1,708 million subordinated liabilities, interest on subordinated liabilities of £1,522 million and the redemption of £545 million of minority interests.

Capital resources

The following table analyses the Group's regulatory capital resources on a fully consolidated basis at 31 December, the basis monitored by the FSA for regulatory purposes (refer to page 74 for further details):

	2009	2008	2007	2006	2005
	£m	£m	£m	£m	£m
Capital base					
Tier 1 capital	76,421	69,847	44,364	30,041	28,218
Tier 2 capital	15,389	32,223	33,693	27,491	22,437
Tier 3 capital	—	260	200	—	—
	91,810	102,330	78,257	57,532	50,655
Less: Supervisory deductions	(4,565)	(4,155)	(10,283)	(10,583)	(7,282)
Total capital	87,245	98,175	67,974	46,949	43,373
Risk-weighted assets					
Credit risk	513,200	551,300			
Counterparty risk	56,500	61,100			
Market risk	65,000	46,500			
Operational risk	33,900	36,900			
	668,600	695,800			
APS relief	(127,600)	—			
	541,000	695,800			
Banking book:					
On-balance sheet			480,200	318,600	303,300
Off-balance sheet			84,600	59,400	51,500
Trading book			44,200	22,300	16,200
			609,000	400,300	371,000
Risk asset ratios	%	%	%	%	%
Core Tier 1	11.0	6.6	4.5		
Tier 1	14.1	10.0	7.3	7.5	7.6
Total	16.1	14.1	11.2	11.7	11.7

Note:
(1) The data for 2009 and 2008 are on a Basel II basis; prior periods are 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 2009, the Group's total RAR was 16.1% (2008 – 14.1%, 2007 – 11.2%) and the Tier 1 RAR was 14.1% (2008 – 10.0%, 2007 – 7.3%).

Risk, capital and liquidity management

On pages 70 to 159 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 labelled with an asterisk (*). Key points within this section generally relate to the Group before RFS Holdings minority interest.

Overview*

Conditions during the year continued to prove challenging as the ongoing deterioration in economic conditions and financial markets seen during 2008 continued into 2009. Market stress peaked during the first quarter of 2009 with broad improvement since then. This reflects a global effort by many governments and central banks to ease monetary conditions, increase liquidity within the financial system and support banks with a combination of increased capital, guarantees and strengthened deposit insurance. One resulting benefit for banks generally has been a significant improvement in the liquidity of money and debt markets. At the same time, regulatory oversight of the banking sector has increased globally and is expected to continue at a heightened level.

More recently, the major economies have started to demonstrate a gradually improving macroeconomic position, although conditions remain fragile. Areas of particular uncertainty include possible effects from governments ending their financial stimulus initiatives and central banks moving to exit from positions of historically very low interest rates, as well as reversing quantitative easing. These look likely to occur against a backdrop of heightened personal and corporate insolvency as well as rising unemployment.

The Group has been developing and adapting to an evolving economic environment, against a background of the strategic review which includes a clearly stated ambition to achieve standalone strength. The core aims of the strategic plan are to improve the risk profile of the Group and to reposition the balance sheet around the Group's core strengths. The Group level risk appetite statements and limits have been reviewed to ensure they are in line with the strategy. Any potential areas of misalignment between risk appetite and the Group strategy have been discussed by the Executive Risk Forum and remediation plans have been put in place.

Enhancements have been made to a number of the risk frameworks, including:

- A new credit approval process has been introduced during the year, based on a pairing of business and risk managers authorised to approve credit. This replaced the former credit committee process;
- Exposure to higher risk countries has been reduced and a new risk limits framework has been implemented across the Group;
- Single name and sector wide credit concentrations continue to receive a high level of attention and further enhancements to the frameworks were agreed in the fourth quarter of the year;
- In addition to the move to value-at-risk (VaR) based on a 99% confidence level, from 95%, the Group has improved and strengthened its market risk limit framework increasing the transparency of market risk taken across the Group's businesses in both the trading and non-trading portfolios;

- The Group's funding and liquidity profile is supported by explicit targets and metrics to control the size and extent of both short-term and long-term liquidity risk; and

- An improved reporting programme has been implemented to increase transparency and improve the management of risk exposures.

Credit impairments in 2009 were materially higher than the previous year. As the year progressed, the level of impairments moderated, with the highest quarterly charge incurred in the second quarter. It is expected that the results for 2010 and 2011 will continue to be affected by a heightened level of credit impairments as exposures in the Non-Core division are managed down and the economic environment continues to impact the Core business. The risk weightings applied to assets are also expected to increase due to procyclicality and as a result the amount of capital that banks generally are required to hold will increase. Future regulatory changes are also expected to increase the capital requirements of the banking sector. Against this background, the Non-Core portfolio is reducing and the Group has materially strengthened its capital base through the B share issuance in December 2009.

*
unaudited

Risk, capital and liquidity governance*

The risk, capital and liquidity management strategies are owned and set by the Group's Board of Directors, and implemented by executive management led by the Group Chief Executive. There are a number of committees and executives that support the execution of the business plan and strategy, as set out below. Representation by and interaction between the individual risk disciplines is a key feature of the governance structure, with the aim of promoting cross-risk linkages.

Note:

For key changes to the risk, capital and liquidity governance structure, refer to the table overleaf.

* unaudited

Business review

Risk, capital and liquidity management

Risk, capital and liquidity governance* continued
The role and remit of these committees is as follows:

Committee	Focus	Membership
Group Audit Committee (GAC)	Financial reporting and the application of accounting policies as part of the internal control and risk assessment process. From a historical perspective, GAC monitors the identification, evaluation and management of all significant risks throughout the Group.	Independent non-executive directors
Board Risk Committee (BRC)	A new committee, formed to provide oversight and advice to the Group Board in relation to current and potential future risk exposures of the Group and future risk strategy. Reports to the Group Board, identifying any matters within its remit in respect of which it considers an action or improvement is needed, and making recommendations as to the steps to be taken. Provides quantitative and qualitative advice to the Remuneration Committee upon the Group Remuneration Policy and the implications for risk management.	At least three independent non-executive directors, one of whom is the Chairman of the Group Audit Committee
Executive Credit Group (ECG)	Formed to replace the Advances Committee and the Group Credit Committee, the ECG decides on requests for the extension of existing or new credit limits on behalf of the Board of Directors which exceed the delegated authorities of individuals throughout the Group as determined by the credit approval grid. The Head of Restructuring and Risk or the Group Chief Credit Officer must be present along with at least one other member to ensure the meeting is quorate.	Group Chief Executive Head of Restructuring and Risk Group Chief Risk Officer Group Chief Credit Officer Chief Executive Officer from each division Group Finance Director
Executive Committee (ExCo)	A newly formed committee responsible for managing Group wide issues and those operational issues material to the broader Group.	Group Chief Executive Business and function heads, as determined by the Group Chief Executive/Board Head of Restructuring and Risk Group Finance Director

Group Risk Committee (GRC)	Recommends limits and approves processes and major policies to ensure the effective management of all material risks across the Group.	Head of Restructuring and Risk Group Chief Risk Officer Group Head of each risk function Group Head of Country Risk Global Head of Risk Architecture Deputy Group Finance Director Chief Operating Officer, RBS Risk Management Chief Executive and Chief Risk Officer from each division
Group Asset and Liability Management Committee (GALCO)	Identifies, manages and controls the Group balance sheet risks.	Group Finance Director Deputy Group Finance Director Head of Restructuring and Risk Chief Executive from each division Group Chief Accountant Group Treasurer and Deputy Group Treasurer Chief Financial Officer, ABN AMRO Director, Group Corporate Finance Director, Group Financial Planning & Analysis Head of Balance Sheet Management, Group Treasury
Executive Risk Forum (ERF)	Acts on all strategic risk and control matters across the Group including, but not limited to, credit risk, market risk, operational risk, compliance and regulatory risk, enterprise risk, treasury and liquidity risk, reputational risk, insurance risk and country risk.	Group Chief Executive Head of Restructuring and Risk Group Chief Risk Officer Group Finance Director Chief Executive Officer from each division

Note:
These committees are supported at a divisional level by a risk governance structure embedded in the businesses.
* unaudited

Risk, capital and liquidity governance* continued

Management responsibilities

All employees have a role to play in the day-to-day management of capital, liquidity and risk which is set and managed by specialist staff in:

- Risk Management: credit risk, market risk, operational risk, regulatory risk, reputational risk, insurance risk and country risk, together with risk analytics; and

- Group Treasury: balance sheet, capital management, intra-group exposure, funding, liquidity and hedging policies.

Independence underpins the approach to risk management, which is reinforced throughout the Group by appropriate reporting lines. Risk Management and Group Treasury functions are independent of the revenue generating business. As part of the move towards greater functional independence, the divisional Chief Risk Officers have a direct reporting line to the Head of Restructuring and Risk as well as to their divisional CEOs.

Group Internal Audit supports the GAC in providing an independent assessment of the design, adequacy and effectiveness of the internal controls relating to risk management.

Risk appetite

Risk appetite is an expression of the maximum level of risk that the Group is prepared to accept in order to deliver its business objectives. Risk and capital management across the Group is based on the risk appetite set by the Board, who ultimately approve annual plans for each division and regularly reviews and monitors the Group's performance in relation to risk.

Risk appetite is defined in both quantitative and qualitative terms as follows:

- Quantitative: encompassing stress testing, risk concentration, VaR, liquidity and credit related metrics; and

- Qualitative: ensuring that the Group applies the correct principles, policies and procedures.

Different techniques are used to ensure that the Group's risk appetite is achieved. The Board Risk Committee considers and recommends for approval by the Group Board, the Group's risk appetite framework and tolerance for current and future strategy, taking into account the Group's capital adequacy and the external risk environment. The ERF is responsible for ensuring that the implementation of strategy and operations are in line with the risk appetite determined by the Board. This is reinforced through policy and limit frameworks ensuring that all staff within the Group make appropriate risk and reward trade-offs within pre-agreed boundaries.

The annual business planning and performance management processes and associated activities together ensure that the expression of risk appetite remains appropriate. Both GRC and GALCO support this work.

Remuneration responsibilities

In August 2009, the Financial Services Authority (FSA) published its Code of Remuneration Practices (the Code). The Code requires the Group to establish, implement and maintain remuneration policies, procedures and practices that promote and are consistent with effective risk management.

The Risk Management function provides input to the Remuneration Committee on the remuneration policy for the Group. Each division is allocated risk objectives as part of the strategic plan and achievement of these objectives is evaluated as part of the annual performance management process.

During 2009 Risk Management provided formal independent 360° feedback for key individuals, reviewing their capability and performance in relation to managing risk. Individuals selected perform roles of significant influence and their activities have, or could have, a material impact on the Group's risk profile.

An annual report on the risk performance of each division, including both qualitative and quantitative information is provided to the Remuneration Committee to allow consideration of adjustments relating to the compensation for the performance year.

Capital*

Capital resources

It is the Group's policy to maintain a strong capital base 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 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 (RWAs) (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 2009, the Group's total RAR was 16.1% (2008 – 14.1%) and the Tier 1 RAR was 14.1% (2008 – 10.0%).

As part of the annual planning and budgeting cycle, each division is allocated capital based upon RWAs and associated regulatory deductions. The budgeting process considers risk appetite, available capital resources, stress testing results and business strategy. The budget is agreed by the Board and allocated to divisions to manage their allocated RWAs.

Group Treasury and GALCO monitor available capital and its utilisation across divisions. GALCO makes the necessary decisions around reallocation of budget and changes in RWA allocations.

* unaudited

Business review

Risk, capital and liquidity management

Capital* continued

Capital resources continued

In addition to the fully consolidated basis monitored by the FSA for regulatory purposes, the Group also monitors its regulatory capital resources on a proportional consolidation basis reflecting the pending separation of the RFS Minority Interest. The Group's regulatory capital resources on a proportional consolidation basis at 31 December 2009 and in accordance with the FSA definitions were as follows:

Composition of regulatory capital (proportional)	2009 £m	2008 £m
Tier 1		
Ordinary and B shareholders' equity	69,890	45,525
Minority interests	2,227	5,436
Adjustments for:		
– Goodwill and other intangible assets – continuing	(14,786)	(16,386)
– Goodwill and other intangible assets of discontinued businesses	(238)	—
– Unrealised losses on available-for-sale debt securities	1,888	3,687
– Reserves arising on revaluation of property and unrealised gains on available-for-sale equities	(207)	(984)
– Reallocation of preference shares and innovative securities	(656)	(1,813)
– Other regulatory adjustments	(950)	9
Less excess of expected losses over provisions net of tax	(2,558)	(770)
Less securitisation positions	(1,353)	(663)
Less APS first loss	(5,106)	—
Core Tier 1 capital	48,151	34,041
Preference shares	11,265	16,655
Innovative Tier 1 securities	2,772	6,436
Tax on the excess of expected losses over provisions	1,020	308
Less deductions from Tier 1 capital	(310)	(316)
Total Tier 1 capital	62,898	57,124
Tier 2		
Reserves arising on revaluation of property and unrealised gains on available-for-sale equities	207	984
Collective impairment allowances	796	666
Perpetual subordinated debt	4,200	9,079
Term subordinated debt	18,120	20,282
Minority and other interests in Tier 2 capital	11	11
Less deductions from Tier 2 capital	(5,241)	(2,055)
Less APS first loss	(5,106)	—
Total Tier 2 capital	12,987	28,967
Tier 3	—	260
Supervisory deductions		

Unconsolidated investments		
– RBS Insurance	(4,068)	(3,628)
– Other investments	(404)	(416)
Other	(93)	(111)
Deductions from total capital	(4,565)	(4,155)
Total regulatory capital	71,320	82,196
Risk weighted assets		
Credit risk	410,400	433,400
Counterparty risk	56,500	61,100
Market risk	65,000	46,500
Operational risk	33,900	36,800
	565,800	577,800
APS relief	(127,600)	—
	438,200	577,800
Risk asset ratio		
Core Tier 1	11.0%	5.9%
Tier 1	14.4%	9.9%
Total	16.3%	14.2%

* unaudited

74

Capital* continued

Capital resourcescontinued

The following table analyses the Group's regulatory capital resources on a fully consolidated basis at 31 December, the basis monitored by the FSA for regulatory purposes (refer to page 74 for further details):

Composition of regulatory capital (statutory)	2009 £m	2008 £m
Tier 1		
Ordinary and B shareholders' equity	69,890	45,525
Minority interests	16,895	21,619
Adjustments for:		
– Goodwill and other intangible assets – continuing	(17,847)	(20,049)
– Goodwill and other intangible assets of discontinued businesses	(238)	—
– Unrealised losses on available-for-sale debt securities	1,888	3,687
– Reserves arising on revaluation of property and unrealised gains on available-for-sale equities	(207)	(984)
– Reallocation of preference shares and innovative securities	(656)	(1,813)
– Other regulatory adjustments	(1,184)	(362)
Less excess of expected losses over provisions net of tax	(2,558)	(770)
Less securitisation positions	(1,353)	(663)
Less APS first loss	(5,106)	—
Core Tier 1 capital	59,524	46,190
Preference shares	11,265	16,655
Innovative Tier 1 securities	5,213	7,383
Tax on the excess of expected losses over provisions	1,020	308
Less deductions from Tier 1 capital	(601)	(689)
Total Tier 1 capital	76,421	69,847
Tier 2		
Reserves arising on revaluation of property and unrealised gains on available-for-sale equities	207	984
Collective impairment allowances	796	666
Perpetual subordinated debt	4,950	9,829
Term subordinated debt	20,063	23,162
Minority and other interests in Tier 2 capital	11	11
Less deductions from Tier 2 capital	(5,532)	(2,429)
Less APS first loss	(5,106)	—
Total Tier 2 capital	15,389	32,223
Tier 3	—	260
Supervisory deductions		
Unconsolidated investments	(4,472)	(4,044)
Other	(93)	(111)
Deductions from total capital	(4,565)	(4,155)

Total regulatory capital	87,245	98,175
Risk-weighted assets		
Credit risk	513,200	551,300
Counterparty risk	56,500	61,100
Market risk	65,000	46,500
Operational risk	33,900	36,900
	668,600	695,800
APS relief	(127,600)	—
	541,000	695,800
Risk asset ratio		
Core Tier 1	11.0%	6.6%
Tier 1	14.1%	10.0%
Total	16.1%	14.1%

* unaudited

75

Capital* continued

Regulatory developments continued

The Group has seen a continuation of challenging financial market and economic conditions during 2009. Although some signs of improvement have started to emerge, the performance of key economies remains uncertain and the Group has continued to experience material impairment losses and credit market write-downs, including further write-downs in respect of monoline exposures. The majority of these are in the Non-Core division, which in time will be run down, significantly reducing the size of the Group's balance sheet and associated capital requirements.

In April 2009, £5 billion of preference shares were redeemed and replaced by ordinary shares using the proceeds of the Second Placing and Open Offer. This strengthened the Group's Core Tier 1 capital, enhancing its financial stability during a tough economic and market period.

As an interim measure pending full compliance with Basel II, the Group, with the agreement of the regulators, consolidates the RWAs of ABN AMRO on the basis of Basel I plus an adjustment factor. The Group is advanced in its preparation for moving to a Basel II compliant approach for the ABN AMRO businesses it will retain. As part of this transition the Group has agreed with the FSA to increase the adjustment factor with effect from 31 December 2009 to reflect changing circumstances. This change has increased RWAs by approximately £8 billion thereby reducing the Core Tier 1 ratio at 31 December 2009 by 20 basis points.

Asset Protection Scheme

On 22 December 2009, the Group acceded to the Asset Protection Scheme ('APS' or 'the Scheme'). The key commercial terms and details of the assets covered by the Scheme are set out on page 127.

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 annual fees in respect of the protection and contingent capital. The Group has the option, subject to HM Treasury consent, to pay the annual 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.

On 19 January 2009, the FSA announced that it expects each bank participating in the UK Government's recapitalisation scheme to have a minimum Core Tier 1 ratio of 4% on a stressed basis. As at 31 December 2009 the Group's Core Tier 1 ratio was 11.0% (2008 – 6.6%). While the RWA relief from the APS enabled the Group to maintain robust capital ratios, it is clear that the next few years pose continuing challenges in respect of impairment levels, trading performance and the return to profitability, RWA volatility including procyclical effects, and increasing regulatory demands.

The Group's policy will be to continue to maintain a strong capital base, to develop this base as appropriate and to utilise it efficiently throughout the Group's activities in order to optimise shareholder returns while maintaining a prudent relationship between the capital base and the underlying risks of the business.

The subscription for £25.5 billion of B shares improved the Group's Core Tier 1 capital ratio by 580 basis points at 31 December 2009.

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 (known as 'the Uncapped Amount'):

- First Loss – the residual first loss, after impairments and writedowns, to date, is deducted from the available capital – split equally between Core Tier 1 and Tier 2 capital;

- HM Treasury share of covered losses – after the first loss piece has been deducted, the 90% of assets covered by HM Treasury are risk weighted at 0%; 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 those of the underlying assets (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 at accession

The Group expects initially to calculate its capital requirements in accordance with the Capped basis. Accordingly, the APS itself (viewed separately from the B share issuance) at accession had no impact on the Pillar 1 regulatory capital requirement in respect of the assets covered by the APS. It will, however, improve the total capital ratios, and the Core Tier 1 ratios, of the Group as a whole. It is also expected that the protection afforded by the APS will assist the Group in satisfying the forward looking stress testing framework applied by the FSA.

* unaudited

Capital* continued

Future regulatory capital effects

As impairments on the pool of assets arise, these will be required to be deducted in full from Core Tier 1 Capital in the normal way. The Group will be entitled to apply these impairments to 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 APS refer to pages 127 to 136.

Regulatory developments

European Directives

The Group is undertaking the necessary preparations to comply with the new European Directives which will, or are expected to, come into force on or before 1 January 2011. These deal with inter alia, the eligibility of hybrid capital; restrictions on large exposures; enhanced risk management of securitisation exposures (including a requirement that banks cannot invest in a securitisation where the originator has not retained an economic interest); higher capital requirements for re-securitisations; and strengthening capital requirements for the trading book.

Basel Committee on Banking Supervision

In December 2009, the Basel Committee issued proposals to strengthen capital and liquidity of banks. The key elements include: raising the quality, consistency and transparency of regulatory capital; increased capital requirements for counterparty exposures on derivatives, repurchase agreements and securities financing activities; the introduction of a leverage ratio; promotion of countercyclical measures to encourage build up of capital buffers and a more forward-looking provisioning based on expected losses instead of the current ‘incurred loss’ provisioning model; and the introduction of a global minimum liquidity standard for internationally active banks, including a short-term liquidity coverage ratio requirement underpinned by a longer-term structural liquidity ratio. The Committee is carrying out an impact assessment in the first part of 2010 to calibrate the new requirements before issuing final proposals by the end of 2010 for phased implementation commencing in 2012.

The Group is working with the trade bodies in responding to the various consultations and will participate fully in the impact assessment.

Basel II

The Group adopted Basel II on 1 January 2008. Pillar 1 focuses on the calculation of minimum capital required to support the credit, market and operational risks in the business. For credit risk, the majority of the Group uses the Advanced Internal Ratings Based Approach for calculating RWAs.

The Group manages market risk in the trading and non-trading (treasury) portfolios through the market risk management framework. The framework includes VaR limits, back-testing, stress testing, scenario analysis and position/sensitivity analysis.

For operational risk, the Group uses the Standardised Approach, which calculates operational RWAs based on gross income. In line with other banks, the Group is considering adopting the advanced measurement approach for all or part of the business.

Using these approaches, the RWA requirements, by division, are as follows:

	2009	2008
RWAs	£bn	£bn
UK Retail	51.3	45.7
UK Corporate	90.2	85.7
Wealth	11.2	10.8
Global Banking & Markets	123.7	151.8
Global Transaction Services	19.1	17.4
Ulster Bank	29.9	24.5
US Retail & Commercial	59.7	63.9
Other	9.4	7.1
Core	394.5	406.9
Non-Core	171.3	170.9
	565.8	577.8
Benefit of APS	(127.6)	n/a
Group before RFS Holdings minority interest	438.2	577.8
RFS Holdings minority interest	102.8	118.0
Group	541.0	695.8

*

unaudited

77

Capital* continued

Capital resources continued

In addition to the calculation of minimum capital requirements for credit, market and operational risk, banks are required to undertake an Individual Capital Adequacy Assessment Process (ICAAP) for other risks. The Group's ICAAP, in particular, focuses on pension fund risk, interest rate risk in the banking book together with stress tests to assess the adequacy of capital over one year and the economic cycle.

The Group publishes its Pillar 3 (Market 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 Group level capital resources and adequacy, discuss a range of credit risk approaches and their associated RWAs under various Basel II approaches such as credit risk mitigation, counterparty credit risk and provisions. Detailed disclosures are also made on equity, securitisation, operational and market risk, as well as providing Interest Rate Risk in the Banking Book disclosures.

Stress and scenario testing

Stress testing forms part of the Group's risk and capital framework and an integral component of Basel II. As a key risk management tool, stress testing 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 occur. Stress testing is used at both a divisional and Group level to assess risk concentrations, estimate the impact of stressed earnings, impairments and write-downs on capital. It determines the overall capital adequacy under a variety of adverse scenarios. The principal business benefits of the stress testing framework include: understanding the impact of recessionary scenarios; assessing material risk concentrations; forecasting the impact of market stress and scenarios on the Group's balance sheet liquidity.

At Group level, a series of stress events are monitored on a regular basis to assess the potential impact of an extreme yet plausible event on the Group. There are four core elements of scenario stress testing:

- Macroeconomic stress testing considers the impact on both earnings and capital for a range of scenarios. They entail multi-year systemic shocks to assess the Group's ability to meet its capital requirements and liabilities as they fall due under a downturn in the business cycle and/or macroeconomic environment;

- Enterprise wide stress testing considers scenarios that are not macroeconomic in nature but are sufficiently broad in nature to impact across multiple risks or divisions and are likely to impact earnings, capital and funding;

- Cross-divisional stress testing includes scenarios which have impacts across divisions relating to sensitivity to a common risk factor(s). This would include sector based stress testing across corporate portfolios and sensitivity analysis to stress in market factors. These stress tests are discussed with senior divisional management and are reported to senior committees across the Group; and

- Divisional and risk specific stress testing is undertaken to support risk identification and management. Current examples include the daily product based stress testing using a hybrid of hypothetical and historical scenarios within market risk.

Portfolio analysis, using historic performance and forward looking indicators of change, uses stress testing to facilitate the measurement of potential exposure to events and seeks to quantify the impact of an adverse change in factors which drive the performance and profitability of a portfolio.

*
unaudited

78

Capital* continued
Risk coverage

The main risks facing the Group are shown below.

Risk type	Definition	Features
Credit risk (including country and political risks)	The risk arising from the possibility that the Group will incur losses owing to the failure of customers to meet their financial obligations to the Group.	Loss characteristics vary materially across portfolios. Significant correlation between losses and the macroeconomic environment. Concentration risk - potential for large material losses.
	The risk arising from country events.	Country risks correlated with macroeconomic developments. Country vulnerabilities changing structurally in the aftermath of the financial crisis.
Funding and liquidity risk	The risk of being unable to meet obligations as they fall due.	Potential to disrupt the business model and stop normal functions of the Group.
Market risk	The risk that the value of an asset or liability may change as a result of a change in market risk factors.	Potential for large, material losses. Significantly correlated with equity risk and the macroeconomic environment. Potential for losses due to stress events.
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. Infrequent material losses.
Operational risk	The risk of financial, customer or reputational loss resulting from inadequate or failed internal processes or systems; from improper behaviour; or from external events.	Frequent small losses. Infrequent material losses.
Regulatory risk	The risks arising from regulatory changes and enforcement.	Risk of regulatory changes. Compliance with regulations. Potential for fines and/or restrictions in business activities.
Other risk	The risks arising from reputation risk.	Additional regulation can be introduced as a result of other risk losses.

		Failure to meet expectations of stakeholders.
	Pension risk is the risk that the Group may have to make additional contributions to its defined benefit pension schemes.	Pension risk arises because of the uncertainty of future investment returns and the projected value of schemes' liabilities.

*
unaudited

79

Credit risk

Credit risk is the risk arising from the possibility that the Group will incur losses owing to the failure of customers to meet their financial obligations. The quantum and nature of credit risk assumed in the Group's different businesses varies considerably, while the overall credit risk outcome usually exhibits a high degree of correlation to the macroeconomic environment. All of the disclosures in this section (pages 80 to 101) are audited unless indicated otherwise with an asterisk (*).

Principles for credit risk management

The key principles for credit risk management in the Group are as follows:

- A credit risk assessment of the customer and credit facilities is undertaken prior to approval of credit exposure. Typically, this includes both quantitative and qualitative elements including: the purpose of the credit and sources of repayment; compliance with affordability tests; repayment history; ability to repay; sensitivity to economic and market developments; and risk-adjusted return based on credit risk measures appropriate to the customer and facility type;

- Credit risk authority is specifically granted in writing to individuals involved in the approval of credit extensions. In exercising credit authority, individuals are required to act independently of business considerations and must declare any conflicts of interest;

- Credit exposures, once approved, are monitored, managed and reviewed periodically against approved limits. Lower quality exposures are subject to more frequent analysis and assessment;

- Credit risk management works with business functions on the ongoing management of the credit portfolio, including decisions on mitigating actions taken against individual exposures or broader portfolios;

- Customers with emerging credit problems are identified early and classified accordingly. Remedial actions are implemented promptly and are intended to restore the customer to a satisfactory status and minimise any potential loss to the Group; and

- Stress testing of portfolios is undertaken to assess the potential credit impact of non-systemic scenarios and wider macroeconomic events on the Group's income and capital.

Credit risk organisation

The credit risk function is organised within a divisionally aligned structure to ensure appropriate proximity to the businesses it covers and to develop and provide the specialisation required to manage the associated credit risk. The function comprises a number of activities: credit approval; transaction/customer assessment; policy formulation and development (in the context of the Group-wide policy framework); portfolio reporting; and quantitative portfolio analytics.

In addition to the activities undertaken within divisional functions, a Group-wide credit risk function sets the overall framework and highest level credit risk policy standards; produces Group-wide credit risk portfolio reporting and analysis; and approves credit transactions which exceed divisional credit authority.

The Group Risk Committee (GRC) considers detailed reports of credit risk performance such as monthly risk portfolio performance trend information. The Group Credit Risk Policy Committee, a subcommittee of the GRC, approves material new credit risk policy standards.

For wholesale credit portfolios, an updated Group-wide credit approval and authority framework was introduced in early 2009, replacing the previous structure of credit committees. The authority held by an individual in respect of a particular extension of credit is determined by a Group-wide credit approval grid which links total credit limit amount for a customer group with customer credit quality (expressed as a credit grade) and the individual's credit experience and expertise (which determines the authority level assigned to them). The Executive Credit Group (ECG) considers credit decisions which exceed the delegated authorities of individuals throughout the Group.

Global Restructuring Group (GRG)

GRG manages problem and potential problem exposures in the Group's wholesale credit portfolios. Its primary function is to work closely with the Group's customer facing businesses to support the proactive management of any problem lending. This may include assisting with the restructuring of a customer's business and/or renegotiation of credit.

GRG reports to the Head of Restructuring and Risk and is structured with specialist teams focused on: large corporate cases (higher value, multiple lenders); small and medium size business cases (lower value, bilateral relationships); and recovery/litigations.

Originating business units liaise with GRG upon the emergence of a potentially negative event or trend that may impact a borrower's ability to service its debt. This may be a significant deterioration in some aspect of the borrower's activity, such as trading, where a breach of covenant is likely or where a borrower has missed or is expected to miss a material contractual payment to the Group or another creditor.

On transfer of a relationship to GRG a strategy is devised to:

- Work with the borrower to facilitate changes that will maximise the potential for turnaround of their situation and return them to profitability;
- Define the Group's role in the turnaround situation and assess the risk/return dimension of the Group's participation;
- Return customers to the originating business unit in a sound and stable condition or, if such recovery cannot be achieved, avoid additional losses and maximise recoveries; and
- Ensure key lessons learned are fed back into origination policies and procedures.

Retail collections and recoveries

There are collections and recoveries functions in each of the consumer businesses. Their role is to provide support and assistance to customers who are currently experiencing difficulties meeting their financial obligations. Where possible, the aim of the collections and recoveries teams is to return the customer to a satisfactory position, by working with them to restructure their finances. If this is not possible, the team has the objective of reducing the loss to the Group.

The ongoing investment in collections and recoveries operations has continued in 2009. Investment has increased staffing levels in all collections and recoveries functions, enhanced staff training to improve efficiency and effectiveness as well as upgraded technology and infrastructure.

80

Credit risk continued

Retail collections and recoveries continued

In the UK and Ireland, the Group has introduced new forbearance policies for customers in financial difficulty based on various government sponsored schemes, customer affordability and prospects. In the US there has been an increase in agreed loan modification programmes, including those sponsored by the US government.

Credit risk framework

The approach taken to managing credit risk varies significantly between wholesale portfolios (loans, and other products giving rise to credit risk, to all but the smaller corporate customers, to financial institutions and to government entities) and retail portfolios (secured and unsecured loans and related products to individuals and small businesses).

Wholesale portfolios

Wholesale risk limits are aggregated at the counterparty level to determine the level of credit approval required and to facilitate consolidated credit risk management.

The credit approval process has two stages, assessment and decision. Credit applications for corporate customers are prepared by relationship managers in the units originating the credit exposures or by the relationship management team with lead responsibility for a counterparty where a customer has relationships with different divisions and business units across the Group. This includes the assignment of risk parameter estimates (probability of default, loss given default and exposure at default) using approved models.

Credit approval authority is discharged by way of a framework of individual delegated authorities that 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. The level of authority granted to an individual 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. For certain counterparties early warning indicators are also in place to detect deteriorating trends of concern in limit utilisation or account performance. A framework is also in place to monitor changes in credit quality at the portfolio level.

As 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.

Retail portfolios

Retail business operations require a large volume of small scale credit decisions, typically 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 best practice 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 a customer's 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 transactions and some residential mortgage applications.

Divisional risk management committees focus on portfolio level decisions which drive credit quality, changes to policy and strategy, and the setting of credit scorecard cut-offs. The divisional risk management committees are also responsible for reviewing ongoing performance of the business and, if necessary, making or recommending adjustments to risk appetite.

Credit risk measurement

Credit risk models are used throughout the Group to support the quantitative risk assessment element of 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.

Probability of default/customer credit grade (PD)

These models assess the probability that a customer will fail to make full and timely repayment of their 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: each counterparty is assigned an internal credit grade which is in turn assigned to a default probability range. 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). Scores are then mapped to grades within each model. Grades are calibrated centrally to default probabilities. Obligor grades can, under certain circumstances, be cascaded to other borrowing entities within the obligor group where there is sufficient dependence on the graded entity. The credit grades for sovereign and central bank entities are assigned by a specialist country risk analysis team using a sovereign grading model. This team is independent of the origination function and is comprised of economists. Certain grading models also cover customers or transactions categorised as specialised lending (for example certain types of investment property and asset finance such as shipping).

- 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 probability of default is used within the credit approval process and ongoing credit risk management, monitoring and reporting. The probabilities of default are used to group customers into risk pools. Pools are then assigned a weighted average probability of default using regulatory default definitions.

Credit risk continued

Credit risk management continued

Exposure at default (EAD)

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 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 calculate the market driven credit risk exposure for products where the exposure is not based solely upon principal and interest due. These models are most commonly used for derivative 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 activities such as limit and excess management.

Loss given default (LGD)

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 LGD 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, plus the cost of collections and a time discount factor for the delay in cash recovery.

Credit risk mitigation

The Group employs a number of structures and techniques to mitigate credit risk:

- Netting of debtor and creditor balances is utilised in accordance with relevant regulatory and internal policies and requires a formal agreement with the customer to net the balances and a legal right of set-off;
- Under market standard documentation net exposure on over-the-counter (OTC) derivative and secured financing transactions is further mitigated by the exchange of financial collateral;
- The Group enhances its position as a lender in a range of transactions, from retail mortgage lending to large wholesale financing, by structuring a security interest in a physical or financial asset;
- Credit derivatives, including credit default swaps, credit linked debt instruments, and securitisation structures are used to mitigate credit risk; and
- Guarantees and similar instruments (for example, credit insurance) from related and third parties 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:

- General requirements, including acceptable credit risk mitigation types and any conditions or restrictions applicable to those mitigants;

- The maximum loan-to-value (LTV) percentages, minimum haircuts or other volatility adjustments applicable to each type of mitigant including, where appropriate, adjustments for currency mismatch, obsolescence and any time sensitivities on asset values;

- 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 the initial and any subsequent valuations of collateral and the frequency with which they are to be revalued (for example, daily in the trading book);

  - Actions to be taken in the event the current 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, for example, any situations where customer default materially impacts the value of a mitigant and applying a haircut or recovery value adjustment which reflects the potential correlation risk;

- Management of concentration risks, for example, 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 is legally effective and enforceable.

Credit risk continued

Credit risk assets*

Credit risk assets consist of loans and advances (including overdraft facilities), instalment credit, finance lease receivables and traded instruments across all customer types. Reverse repurchase agreements and issuer risk (primarily debt securities – see page 104) are excluded. Where relevant, and unless otherwise stated, data reflects the effect of credit mitigation techniques.

The discussions and disclosures in this section (pages 83-94) relate only to the Group before RFS Holdings minority interest. Facilities included within RFS Holdings minority interests have not been migrated to the RBS risk systems, as they will not be part of the Group following separation of the ABN AMRO business. All the disclosures in this section are unaudited and are labelled with an asterisk (*)

	2009	2008(1)
Credit risk assets	£m	£m
UK Retail	103,029	97,069
UK Corporate	109,908	126,736
Wealth	15,951	17,604
Global Banking & Markets	224,355	450,321
Global Transaction Services	7,152	8,995
Ulster Bank	42,042	64,695
US Retail & Commercial	52,104	82,862
Other	2,981	6,594
Core(1)	557,522	n/a
Non-Core	151,264	n/a
	708,786	854,876

Note:

(1) The 2008 analysis between Core and Non-Core is not available.

Key points

- Total credit risk assets reduced by £146 billion, or 17% during 2009 or 13% on a constant currency basis.
- Reductions occurred across industry sectors and in most regions. The largest reductions were in lending balances and derivatives.
- As part of the strategic review, the designation of assets between Core and Non-Core divisions was completed during the first half of 2009, hence the portfolio is reported according to the divisional structure as at 31 December 2009 in the table above.

Credit concentration risk

The Group defines four key areas of concentration in credit risk that are monitored, reported and managed at both Group and divisional levels. These are single name, industry/sector, country and product/asset class. Frameworks to address single name, industry/sector and country concentrations are established and continue to be enhanced and embedded into business processes across the Group. Aspects of the product/asset class framework are in place whilst others will be developed during the course of 2010.

Under the Group's credit approval framework, the required approval level is linked to the size of exposure with exposures above a certain level requiring the highest level of approval, held by a very small number of executives. In addition, the Group's single name concentration framework includes specific approval requirements; additional reporting and monitoring; and the requirement to develop plans to address and reduce excess exposures.

The Group has also developed a more robust approach and framework for managing sector concentrations, a major outcome of which is the regular review of the most material concentrations at the Executive Risk Forum (ERF). These reviews 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.

Reviews conclude with specific sector caps and other portfolio strategies to align the Group's exposure profile with its appetite.

Country risk

Country risk arises from sovereign events (for example, default or restructuring); economic events (for example, contagion of sovereign default to other parts of the economy, cyclical economic shock); political events (for example, convertibility restrictions and expropriation or nationalisation); and natural disaster or conflict. Losses are broadly defined and include credit, market, liquidity, operational and franchise risk related losses.

The Group's appetite for country risk is set by the ERF in the form of limits by country risk grade, with sub-limits on term exposure. Countries where exposures exceed this limit framework are approved by the ERF while authority is delegated to the Group Country Risk Committee (GCRC) to manage exposures within the framework. Specific limits are set for each country based on a risk assessment taking into account the Group's franchise and business mix in that country. Additional limitations – on product types with higher loss potential, for example – are established to address specific vulnerabilities in the context of a country's outlook and/or the Group's business strategy in a particular country. A country watch list framework is in place to proactively monitor emerging issues and facilitate the development of mitigation strategies.

*
unaudited

Credit risk continued

Credit risk assets* continued

The country risk table below shows credit risk assets exceeding £1 billion by borrowers domiciled in countries with an external rating of A+ and below from either Standard & Poor's or Moody's, and is stated gross of mitigating action which may have been taken to reduce or eliminate exposure to country risk events.

	2009							2008				
	Personal	Sovereign	Banks and financial institutions	Corporate	Total	Core	Non-Core	Personal	Sovereign	Banks and financial institutions	Corporate	Total
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Italy	27	104	1,999	5,636	7,766	3,827	3,939	23	131	3,263	7,555	10,972
India	547	5	476	2,578	3,606	2,887	719	1,020	6	738	3,800	5,564
Russia	41	—	395	2,928	3,364	2,803	561	51	—	362	5,361	5,774
South Korea	1	—	1,038	2,308	3,347	3,238	109	2	—	1,743	1,104	2,849
Turkey	11	301	590	1,906	2,808	2,412	396	25	364	603	3,035	4,027
Poland	6	62	113	1,840	2,021	1,847	174	7	38	309	1,309	1,663
China	21	49	798	1,096	1,964	1,695	269	25	61	1,146	2,027	3,259
Romania	512	47	452	874	1,885	64	1,821	584	145	160	917	1,806
Portugal	5	42	281	1,119	1,447	943	504	6	34	405	1,914	2,359
Chile	—	41	447	865	1,353	526	827	—	26	384	1,251	1,661
Brazil	3	—	767	439	1,209	1,151	58	4	—	1,012	642	1,658
Mexico	1	7	227	934	1,169	740	429	4	57	211	2,000	2,272
Kazakhstan	45	15	365	646	1,071	91	980	69	17	901	859	1,846
Hungary	3	23	56	956	1,038	579	459	5	74	101	831	1,011

Key points

- There has been a sustained focus on country exposures, both in terms of those countries that represent a larger concentration and those that, under the country watch list process, have been identified as exhibiting signs of actual or potential stress.

- This process, coupled with the Group's strategic focus on a reduced number of countries, has yielded material reductions in exposure.

- The reductions are magnified by the relative strength of sterling in the year, when it gained 9% on a trade weighted basis against other currencies.

Most economies enter 2010 in a tentative recovery phase, attributed largely to official stimulus, resilient consumption and global restocking. International prospects vary and significant risks remain, particularly around exiting government support, advanced sovereign debt levels and rising inflationary pressures. Currently low yields may not last as these trends play out. Asia remains the best performing region, thanks to limited sovereign and corporate leverage. However, growth prospects remain linked to global trade flows. Middle East sovereigns are generally strong, but the private sector continues to feel the impact of weakness in real estate and construction. Latin America proved relatively insulated from the crisis, and policy gains look set to be sustained. Peripheral Euro zone sovereigns with heavy debt burdens face increased risks, with credible adjustment programmes needed. Eastern Europe has made some progress in addressing key weaknesses, but vulnerabilities in some countries remain and growth prospects are modest.

* unaudited

Credit risk continued
Credit risk assets*continued
Asset quality by industry and geography
Industry analysis plays an important part in assessing potential concentration risk in the loan portfolio. Particular attention is given to industry sectors where the Group believes there is a high degree of risk or potential for volatility in the future.

The table below analyses credit risk assets by industry sector and geography.

	2009								2008
Industry sector	UK £m	Western Europe (excl UK) £m	North America £m	Asia Pacific £m	Latin America £m	Other (1) £m	Total £m	of which Core £m	Total £m
Personal	120,720	23,530	37,680	2,948	63	1,361	186,302	165,562	197,888
Banks and financial institutions	38,775	66,698	18,817	13,158	10,216	5,305	152,969	133,900	180,504
Property	61,779	27,736	8,315	2,478	2,924	507	103,739	57,073	112,980
Transport and storage (2)	14,565	7,954	7,514	5,841	2,917	7,370	46,161	30,863	58,995
Manufacturing	9,309	14,646	7,965	3,627	1,643	3,948	41,138	31,199	67,846
Wholesale and retail trade	15,584	7,458	5,497	945	829	1,704	32,017	25,180	35,180
Telecom, media and technology	8,956	7,956	5,312	2,232	804	1,528	26,788	18,554	42,374
Public sector	11,091	4,448	6,016	2,109	279	760	24,703	21,823	39,890
Building	10,303	7,494	1,852	836	183	1,098	21,766	16,642	29,297
Tourism and leisure	11,396	3,268	2,700	755	586	481	19,186	15,583	19,528
Power, water and waste	4,745	6,197	3,502	1,179	1,215	941	17,779	12,055	26,628
Natural resources and nuclear	2,554	3,546	5,511	1,861	844	2,895	17,211	12,479	25,318
Business services	8,981	2,056	2,324	675	1,029	588	15,653	13,395	14,497
Agriculture and fisheries	921	618	1,671	18	64	82	3,374	3,214	3,951
2009 Total	319,679	183,605	114,676	38,662	23,596	28,568	708,786	557,522	854,876
of which Core	271,758	133,824	89,487	28,718	14,048	19,687	557,522		
2008 Total	326,639	225,870	178,139	56,074	31,235	36,919	854,876		

Notes:

(1) Other' comprises Central and Eastern Europe, Middle East, Central Asia and Africa.
(2) Excludes net investment in operating leases in Shipping and Aviation portfolios as they are accounted for as part of property, plant and equipment; however operating leases are included in the monitoring and management of these portfolios.
(3) Certain sector and sub-sector classes were refined in 2009.

Key points

- Exposures have decreased materially across industry sectors and geographies, with the exception of the UK where exposure is only 2% lower at 31 December 2009 compared with a year earlier.

- Within the UK, exposure to corporate sectors was down 8%. Banks, financial institutions and public sector were unchanged and exposure to personal customers was up 6% in 2009.

Single name concentrations

During the first half of the year, the Group implemented an enhanced framework to address the risk arising from concentrations of exposure to related groups of borrowers. Despite market illiquidity that reduced the scope for exposure management strategies against certain assets, and negative credit migration, that created additional cases in excess of the framework's parameters, some progress was made against exceptions arising from the framework. Overall there were 9% fewer exceptions at the end of the period than at the beginning. Plans have been developed and continue to be refined to deliver alignment with the framework over the course of the Group's strategic plan.

* unaudited

Credit risk continued
Credit risk assets*continued
Credit risk asset quality
Using the PD models described above, 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, measurement of risk is easily aggregated and can be reported at increasing levels of granularity depending on audience and business need.

		2009				2008	
		Core	Non-Core	Total	%	Total	%
Asset quality band	PD range	£m	£m	£m	of total	£m	of total
AQ1	0% – 0.03%	124,172	20,570	144,742	20.3	208,033	24.4
AQ2	0.03% – 0.05%	13,470	1,958	15,428	2.2	29,939	3.5
AQ3	0.05% – 0.10%	27,456	6,462	33,918	4.8	44,724	5.2
AQ4	0.10% – 0.38%	84,594	17,032	101,626	14.3	159,067	18.6
AQ5	0.38% – 1.08%	107,960	27,135	135,095	19.1	157,138	18.5
AQ6	1.08% – 2.15%	78,048	19,050	97,098	13.7	107,191	12.5
AQ7	2.15% – 6.09%	42,611	14,449	57,060	8.1	48,271	5.6
AQ8	6.09% – 17.22%	21,484	4,479	25,963	3.7	25,682	3.0
AQ9	17.22% – 100%	10,597	5,845	16,442	2.3	12,034	1.4
AQ10	100	16,316	23,118	39,434	5.6	19,130	2.2
Other (1)		30,814	11,166	41,980	5.9	43,667	5.1
		557,522	151,264	708,786	100	854,876	100

Note:

(1) Other' largely comprises assets covered by the standardised approach for which a PD equivalent to those assigned to assets covered by the internal ratings based approach is not available.

Key points

- In addition to the overall portfolio contraction, the table above evidences the negative rating migration observed across the Group's portfolios during the course of 2009, with the lower quality bands (AQ7 and below) all showing increased exposure.

- A significant majority of this increase occurred in the first half of 2009. Exposure in bands AQ7 and below grew by 23% in the first six months of the year and by a further 6% since 30 June 2009.

* unaudited

Credit risk continued
Credit risk assets*continued
Key credit portfolios

Personal credit risk assets	2009 £m	2008 £m
UK Retail:		
– Mortgages	85,529	74,528
– Cards, loans and overdrafts	20,316	22,475
Ulster Bank:		
– Mortgages	22,304	24,531
– Other personal	1,172	1,350
Citizens:		
– Mortgages	26,534	34,394
– Auto and cards	6,917	9,126
– Other (1)	4,205	5,286
EMEA and Asia Pacific Non-Core	3,084	3,942
Other (2)	16,241	22,256
	186,302	197,888

Notes:

(1) Mainly student loans and recreational vehicles/marine.
(2) Personal exposures in other divisions, including Wealth, and RBS Insurance.

Residential mortgages
The table below analyses the distribution of residential mortgages by loan-to-value (LTV) (indexed).

	UK Retail		Ulster Bank		Citizens	
Residential mortgages – distribution by average LTV (1) (indexed)	2009 %	2008 %	2009 %	2008 %	2009 %	2008 %
<=50%	39.2	46.0	40.7	47.1	26.3	29.7
>50% and <= 60%	10.1	10.9	7.6	8.7	7.9	9.0
>60% and <= 70%	10.9	10.6	7.6	8.4	9.0	10.7
>70% and <= 80%	13.3	10.5	7.5	8.6	12.7	16.3
>80% and <= 90%	11.2	9.2	8.0	9.6	14.5	15.5
>90% and <= 100%	7.6	7.8	9.0	8.5	12.2	9.5
>100%	7.7	4.9	19.6	9.1	17.4	9.3
Total portfolio average LTV at 31 December	59.1	54.5	62.5	54.3	72.0	69.1
Average LTV on new originations during the year	67.2	67.2	72.8	71.1	62.4	64.3

Note:

(1) LTV averages calculated by transaction volume.

* unaudited

87

Credit risk continued
Credit risk assets* continued
The table below details residential mortgages three months or more in arrears (by volume).

	2009	2008
	%	%
UK Retail (1)	1.8	1.5
Ulster Bank	3.3	1.6
Citizens	1.5	0.9

Note:

(1) UK Retail analysis covers the Royal Bank and NatWest brands and covers 77% of the UK Retail mortgage portfolio (the remainder operates under the same credit policies).

UK residential mortgages
The UK mortgage portfolio totalled £85.5 billion at 31 December 2009, an increase of 15% from 31 December 2008, due to strong sales growth and lower redemption rates. Of the total portfolio, 98% is designated as Core business with the primary brands being the Royal Bank of Scotland, NatWest, the One Account and First Active. The assets comprise prime mortgage lending and include 6.6% (£5.6 billion) of exposure to residential buy-to-let. There is a small legacy self certification book (0.4% of total assets); which was withdrawn from sale in 2004.

UK net new mortgage lending in 2009 was strong at £11 billion and the Group has exceeded its commitment to the UK Government on net mortgage lending. The average LTV for new business during 2009 was unchanged at 67.2%. The maximum LTV available to new customers remains at 90%.

The arrears rate (three or more payments missed) on the combined Royal Bank of Scotland and NatWest brands was 1.8% at 31 December 2009. After a period of deterioration driven by the economic environment this stabilised in the second half of 2009 (arrears rate stood at 1.8% at 30 June 2009 and 1.5% at 31 December 2008). The arrears rate on the buy-to-let portfolio was 1.6% at 31 December 2009 (1.6% at 30 June 2009 and 1.5% at 31 December 2008).

The mortgage impairment charge was £129 million in 2009, compared with £33 million in 2008, attributable to declining house prices driving lower recoveries and an increase in defaults reflecting the difficult economic environment. Default rates remain sensitive to economic developments, notably unemployment rates. Provision as a proportion of balances at 31 December 2009 were 0.3% and 0.2% at 31 December 2008.

A number of initiatives aimed at increasing the levels of support to customers experiencing difficulties were implemented in 2008 and will continue in 2010. The Group does not initiate repossession proceedings for at least six months after arrears are evident and participates in various government-led initiatives such as the mortgage rescue scheme and homeowner mortgage support.

Ulster Bank residential mortgages

The residential mortgage portfolio across the Ulster Bank and First Active brands totalled £22.3 billion at 31 December 2009; 91% is in the Republic of Ireland and 9% in Northern Ireland. This represents a decline of 4% in the Republic of Ireland and an increase of 13% in Northern Ireland from 31 December 2008. 27% of the portfolio is Non-Core.

The arrears rate increased to 3.3% at 31 December 2009 from 1.6% at 31 December 2008. As a result, the impairment charge for 2009 was £115 million versus £23 million for 2008. Repossessions totalled 96 in 2009, compared with 37 in 2008 with the majority of these being voluntary.

During 2009 new business originations in the Republic of Ireland were very low across all segments. The bank introduced new products –Momentum and SecureStep – in both Northern Ireland and the Republic of Ireland which aim to support market activity for new build properties. In Northern Ireland, lending increased in the second half of 2009 as a degree of confidence returned to the property market.

Citizens real estate

Citizens total residential real estate portfolio totalled $42 billion at 31 December 2009 (2008 – $50 billion). The real estate portfolio comprises $11 billion of first lien mortgages and $31 billion of home equity loans and lines (Core portfolio 48% first lien). 83% of the portfolio is Core business; $10 billion of mortgages and $25 billion of home equity loans and lines (48% of the latter being first lien). The serviced by others (SBO) portfolio (96% second lien) is the largest component of the Non-Core portfolio.

Citizens has focused its origination efforts in the more mature and stable markets of New England and Mid Atlantic (Citizen’s ‘footprint states’), targeting low risk products and adopting conservative risk policies. Loan acceptance criteria were tightened during 2009 to address deteriorating economic and market conditions. At 31 December 2009, the portfolio consisted of $34 billion (80% of the total portfolio) in these footprint states.

* unaudited

Credit risk continued

Credit risk assets*continued

The SBO portfolio consists of purchased pools of home equity loans and lines whose current LTV (95.6% on a weighted average basis at 31 December 2009) and geographic profiles (74% outside of Citizen's footprint states and a 30% concentration in California, Arizona and Nevada) have, in the current economic climate, resulted in an annualised write-off rate of 10.7% in 2009. The SBO book has been closed to new purchases since the third quarter of 2007 and is in runoff, with exposure down from $7.0 billion at 31 December 2008 to $5.5 billion at 31 December 2009.

The current weighted average LTV of the real estate portfolio rose slightly during the year to 72.0% at 31 December 2009 (67.5% excluding the SBO portfolio), driven by significant price declines throughout the US. Based on the latest Case-Shiller forecast for the US market, economists still anticipate significant decreases in the first half of 2010 with improvements expected in late 2010 or early 2011.

The arrears rate increased significantly from 0.9% at 31 December 2008 to 1.5% at 31 December 2009. In part, this reflects the contraction of the portfolio caused by fewer new loans added, Citizen choosing to exercise its option to sell certain mortgages to the secondary market under long-term agreements, and higher run-off or pay-down rates across all residential products.

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. New defaults as a proportion of average loans and receivables were:

	2009		2008	
	Average loans and receivables	Impairment charge as a % of loans and receivables	Average loans and receivables	Impairment charge as a % of loans and receivables
Personal lending	£m	%	£m	%
UK Retail cards (1)	6,101	8.7	6,617	6.4
UK Retail loans (1)	12,062	5.9	13,545	3.3
	$m	%	$m	%
Citizens cards (2)	2,286	8.9	2,275	4.9
Citizens auto loans (2)	9,759	1.2	11,386	1.1

Notes:

(1) The charge for UK Retail assets refers to impairment on assets in the year.

(2) The charge for Citizens assets refers to charge offs in the year, net of recoveries realised in the year.

The UK personal lending portfolio, of which 97% is in Core businesses, comprises credit cards, unsecured loans and overdrafts and totalled £20.3 billion at 31 December 2009, a decrease of 10% from 31 December 2008 (£22.5 billion) due to a general market trend of customers repaying debt on credit cards and loan balances and a reduction in new lending.

Risk appetite continues to be actively managed across all unsecured products, reflecting the challenging economic environment. Support continues for customers in financial difficulties through breathing space initiatives on all unsecured products, whereby a thirty day period allows customers to work with a not-for-profit debt advice agency to establish a debt repayment plan. During this time the Group suspends collection activity. A further extension of thirty days can be granted if progress is made and discussions are continuing. Investment in collection and recovery processes continues, addressing both continued support for our customers and the management of impairments.

Default rates on both cards and loans in the UK increased in 2009, driven by the deterioration in the economic environment and, to a lesser extent, the reduction in total balances. Default rates are still sensitive to economic developments, notably unemployment rates.

The Citizens credit card portfolio totalled US$2.3 billion, at 31 December 2009. Core assets comprised 58% of the portfolio.

The Citizens cards business adopts conservative risk strategies compared to the US market as illustrated by the business generally performing better than industry benchmarks (provided by VISA). The latest available metrics (December 2009) show the rate for 60+ days delinquency as a percentage of total outstandings at 4.4% (compared to an industry figure of 4.7%) and net contractual charge-offs as a percentage of total outstandings at 7.1% (compared to an industry figure of 7.4%).

For new customers, lending criteria have been tightened and initial credit lines reduced. Existing customers are regularly monitored for changes in asset quality and behaviour and, where appropriate, proactive measures are taken to limit or reduce credit exposure.

Citizens is a leading provider of retail auto financing to US consumers through a network of 3,500 auto dealers located in 23 US states. It maintains a conservative, prime indirect auto lending credit programme with loss rates that have historically been below national averages. Current outstanding retail auto loan balances totalled $8.8 billion as of 31 December 2009, when the 30-day delinquency rate stood at 2.6%. This compares to data reported by the American Bankers' Association (latest available is at 30 September 2009) showing the nationwide indirect auto lending delinquency rate at 2.8%. Citizens recently shifted its focus on auto financing, moving from a nationwide emphasis to its regional lending footprint. This, together with enhanced collection activities, has resulted in better than expected loss results. Total portfolio losses fell from $129.6 million in 2008 to $120.6 million in 2009.

* unaudited

Credit risk continued
Credit risk assets*continued
Corporate sectors
This section discusses the components of property, transport and storage (automotive, shipping, aviation) and retail sectors, given their significance in the current market environment.

Wholesale property
The Group's exposure to the wholesale property sector totals £104 billion, of which £85 billion is commercial property financing and analysed in detail below. The remainder comprises lending to property related sectors, including housing associations, estate agents and management companies, and non-lending exposures on off balance sheet instruments and FX/derivatives.

Commercial property
The commercial property finance portfolio totalled £85 billion at 31 December 2009, an £11 billion or 12% decrease during the year. The Non-Core portion of the portfolio totalled £38 billion, or 44% of the portfolio.

	2009		2008	
Domicile of obligor	£m	%	£m	%
UK	55,904	66	55,986	58
Western Europe	19,212	22	28,439	30
Americas	6,520	8	7,996	8
RoW	3,575	4	4,250	4
	85,211	100	96,671	100

	2009		2008	
Segment	£m	%	£m	%
Investment:				
Commercial	47,371	56	54,028	56
Residential	12,921	15	13,937	14
	60,292	71	67,965	70
Development:				
Commercial	11,081	13	11,843	12
Residential	11,271	13	12,154	13
	22,352	26	23,997	25
Other	2,567	3	4,709	5
	85,211	100	96,671	100

Speculative lending represents less than 1% of the portfolio. The Group’s appetite for originating speculative commercial property lending is limited and any such business requires exceptional approval under the credit approval framework.

The decrease in asset valuations has placed pressure on the portfolio with more clients seeking renegotiations of LTV covenants in the context of granting structural enhancements or equity injections. The average LTV is 91% while the average interest coverage ratios for GBM and UK Corporate originated investment portfolios (Core and Non-Core combined) are 1.60 times and 1.64 times, respectively.

Whilst asset valuations stabilised during the latter part of 2009, the outlook remains challenging, with liquidity to support refinancing still reduced and high levels of concern regarding tenant failures. Wherever feasible, the Group works closely with clients to restructure loans while achieving mutual benefits.

Portfolios are subject to close monitoring within the originating division and a dedicated unit in the GRG focuses on commercial real estate to ensure that expertise is readily available to manage this portfolio actively on a coordinated basis globally.

* unaudited

Credit risk continued
Credit risk assets*continued
Corporate sectorscontinued
Transport and storage
The automotive, shipping and aviation portfolios form part of the transport and storage industry sector, which stood at £46.2 billion at 31 December 2009, down 22% during the year. The remainder of the portfolio largely comprises land-based freight, storage and logistics companies.

Automotive
Exposure to the automotive sector decreased from £13.3 billion at 31 December 2008 to £8.9 billion at 31 December 2009.

	2009				2008	
	Core	Non-Core	Total		Total	
Segment	£m	£m	£m	%	£m	%
Original equipment manufacturers (OEMs)	1,204	60	1,264	14	2,681	20
Captive finance companies	609	84	693	8	1,131	9
Component suppliers	750	81	831	9	1,854	14
Retailers/services	4,040	766	4,806	54	5,099	38
Rental	1,150	147	1,297	15	2,533	19
	7,753	1,138	8,891	100	13,298	100

	2009				2008	
	Core	Non-Core	Total		Total	
Domicile of obligor	£m	£m	£m	%	£m	%
Americas	1,325	402	1,727	19	3,520	26
Central Eastern Europe, Middle East and Africa	373	152	525	6	872	7
UK	3,530	426	3,956	45	3,884	29
Other Europe	1,949	97	2,046	23	4,098	31
Asia	576	61	637	7	924	7
	7,753	1,138	8,891	100	13,298	100

The global automotive industry continues to face long-term structural challenges of overcapacity, weakened consumer demand owing to economic conditions, reduced credit availability and high input costs. The global OEMs are experiencing changing demand patterns with a greater focus on developing markets versus their established markets. Shifting production capacity to lower cost overseas locations remains a priority but one that risks labour force issues. The industry is also challenged by increasingly stringent environmental legislation that is forcing a shift to smaller, lower emission vehicles. In 2009 the automotive industry benefited from considerable government support in the form of direct intervention (US manufacturers) and other forms (for example, car scrappage schemes). Whilst there are some emerging signs of recovery and stability, albeit with volumes at historically low levels, the outlook remains fragile as government support is withdrawn and underlying demand is likely to remain subdued.

The portfolio has been reduced in size by a third since 31 December 2008 and whilst average credit quality was impacted by the restructuring of the large US manufacturers at the start of 2009, this restructuring provided a degree of stability to the portfolio that was largely maintained for the remainder of the year. Impairment provisions to date have not been material.

* unaudited

Business review

Risk, capital and liquidity management

Credit risk continued
Credit risk assets*continued
Corporate sectorscontinued
Shipping

			2009			2008
	Core	Non-Core	Total		Total	
Sector	£m	£m	£m	%	£m	%
Dry bulk	2,568	777	3,345	28	3,775	28
Tankers	3,103	1,640	4,743	39	4,975	37
Container	756	685	1,441	12	1,256	10
Gas/offshore	137	1,851	1,988	16	1,786	13
Other	168	419	587	5	1,549	12
	6,732	5,372	12,104	100	13,341	100

Note:

(1) Figures shown relate to direct shipping financing exposure and do not include related operating lease and counterparty exposures of £1.1 billion in 2009 and £3.3 billion in 2008.

The Group's shipping portfolio is primarily focused on fully secured mortgage finance business in the dry bulk and tanker sectors, with a limited exposure to container vessels.

The performance of the sector over the past twelve months has been materially impacted by both the global downturn and the high volume of new capacity that has been delivered and will continue to come on stream into 2011.

The Group's strategy is to focus on cash flows relating to the ships financed and to work with long-term industry participants in Europe and North America where the Group has long-standing relationships and where the companies have demonstrated an ability to withstand cyclical downturns with a consistent track record through cyclical volatility. Asset selection has been to focus on modern tonnage (average vessel age is eight years).

The Group has refined its strategy during the course of 2009 to define a core business focussed on a well established client base of owners in Europe and North America where the Group has long-standing relationships with companies that have a demonstrated ability to withstand cyclical downturns.

The performance of the portfolio reflects a rising level of stress with a number of transactions restructured in response to asset price reductions and security covenant breaches. The value of the fleet is reviewed on a quarterly basis and a large majority of deals remain fully secured. There have been few instances of payment default and in the majority of cases owners have supported transactions via cash injections. Cases on the Group's watch list that are more closely monitored and controlled have increased and now stand at £1 billion, or 7% of the total portfolio.

* unaudited

92

Credit risk continued
Credit risk assets*continued
Corporate sectorscontinued
Aviation

	2009				2008	
	Core £m	Non-Core £m	Total £m	%	Total £m	%
Operating leases (1)	—	7,126	7,126	46	10,270	50
Secured debt	1,360	3,352	4,712	30	5,252	26
Sovereign guaranteed debt	—	2,774	2,774	18	3,324	17
Unsecured debt	910	—	910	6	1,093	5
Other	—	—	—	—	405	2
	2,270	13,252	15,522	100	20,344	100

Note:

(1) Operating lease assets, which are included in property, plant and equipment, represent the net investment in aircraft owned and on order. A smaller figure, £1 billion, is included within credit risk assets, representing the risk of customer default on lease agreements.

The aviation portfolio comprises a number of activities, but is primarily focused on the Dublin based Aviation Capital business, which has been designated as Non-Core.

The aviation sector has been under considerable pressure owing to the global downturn and compounded by the impact of the H1N1 virus (particularly in South America), overcapacity (notably in India and North America) and intense competition. Despite the publicised failure of several airlines, within the Group's portfolio there have been very low incidences of payment defaults and exposures requiring restructuring.

The Group's strategy is to focus on modern assets that are widely used across airlines and to maintain relationships with the strongest operators with the most flexible cost base. The majority of the portfolio is secured on modern aircraft and, although asset prices have weakened, exposures remain fully secured.

Aviation exposure on the Group's watch list, where there is an increased level of management control and oversight, totalled £1.4 billion at 31 December 2009. Notwithstanding reduced passenger volumes, the leased fleet remains fully utilised. The young age and commodity nature of the assets and the quality of the lessees, result in a limited expectation of aircraft being returned.

* unaudited

Business review

Risk, capital and liquidity management

Credit risk continued
Credit risk assets* continued
Corporate sectors continued

Retail

The Group's retail portfolio is a component of the wholesale and retail trade industry sector, for which credit risk assets totalled £32 billion at 31 December 2009. Retail comprises £16.3 billion or 51% of the total portfolio, with the remainder being exposure to wholesalers and service-orientated customers.

	2009				2008	
	Core	Non-Core	Total		Total	
Domicile of obligor	£m	£m	£m	%	£m	%
Americas	2,406	146	2,552	15	4,088	22
Central Eastern Europe, Middle East and Africa	394	74	468	3	589	3
UK	6,810	1,180	7,990	49	7,483	41
Other Europe	3,160	1,889	5,049	31	5,531	30
Asia	211	64	275	2	643	4
	12,981	3,353	16,334	100	18,334	100

	2009				2008	
	Core	Non-Core	Total		Total	
Segment	£m	£m	£m	%	£m	%
Household goods	2,127	338	2,465	15	3,117	17
Food, beverages and tobacco	3,191	162	3,353	21	4,235	23
Clothing and footwear	1,176	379	1,555	9	2,345	13
Pharmaceutical, health and beauty	1,424	236	1,660	10	2,049	11
Other retail	5,063	2,238	7,301	45	6,588	36
	12,981	3,353	16,334	100	18,334	100

The Group's exposure to the retail sector was £16.3 billion at 31 December 2009, down 11% on the prior year. The portfolio is well spread geographically and across sub-sectors.

Economic weakness and reduced consumer confidence is affecting the sector, with the impact most severe for stores reliant on high discretionary spend and for smaller retailers. Food retailers generally fared well during the year, as did the 'value' end of the sector in the context of reduced household spending.

Whilst there has been some flow of retail customers into the GRG, the total value of debt managed by that team remains low. Economic conditions are, however, increasingly bringing to light those in the sector with poor operating models and stretched balance sheets. The more successful operators continue to adapt their customer proposition, operating models and capital structure to the new environment whilst keeping tight control on working capital.

*unaudited

Credit risk continued

Risk elements and impairments

All the disclosures in this section (pages 95 to 101) are audited. The Group classifies impaired assets as either risk elements in lending (REIL) or potential problem loans (PPL). REIL represents non-accrual loans, loans that are accruing but are past due 90 days and restructured loans. PPL represents impaired assets which are not included in REIL, but where information about possible credit problems cause management to have serious doubts about the future ability of the borrower to comply with loan repayment terms.

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.

The analyses of risk elements in lending and impairments as discussed below, form a key part of the data provided to senior management on the credit performance of the Group's portfolios.

Risk elements in lending and potential problem loans by division

	REIL	PPL	REIL & PPL	Total provision	Total provision as % of REIL	Total provision as % of REIL & PPL
	£m	£m	£m	£m	%	%
2009						
UK Retail	4,641	—	4,641	2,677	58	58
UK Corporate	2,330	97	2,427	1,271	55	52
Wealth	218	38	256	55	25	21
Global Banking & Markets	1,800	131	1,931	1,289	72	67
Global Transaction Services	197	4	201	189	96	94
Ulster Bank	2,260	2	2,262	962	43	43
US Retail & Commercial	643	—	643	478	74	74
Core	12,089	272	12,361	6,921	57	56
Non-Core	22,900	652	23,552	8,252	36	35
Group before RFS Holdings minority interest	34,989	924	35,913	15,173	43	42
RFS Holdings minority interest	3,260	85	3,345	2,110	65	63
Group	38,249	1,009	39,258	17,283	45	44
2008						
UK Retail	3,832	—	3,832	2,086	54	54
UK Corporate	1,254	74	1,328	696	56	52
Wealth	107	24	131	34	32	26
Global Banking & Markets	869	18	887	621	71	70
Global Transaction Services	53	—	53	43	81	81
Ulster Bank	1,196	1	1,197	491	41	41

US Retail & Commercial	424	—	424	298	70	70
Core	7,735	117	7,852	4,269	55	54
Non-Core	11,056	109	11,165	5,182	47	46
Group before RFS Holdings minority interest	18,791	226	19,017	9,451	50	50
RFS Holdings minority interest	2,470	—	2,470	1,565	63	63
Group	21,261	226	21,487	11,016	52	51
2007						
UK Retail	3,369	—	3,369	2,048	61	61
UK Corporate	1,187	16	1,203	737	62	61
Wealth	45	11	56	26	58	46
Global Banking & Markets	830	67	897	493	59	55
Global Transaction Services	73	—	73	22	30	30
Ulster Bank	442	1	443	314	71	71
US Retail & Commercial	229	—	229	220	96	96
Other	—	—	—	30	—	—
Core	6,175	95	6,270	3,890	63	62
Non-Core	2,076	36	2,112	1,082	52	51
Group before RFS Holdings minority interest	8,251	131	8,382	4,972	60	59
RFS Holdings minority interest	2,480	540	3,020	1,480	60	49
Group	10,731	671	11,402	6,452	60	57

Key points

- Provision coverage fell during the year from 52% to 45% (REIL & PPL coverage fell from 51% to 44%) as a consequence of the growth in REIL being concentrated in secured, property-related loans. These loans require relatively lower provisions in view of their collateralised nature. With many of these being in Non-Core, the provision coverage ratio is lower in Non-Core than in Core.

- Provision coverage in Core business improved from 55% to 57%.

- REIL in the Core businesses increased by £4.4 billion to £12.1 billion while REIL in Non-Core more than doubled to £22.9 billion.

Business review

Risk, capital and liquidity management

Credit risk continued

Risk elements in lending and potential problem loans

			2009			2008		20
	Core £m	Non-Core £m	Group before RFS Holdings minority interest £m	RFS Holdings minority interest £m	Group £m	Group before RFS Holdings minority interest £m	Group £m	Gr be Hold minc inte £r
Loans accounted for on a non-accrual basis(2):								
Domestic	6,348	7,221	13,569	3	13,572	8,579	8,588	5,
Foreign	4,383	13,859	18,242	3,211	21,453	8,503	10,891	2,
	10,731	21,080	31,811	3,214	35,025	17,082	19,479	7,
Accruing loans which are contractually overdue 90 days or more as to principal interest(3):								
Domestic	1,135	1,089	2,224	—	2,224	1,201	1,201	21
Foreign	223	731	954	46	1,000	508	581	85
	1,358	1,820	3,178	46	3,224	1,709	1,782	30
Total REIL	12,089	22,900	34,989	3,260	38,249	18,791	21,261	8,
Potential problem loans(4):								
Domestic	137	287	424	—	424	218	218	63
Foreign	135	365	500	85	585	8	8	68
Total PPL	272	652	924	85	1,009	226	226	13
REIL as a % of gross lending to customers excluding reverse repos(5)	2.8 %	15.1 %	6.1 %	2.4 %	5.4 %	2.7 %	2.5 %	1.
REIL and PPL as a % of gross lending to customers excluding reverse repos(5)	2.9 %	15.5 %	6.2 %	2.5 %	5.5 %	2.7 %	2.5 %	1.

Notes:

(1) For the analysis above, 'Domestic' consists of the United Kingdom domestic transactions of the Group. 'Foreign' comprises the Group's transactions conducted through the offices outside the UK and those offices in the UK specifically organised to service international banking transactions.
(2) All loans against which an impairment provision is held are reported in the non-accrual category.
(3) Loans where an impairment event has taken place but no impairment recognised. This category is used for fully collateralised non-revolving credit facilities.
(4) Loans for which an impairment event has occurred but no impairment provision is necessary. This category is used for fully collateralised advances and revolving credit facilities where identification as 90 days overdue is not feasible.

(5) Includes gross loans relating to disposal groups in 2009.

Key points

- At 31 December 2009 REIL were 80% greater than at 31 December 2008. The majority of this growth was attributable to property assets, particularly in Non-Core which had a 107% increase in REIL.

- PPL also increased compared with 31 December 2008.

- REIL growth slowed in the second half of the year (15%) compared with the first half (57%), reflecting the moderating asset quality trend observed as the year progressed. REIL levels in the fourth quarter were flat to the third quarter.

- REIL and PPL represented 5.5% of gross lending to customers, up from 2.5% at the end of 2008.

Credit risk continued

Impairment loss provision methodology

Provisions for impairment losses are assessed under three categories:

· Individually assessed provisions: provisions required for individually significant impaired assets which are assessed on a case by case basis, taking into account the financial condition of the counterparty and any guarantee and other collateral held after being stressed for downside risk. This incorporates an estimate of the discounted value any recoveries and realisation of security or collateral. The asset continues to be assessed on an individual basis until it is repaid in full, in transferred to the performing portfolio or written-off;

· Collectively assessed provisions: provisions on impaired credits below an agreed threshold which are assessed on a portfolio basis, reflect the homogeneous nature of the assets, such as credit cards or personal loans. The provision is determined from a quantitative review of the relevant portfolio, taking account of the level of arrears, security and average loss experience over the recovery period; and

· Latent loss provisions: provisions held against impairments in the performing portfolio that have been incurred as a result of events occuring before the balance sheet date but which have not been identified at the balance sheet date. The Group has developed methodologies to estimate latent loss provisions that reflect:

  - Historical loss experience adjusted where appropriate, in the light of current economic and credit conditions; and

  - The period (‘emergence period’) between an impairment event and a loan being identified and reported as impaired.

Recoverable cash flows are estimated using two parameters: loss given default (LGD) – this is the estimated loss amount, expressed as a percentage, that will be incurred if the borrower defaults; and the probability that the borrower will default (PD).

Emergence periods are estimated at a portfolio level and reflect the portfolio product characteristics such as a coupon period and repayment terms, and the duration of the administrative process required to report and identify an impaired loan as such. Emergence periods vary across different portfolios from two to 225 days. They are based on actual experience within the particular portfolio and are reviewed regularly.

The Group’s retail business segment their performing loan books into homogenous portfolios such as mortgages, credit cards or unsecured loans, to reflect their different credit characteristics. Latent provisions are computed by applying portfolio-level LGDs, PDs and emergence periods. The wholesale calculation is based on similar principles but there is no segmentation into portfolios: PDs and LGDs are calculated on an individual basis.

Provision analysis

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.

Business review

Risk, capital and liquidity management

Credit risk continued

Impairment charge

The following table shows impairment losses charged to the income statement.

	Restated 2009 Core	Restated 2009 Non-Core	Restated 2009 Group	2008 Group	2007 Group
	£m	£m	£m	£m	£m
New impairment losses	4,867	9,357	14,224	7,700	2,169
less: recoveries of amounts previously written-off	(189)	(136)	(325)	(261)	(244)
Charge to income statement	4,678	9,221	13,899	7,439	1,925
Comprising:					
Loan impairment losses	4,567	8,523	13,090	6,478	1,903
Impairment losses on available-for-sale securities	111	698	809	961	22
Charge to income statement	4,678	9,221	13,899	7,439	1,925

Impairment charge by division	Restated 2009	2008	2007
Division	£m	£m	£m
UK Retail	1,679	1,019	975
UK Corporate	927	319	178
Wealth	33	16	3
Global Banking & Markets	640	522	66
Global Transaction Services	39	54	14
Ulster Bank	649	106	46
US Retail & Commercial	702	437	246
RBS Insurance	8	42	—
Central items	1	(19)	3
Core	4,678	2,496	1,531
Non-Core	9,221	4,936	399
Group before RFS Holdings minority interest	13,899	7,432	1,930
RFS Holdings minority interest	—	7	(5)
Group	13,899	7,439	1,925

Key point

- Impairment losses increased by £6.5 billion to £14.0 billion. Non-Core accounted for 62% (£4.3 billion) of the increase. Retail and commercial business in UK, Ireland and the US also recorded significant increases in loans impairments.

Credit risk continued

Analysis of loan impairment charge

	Restated 2009 Core	2009 Non-Core	2009 Group	2008 Group	2007 Group
	£m	£m	£m	£m	£m
Latent loss	991	193	1,184	769	25
Collectively assessed	2,545	1,449	3,994	2,391	1,634
Individually assessed (1)	1,019	6,859	7,878	3,200	244
Charge to income statement (2)	4,555	8,501	13,056	6,360	1,903
Charge as a % of customer loans and advances – gross (3)	1.1%	5.7%	2.3%	0.9%	0.4%

Notes:

(1) Excludes loan impairment charge against loans and advances to banks of £34 million (2008 – £118 million; 2007 – nil).
(2) Excludes impairments of available-for-sale securities of £809 million (2008 – £961 million; 2007 – £22 million).
(3) Gross of provisions and excluding reverse repurchase agreements. Includes gross loans relating to disposal groups.

Analysis of loan impairment provisions on loans to customers

	2009 Core	2009 Non-Core	2009 Group before RFS Holdings minority interest	2009 RFS Holdings minority interest	2009 Group	2008 Group before RFS Holdings minority interest	2008 Group	2007 Group before RFS Holdings minority interest	2007 Group
	£m	£m	£m	£m	£m	£m	£m	£m	£m
Latent loss	2,005	735	2,740	336	3,076	1,719	1,944	734	1,050
Collectively assessed	3,509	1,266	4,775	479	5,254	3,692	4,102	3,162	3,845
Individually assessed (1)	1,272	6,229	7,501	1,295	8,796	3,913	4,843	1,073	1,554
	6,786	8,230	15,016	2,110	17,126	9,324	10,889	4,969	6,449

Note:

(1) Excludes provision of £157 million relating to loans and advances to banks (2008 – £127 million; 2007 – £3 million).

Credit risk continued

Movement in loan impairment provisions

The following table shows the movement in the provision for impairment losses for loans and advances.

	Restated Individually assessed Banks £m	Customers £m	Collectively assessed £m	Latent £m	2009 Total £m	2008 Total £m	2007 Total £m
Group							
At 1 January	127	4,843	4,102	1,944	11,016	6,452	3,935
Transfers to disposal groups	—	(155)	(111)	(58)	(324)	(767)	—
Currency translation and other adjustments	(4)	(326)	(78)	(122)	(530)	1,441	183
Acquisition of subsidiaries	—	—	—	—	—	—	2,221
Disposals	—	(65)	—	—	(65)	(178)	—
Amounts written-off	—	(3,940)	(2,999)	—	(6,939)	(3,148)	(2,011)
Recoveries of amounts previously written-off	—	94	305	—	399	319	342
Charge to income statement – continuing operations (1)	34	7,878	3,994	1,184	13,090	6,478	1,903
Charge to income statement – discontinued operations	—	713	203	128	1,044	613	43
Discount unwind	—	(246)	(162)	—	(408)	(194)	(164)
At 31 December (2)	157	8,796	5,254	3,076	17,283	11,016	6,452

Notes:

(1) Includes charge relating to loans and advances to banks of £34 million (2008 – £118 million; 2007 – nil).
(2) Includes closing provisions relating to loans and advances to banks of £157 million (2008 – £127 million; 2007 – £3 million).

Business review continued

Credit risk continued
Movement in loan impairment provisions continued
The movement in provisions balance by division is shown in the table below.

Restated

	UK Retail £m	UK Corporate Banking £m	Wealth £m	Global Banking & Markets £m	Global Transaction Services £m	Ulster Bank £m	US Retail & Commercial £m	Non-Core £m	RFS Holdings minority interest £m	2009 £m	2008 £m	2007 £m
At 1 January	2,086	696	34	621	43	491	298	5,182	1,565	11,016	6,452	3,935
Transfer to disposal groups	—	—	—	(16)	—	—	—	(305)	(3)	(324)	(767)	—
Currency translation and other adjustments	67	5	1	365	128	(109)	(34)	(851)	(102)	(530)	1,441	137
Acquisition of subsidiaries	—	—	—	—	—	—	—	—	—	—	—	2,221
Disposal of subsidiaries	—	—	—	(62)	—	—	—	(3)	—	(65)	(178)	—
Net increase in provisions of discontinued operations	—	—	—	—	—	—	—	—	—	—	—	46
Amounts written-off	(1,150)	(352)	(12)	(169)	(23)	(34)	(546)	(4,192)	(461)	(6,939)	(3,148)	(2,011)
Recoveries of amounts previously written-off	97	20	—	11	2	1	58	136	74	399	319	342
Charged to the income statement (1) continuing operations	1,679	923	33	542	39	649	702	8,523	—	13,090	6,478	1,903

Charged to the income statement - discontinued operations	—	—	—	—	—	—	—	—	1,044	1,044	613	43
Unwind of discount	(102)	(21)	(1)	(3)	—	(36)	—	(238)	(7)	(408)	(194)	(164)
At 31 December (2)	2,677	1,271	55	1,289	189	962	478	8,252	2,110	17,283	11,016	6,452

Notes:

(1) Includes charge relating to loans and advances to banks of £34 million (2008 - £118 million; 2007 - nil).
(2) Includes closing provisions relating to loans and advances to banks of £157 million (2008 - £127 million; 2007 - £3 million).

Key points

- The provision charge for 2009 was approximately double the previous year.

- Wholesale portfolios continue to drive the trend in provisions, with a notable concentration in the property sector.

Analysis of AFS impairment charge
The following table analyses the AFS impairment charge.

	Restated 2009		2008		2007	
	Group before RFS Holdings minority interest	Group	Group before RFS Holdings minority interest	Group	Group before RFS Holdings minority interest	Group
	£m	£m	£m	£m	£m	£m
Debt securities	601	601	851	858	20	20
Equity securities	208	208	103	103	2	2
Total	809	809	954	961	22	22
Charge as a % of AFS assets	0.6%	0.6%	0.7%	0.8%	—	—

Business review

Risk, capital and liquidity management

Balance sheet analysis

All the disclosures in this section (pages 102 to 106) are audited. The following tables provide an analysis of the credit quality and distribution of financial assets by the Group's internal credit quality gradings, geography and industry sector. Credit risk assets analysed on the preceding pages are reported internally to senior management, however they exclude certain exposures and take account of netting agreements including master netting arrangements that provide a right of legal set-off but do not meet the criteria for off-set in IFRS. The analysis below is therefore provided to supplement the credit risk assets analysis and to reconcile to the consolidated balance sheet.

Credit quality

	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
2009	£m	£m	£m	£m	£m	£m	£m	£m	£m
AQ1	52,234	79,453	115,738	6,592	390,786	754	62,488	9,792	717,837
AQ2	—	1,873	14,025	306	11,740	9	27,984	4,854	60,791
AQ3	1	2,206	36,165	199	10,903	—	28,749	6,417	84,640
AQ4	23	1,455	128,981	605	8,872	—	53,979	16,174	210,089
AQ5	2	2,851	159,914	149	8,639	37	44,342	8,228	224,162
AQ6	1	471	111,588	49	2,674	—	31,235	2,736	148,754
AQ7	—	122	64,724	26	2,326	98	27,057	2,605	96,958
AQ8	—	172	31,272	—	1,448	—	12,730	1,179	46,801
AQ 9	—	237	21,411	—	2,007	—	5,379	1,465	30,499
AQ10	—	386	10,460	—	2,019	—	3,698	570	17,133
Accruing past due	—	36	16,331	3,910	39	—	—	—	20,316
Non-accrual	—	115	34,910	197	1	—	—	—	35,223
Impairment provision	—	(157)	(17,126)	—	—	—	—	—	(17,283)
Group	52,261	89,220	728,393	12,033	441,454	898	297,641	55,020	1,675,920
2008									
AQ1	12,397	98,082	157,212	11,958	837,987	630	123,399	10,279	1,251,944
AQ2	3	7,250	21,656	535	27,225	—	23,379	2,132	82,180
AQ3	—	14,296	68,663	550	35,756	—	26,797	2,851	148,913
AQ4	—	12,792	141,857	34	46,318	—	64,891	13,800	279,692
AQ5	—	1,066	175,544	252	27,047	—	64,308	19,124	287,341
AQ6	—	680	124,606	217	6,632	222	18,145	12,246	162,748
AQ7	—	201	107,624	248	4,547	—	17,915	8,208	138,743

AQ8	—	305	28,517	—	1,477	—	14,603	1,269	46,171
AQ9	—	356	17,329	9	2,136	—	6,298	1,160	27,288
AQ10	—	279	7,586	—	3,423	—	1,989	468	13,745
Accruing past due	—	—	15,667	4,029	11	—	—	—	19,707
Non-accrual	—	129	19,350	—	—	—	—	—	19,479
Impairment provision	—	(127)	(10,889)	—	—	—	—	—	(11,016)
Group	12,400	135,309	874,722	17,832	992,559	852	361,724	71,537	2,466,935

Note:

(1) Excluding items in the course of collection of £2,533 million (2008 – £2,888 million).

Balance sheet analysis continued
Credit quality continued
The following tables show 2007 and 2008 based on the old AQ1-5 bands.

2008	Cash and balances at 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
AQ1	12,400	131,963	310,950	12,612	912,728	691	209,359	19,693	1,610,396
AQ2	—	872	141,849	516	36,528	—	55,109	18,461	253,335
AQ3	—	1,247	187,899	290	30,079	161	48,554	19,502	287,732
AQ4	—	282	150,705	129	5,181	—	23,458	10,977	190,732
AQ5	—	943	59,191	256	8,032	—	25,244	2,904	96,570
Accruing past due	—	—	15,667	4,029	11	—	—	—	19,707
Non-accrual	—	129	19,350	—	—	—	—	—	19,479
Impairment provision	—	(127)	(10,889)	—	—	—	—	—	(11,016)
Group	12,400	135,309	874,722	17,832	992,559	852	361,724	71,537	2,466,935
2007									
AQ1	17,866	204,083	275,715	14,491	240,114	669	131,750	26,120	910,808
AQ2	—	5,797	174,074	98	23,333	—	89,682	16,314	309,298
AQ3	—	4,937	221,561	344	11,299	—	74,126	11,740	324,007
AQ4	—	407	84,791	21	2,352	—	25,320	4,032	116,923
AQ5	—	1,119	55,273	68	304	143	17,301	3,714	77,922
Accruing past due	—	—	13,236	1,567	—	65	—	—	14,868
Non-accrual	—	25	10,337	—	—	—	—	—	10,362
Impairment provision	—	(3)	(6,449)	—	—	—	—	—	(6,452)
Group	17,866	216,365	828,538	16,589	277,402	877	338,179	61,920	1,757,736

Note:

(1) Excluding items in the course of collection of £2,888 million in 2008 (2007 – £3,095 million).

Business review

Risk, capital and liquidity management

Balance sheet analysis continued

Debt securities

The table below analyses debt securities by external ratings, mapped on to the Standard & Poor's ratings scale.

2009	UK and US government £m	Other government £m	Bank and Building Society £m	Asset-backed securities £m	Corporate £m	Other £m	Total £m
AAA	49,820	44,396	4,012	65,067	2,263	—	165,558
BBB- and above	—	39,009	9,523	17,071	5,476	—	71,079
Non-investment grade	—	353	169	3,515	2,042	—	6,079
Unrated	—	504	289	1,949	2,601	1,036	6,379
Group before RFS Holdings minority interest	49,820	84,262	13,993	87,602	12,382	1,036	249,095
RFS Holdings minority interest	904	11,871	3,803	580	906	95	18,159
Group	50,724	96,133	17,796	88,182	13,288	1,131	267,254
2008							
AAA	35,301	43,197	8,126	93,853	3,953	—	184,430
BBB- and above	—	15,862	13,013	11,437	10,172	—	50,484
Non-investment grade	—	242	127	3,678	2,259	—	6,306
Unrated	—	409	1,445	2,175	4,517	3,393	11,939
Group before RFS Holdings minority interest	35,301	59,710	22,711	111,143	20,901	3,393	253,159
RFS Holdings minority interest	7	10,761	1,652	—	885	1,085	14,390
Group	35,308	70,471	24,363	111,143	21,786	4,478	267,549

Key points

- 66% of the portfolio is AAA rated; 95% is investment grade.
- Securities issued by central and local governments comprised 54% of the portfolio at 31 December 2009.
- 63% of corporate debt securities are investment grade. Of £2.6 billion unrated corporate securities, £1.1 billion relates to US funds derivatives portfolio.
- See Market turmoil section on page 137 for further analysis of asset-backed securities.

Balance sheet analysis continued
Past due analysis
The following loans and advances to customers were past due at the balance sheet date but not considered impaired:

	2009						
	Core	Non-Core	Group before RFS Holdings minority interest	RFS Holdings minority interest	Group	2008 Group	2007 Group
	£m	£m	£m	£m	£m	£m	£m
Past due 1-29 days	5,101	1,486	6,587	1,209	7,796	9,517	8,768
Past due 30-59 days	1,943	357	2,300	424	2,724	2,941	2,745
Past due 60-89 days	2,203	207	2,410	177	2,587	1,427	1,354
Past due 90 days or more	1,358	1,820	3,178	46	3,224	1,782	369
	10,605	3,870	14,475	1,856	16,331	15,667	13,236

Note:

(1) These balances include loans and advances to customers that are past due through administrative and other delays in recording payments or in finalising documentation and other events unrelated to credit quality.

Industry risk – geographical analysis
The table below analyses financial assets by location of office and by industry type.

2009	Loans and advances to banks and customers £m	Securities £m	Derivatives £m	Other (1) £m	Total £m	Netting and offset(2) £m
UK	446,590	142,919	280,943	6,537	876,989	252,352
US	102,106	55,796	128,756	5,920	292,578	113,670
Europe	248,204	71,016	5,228	149	324,597	—
RoW	40,529	18,529	26,527	848	86,433	19,803
	837,429	288,260	441,454	13,454	1,580,597	385,825
Central and local government	9,006	155,118	7,013	205	171,342	1,725
Manufacturing	48,683	2,260	5,420	116	56,479	3,184
Construction	15,214	615	928	63	16,820	1,452
Finance (3)	201,779	107,116	411,017	12,118	732,030	372,343
Service industries and business activities	154,657	15,403	12,025	795	182,880	5,824
Agriculture, forestry and fishing	8,665	282	65	9	9,021	76
Property	103,013	4,509	4,517	108	112,147	1,114

Individuals:						
Home mortgages	230,412	729	241	—	231,382	7
Other	43,341	1	212	40	43,594	61
Finance lease and instalment credit	20,103	306	16	—	20,425	39
Interest accruals	2,556	1,921	—	—	4,477	—
	837,429	288,260	441,454	13,454	1,580,597	385,825

For notes refer to the following page.

Business review

Risk, capital and liquidity management

Balance sheet analysis continued

Industry risk – geographical analysis continued

2008	Loans and advances to banks and customers £m	Securities £m	Derivatives £m	Other (1) £m	Total £m	Netting and off-set(2) £m
UK	538,917	135,668	569,098	8,059	1,251,742	499,426
US	132,107	64,476	366,113	6,829	569,525	326,473
Europe	293,498	71,293	12,209	3,718	380,718	843
RoW	59,413	22,652	45,139	552	127,756	31,926
	1,023,935	294,089	992,559	19,158	2,329,741	858,668
Central and local government	15,712	102,293	6,382	197	124,584	1,987
Manufacturing	75,489	2,136	14,160	308	92,093	6,498
Construction	20,907	214	984	32	22,137	1,488
Finance	285,550	160,842	939,154	16,039	1,401,585	836,428
Service industries and business activities	190,537	24,355	25,933	2,470	243,295	10,858
Agriculture, forestry and fishing	9,055	144	45	16	9,260	87
Property	106,633	2,512	5,586	71	114,802	1,067
Individuals:						
Home mortgages	234,598	50	18	—	234,666	52
Other	55,960	279	272	25	56,536	84
Finance lease and instalment credit	22,355	23	25	—	22,403	119
Interest accruals	7,139	1,241	—	—	8,380	—
	1,023,935	294,089	992,559	19,158	2,329,741	858,668
2007						
UK	595,347	161,873	254,797	12,746	1,024,763	202,503
US	143,805	69,921	9,708	3,308	226,742	23,059
Europe	232,049	78,044	7,322	157	317,572	109,071
RoW	83,249	37,918	5,575	1,255	127,997	6,166
	1,054,450	347,756	277,402	17,466	1,697,074	340,799
Central and local government	10,077	103,205	4,148	212	117,642	1,540
Manufacturing	51,719	3,418	6,010	—	61,147	4,259
Construction	18,760	631	757	—	20,148	1,685
Finance (3)	442,532	204,587	259,294	17,178	923,591	299,705
Service industries and business activities	151,822	21,356	5,787	1	178,966	31,456
Agriculture, forestry and fishing	9,181	72	100	—	9,353	104
Property	88,837	5,013	1,005	7	94,862	2,033
Individuals:						
Home mortgages	185,095	1,813	5	—	186,913	—

Other	68,179	4,432	15	23	72,649	10
Finance lease and instalment credit	19,498	131	281	45	19,955	5
Interest accruals	8,750	3,098	—	—	11,848	2
	1,054,450	347,756	277,402	17,466	1,697,074	340,799

Notes:

(1) Includes settlement balances of £12,033 million at 31 December 2009 (2008 – £17,832 million; 2007 – £16,589 million).

(2) This column 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.

Business review continued

Funding and liquidity risk

All the disclosures in this section (pages 107 to 113) are audited unless indicated otherwise with an asterisk (*).

The Group’s liquidity policy is designed to ensure that the Group can at all times meet its obligations as they fall due.

Liquidity management within the Group addresses the overall balance sheet structure and the control, within prudent limits, of risk arising from the mismatch of maturities across the balance sheet and from exposure to undrawn commitments and other contingent obligations.

Following a difficult first quarter of 2009, most indicators of stress in financial markets are close to or better than in late 2008. Liquidity conditions in money and debt markets have improved significantly since the beginning of the second quarter of 2009. Contributing to the improvement has been a combination of ongoing central bank and other official liquidity support schemes, guarantee schemes and rate cuts. Signs of underlying macroeconomic trends such as stabilisation of the UK economy, also helped to sustain a recovery in debt markets.

Liquidity risk framework and governance

The Group has an approved risk appetite supported by explicit targets and metrics to control the size and extent of both short-term and long-term liquidity risk. These metrics are reviewed by the Board and Group Asset and Liability Management Committee (GALCO) on a regular basis. The Group uses stress tests to refine and update the risk appetite in light of changing conditions.

The GALCO, chaired by the Group Finance Director, has the responsibility to set Group policy and ensure that it is cascaded and communicated to the business divisions. Group Treasury is the functional area with responsibility for monitoring and control of the Group's funding and liquidity positions.

Group Treasury is supported by a governance process that includes a Liquidity Risk Forum comprising functional areas across the organisation that are responsible for liquidity management, including monitoring through divisional and regional asset and liability committees.

The Group uses funds transfer pricing to ensure the costs of liquidity as well as funding are integrated into the business decision making process.

The Group continues to improve and augment funding and liquidity risk management practices in light of experience of the market over the last two years and of emerging regulatory and industry standards such as the FSA policy statement on strengthening liquidity standards.

Structural management

The Group regularly evaluates its structural liquidity risk and applies a variety of balance sheet management and term funding strategies to maintain this risk within its policy parameters. The degree of maturity mismatch within the overall long-term structure of the Group’s assets and liabilities is managed within internal policy guidelines, aimed at ensuring term asset commitments are funded on an economic basis over their life. In managing its overall term structure, the Group analyses and takes into account the effect of retail and corporate customer behaviour on actual asset and liability maturities where they differ materially from the underlying contractual maturities.

The Group targets diversification in its funding sources to reduce funding risk. A key source of funds for the Group is its core customer deposits gathered by its retail banking, private client, corporate and small and medium enterprises franchises. The Group's multi-brand offering and strong client focus is a key part of the funding strategy and continues to benefit the Group's funding position.

The Group also accesses the wholesale funding market to provide additional flexibility in funding sources. The Group has actively sought to manage its liquidity position through increasing the duration of short-term wholesale funding, continued diversification of wholesale debt investors and depositors, supplemented by long-term issuance, government guaranteed debt, and a programme of ensuring that assets held are eligible as collateral to access central bank liquidity schemes.

Cash flow management

The short-term maturity structure of the Group's assets and liabilities is managed daily to ensure that all material or potential cash flows, undrawn commitments and other contingent obligations can be met. The primary focus of the daily management activity is to ensure access to sufficient liquidity to meet cash flow obligations within key time horizons, including out to one month ahead and FSA target horizons such as 90 days.

Potential sources of liquidity include cash inflows from maturing assets, new borrowings or the sale of various debt securities held. Short-term liquidity risk is generally managed on a consolidated basis with liquidity mismatch limits in place for subsidiaries and non-UK branches which have material local treasury activities, thereby assuring that the daily maintenance of the Group's overall liquidity risk position is not compromised.

Volume management

The Group also actively monitors and manages future business volumes to assess funding and liquidity requirements and ensure that the Group operates within the risk appetite and metrics set by the Board. This includes management of undrawn commitments, conduits and liquidity facilities within acceptable levels.

Liquidity reserves

The Group has built up a diversified stock of highly marketable liquid assets including highly rated central government debt that can be used as a buffer against unforeseen impacts on cash flow or in stressed environments. The makeup of this portfolio of assets is sub-divided into tiers on the basis of asset liquidity, with haircuts applied to ensure that realistic liquidation values are used in key metrics. This portfolio includes a centrally held buffer against severe liquidity stresses and locally held buffers to meet self sufficiency needs.

Funding and liquidity risk continued
Stress testing
The Group performs stress tests to simulate how events may impact its funding and liquidity capabilities. Such tests assist in the planning of the overall balance sheet structure, help define suitable limits for control of the risk arising from the mismatch of maturities across the balance sheet and from undrawn commitments and other contingent obligations, and feed into the risk appetite and contingency funding plan. The form and content of stress tests are updated where required as market conditions evolve. These stresses include the following scenarios:

•Idiosyncratic stress: an unforeseen, name-specific, liquidity stress, with the initial short-term period of stress lasting for at least two weeks;

•Market stress: an unforeseen, market-wide liquidity stress of three months duration;

•Idiosyncratic and market stress: a combination of idiosyncratic and market stress;

•Rating downgrade: one and two notch long-term credit rating downgrade scenarios; and

•Daily market lockout: no access to unsecured funding and no funding rollovers are possible.

Contingency planning
Contingency funding plans have been developed which incorporate early warning indicators to monitor market conditions. The Group reviews its contingency funding plans in the light of evolving market conditions and stress test results. The contingency funding plans cover: the available sources of contingent funding to supplement cash flow shortages; the lead times to obtain such funding; the roles and responsibilities of those involved in the contingency plans; the communication and escalation requirements when early warning indicators signal deteriorating market conditions; and the ability and circumstances within which the Group accesses central bank liquidity.

Monitoring
Liquidity risk is constantly monitored to evaluate the Group’s position having regard to its risk appetite and key metrics. Daily, weekly and monthly monitoring and control processes are in place, which allow management to take appropriate action. Actions taken to improve the liquidity risk include a focus on improving the loan to deposit ratio, issuing longer-term wholesale funding, both guaranteed and unguaranteed, and the size of the conduit commitments. Metrics include, but are not limited to;

Wholesale funding > one year: As the wholesale funding markets have improved over the course of 2009 the Group has been better able to manage both its short and longer-term funding requirements and has significantly reduced its reliance on central bank funding. In 2009, the Group issued £21 billion of public, private and structured unguaranteed debt securities with a maturity greater than one year including issuances with maturities of ten years and five years of £3 billion and £2 billion respectively. To provide protection from liquidity risk in these markets the Group targets a ratio of wholesale funding greater than one year. The proportion of outstanding debt instruments issued with a remaining maturity of greater than 12 months has increased from 45% at 31 December 2008 to 50% at 31 December 2009, reflecting a lengthening of the maturity profile of debt issuance over the period. The Group is also targeting an absolute funding reliance (unsecured wholesale funding with a residual maturity of less than one year) of less than £150 billion by 2013. The 2013 target can also be segmented further into bank deposits of less than £65 billion and other unsecured wholesale funding of less than £85 billion. The reliance on wholesale funding has improved from £343 billion at 31 December 2008 to £249 billion at December 2009 (and this figure includes £109 billion of bank deposits).

In common with other UK banks, the Group has benefited from the UK Government's scheme to guarantee debt issuance. At 31 December 2009 the Group had debt securities in issue amounting to £52 billion (2008 – £32 billion), which is approximately 38% of the total UK Government guaranteed debt.

Loan to deposit ratio: The Group monitors the loan to deposit ratio as a key metric. This ratio has decreased from 118% at 31 December 2008 to 104% at 31 December 2009 for Core and from 151% at 31 December 2008 to 134% at 31 December 2009 for the Group. The Group has a target of 100% for 2013. The gap between customer loans and customer deposits (excluding repos) narrowed by £91 billion from £233 billion at 31 December 2008 to £142 billion at 31 December 2009.

Business review continued

Funding and liquidity risk continued
Monitoring continued
Undrawn commitments: The Group has been actively managing down the amount of undrawn commitments that it is exposed to. Undrawn commitments decreased from £349 billion at 31 December 2008 to £289 billion at 31 December 2009.

Repo Agreements: At 31 December 2009 the Group had £68 billion of customer secured funding and £38 billion of bank secured funding, which includes borrowing using central bank funding schemes. With markets continuing to stabilise through the course of 2009, the Group has significantly reduced its reliance on secured funding from central bank liquidity schemes.

Liquidity reserves: The total stock of liquid assets has increased by £81 billion during 2009 from £90 billion at 31 December 2008 to £171 billion at 31 December 2009; this reflects the injection of £25.5 billion of B shares at the end of December 2009 provided as treasury bills and cash. The Group is targeting a liquidity pool of £150 billion by 2013. The table below shows the breakdown of these assets. In addition to available liquid assets, the Group has a pool of unencumbered assets that are available for securitisation to raise funds if and when required.

The types of assets which can be used in securitisation include lending assets, and the Group benefits from not having encumbered significant amounts of lending assets historically.

Conduit commitments: The Group has taken additional measures to improve the balance sheet structure. One area of focus has been reducing the size of the multi-seller conduits business, which relies upon funding assets through the issuance of short term asset-backed commercial paper. Total facilities have declined by £17.9 billion to £25.0 billion at 31 December 2009. This has reduced the liquidity risk to the Group through the commitments provided for this type of business.

Liquidity reserves	2009 £m	2008 £m
Government securities	57,407	27,303
Cash and central bank balances	51,500	11,830
Unencumbered collateral (1)	42,055	30,054
Other liquid assets	19,699	20,647
Total liquidity reserve	170,661	89,834

Note:

(1) Includes secured assets which are eligible for discounting at central banks.

Funding profile

The contractual maturity of on balance sheet assets and liabilities, shown in the tables overleaf, highlight the maturity transformation which underpins the role of banks to lend longer-term but funded 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 profile of many assets and liabilities exhibit greater stability and longer maturity than the contractual maturity. The Group models the behavioural maturity of liabilities so that it can target a diversified and stable funding base.

Funding and liquidity risk continued
Funding profile continued
The table below analyses the contractual undiscounted cash flows receivable and payable up to a period of twenty years including future receipts and payments of interest of the on balance sheet assets by contractual maturity.

2009	0-3 months £m	3-12 months £m	1-3 years £m	3-5 years £m	5-10 years £m	10-20 years £m
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
Total assets	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
Total liabilities	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	—	—	—	—	—
2008						
Assets by contractual maturity						
Cash and balances at central banks	12,333	25	—	—	2	29
Loans and advances to banks	61,630	19,369	2,673	921	111	70
Debt securities	26,006	12,895	24,629	23,927	57,846	24,535
Settlement balances	17,830	—	—	—	2	—
Other financial assets	621	193	58	111	343	—
Total maturing assets	118,420	32,482	27,360	24,959	58,304	24,634

Loans and advances to customers	195,553	81,054	138,378	125,621	160,271	152,084
Derivatives held for hedging	266	1,796	2,281	1,359	1,517	649
Total assets	314,239	115,332	168,019	151,939	220,092	177,367
Liabilities by contractual maturity						
Deposits by banks	154,614	14,347	3,345	2,754	2,048	34
Debt securities in issue	131,714	48,652	40,067	38,223	38,667	5,626
Subordinated liabilities	1,753	4,271	6,824	5,793	24,503	13,030
Settlement balances and other liabilities	13,351	5	12	6	10	6
Total maturing liabilities	301,432	67,275	50,248	46,776	65,228	18,696
Customer accounts	523,268	33,450	6,577	6,337	7,298	5,319
Derivatives held for hedging	394	2,216	2,543	1,334	2,682	1,373
Total liabilities	825,094	102,941	59,368	54,447	75,208	25,388
Maturity gap	(183,012)	(34,793)	(22,888)	(21,817)	(6,924)	5,938
Cumulative maturity gap	(183,012)	(217,805)	(240,693)	(262,510)	(269,434)	(263,496)

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.

Business review continued

Funding and liquidity risk continued
Funding profile continued
The tables on the previous page show the timing of cash inflows and outflows to settle financial assets and liabilities. They have been prepared on the following basis:

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 asset or liability is triggered by, or is subject to, specific criteria, such as market price hurdles being reached, the asset is included in the latest date on which it can repay regardless of early repayment, the liability is included at the earliest possible date that 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 repayment of assets and liabilities are linked, the repayment of assets in securitisations are shown on the earliest date that the asset can be prepaid as this is the basis used for liabilities.

Assets and liabilities with a contractual maturity of greater than twenty years – 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.

Held-for-trading assets and liabilities – held-for-trading assets and liabilities amounting to £651 billion (assets) and £568 billion (liabilities) (2008 – £1,227 billion assets, £1,147 billion liabilities) have been excluded from the table in view of their short term nature.

Wholesale funding breakdown
The table below shows the composition of the sources of wholesale funding of the Group before RFS minority interest. The Group has implemented its funding strategy of reducing its reliance on short-term wholesale funding. Deposits by banks have decreased by £63 billion to £116 billion; comprising 14.3% of total funding sources at 31 December 2009, down from 18.8% at 31 December 2008. Short-term debt securities such as commercial paper and certificates of deposits in issue have also reduced by £41 billion to £103 billion at 31 December 2009 from £144 billion at 31 December 2008.

	2009		2008	
	£m	%	£m	%
Deposits by banks (1)	115,642	14.3	178,943	18.8
Debt securities in issue:				
– Commercial paper	44,307	5.5	69,891	7.3
– Certificates of deposits	58,195	7.2	73,925	7.8

– Medium term notes and other bonds	125,800	15.6	108,529	11.4
– Securitisations	18,027	2.2	17,113	1.8
	246,329	30.5	269,458	28.3
Subordinated debt	31,538	3.9	43,678	4.6
Total wholesale funding	393,509	48.7	492,079	51.7
Customer deposits (1)	414,251	51.3	460,318	48.3
	807,760	100.0	952,397	100.0

Note:

(1) Excluding repurchase agreements and stock lending.

The total level of the Group's wholesale funding has reduced year on year by £99 billion with the majority of the reduction attributable to a reduced reliance on inter-bank funding.

Business review

Risk, capital and liquidity management

Funding and liquidity risk continued

Wholesale funding breakdown continued

The table below shows the maturity profile of the Group's debt securities in issue and subordinated debt. The composition of the profile reflects the increased proportion of the Group's debt securities in issue of greater than 1 year maturity. Debt securities with a remaining maturity of less than 1 year has reduced by £33 billion to £139 billion at 31 December 2009 (2008 – £172 billion). The proportion of debt securities in issue with remaining maturity greater than 1 year has increased from 45% at 31 December 2008 to 50% at 31 December 2009.

	2009				2008	
	Debt securities in issue £m	Subordinated debt £m	Total £m	%	Total £m	%
Less than one year	136,901	2,144	139,045	50.0	172,234	55.0
1-5 years	70,437	4,235	74,672	26.9	61,842	19.8
More than 5 years	38,991	25,159	64,150	23.1	79,060	25.2
	246,329	31,538	277,867	100.0	313,136	100.0

Wholesale funding maturity profile

Outlook for 2010*

Whilst there have been improvements in the state of the global economy over the course of 2009, the outlook for 2010 remains uncertain. In line with meeting the objectives of the strategic plan, the Group is actively focusing on closing the customer funding gap, continuing to exit Non-Core businesses and focusing on reducing undrawn and contingent commitments. This will reduce the absolute need for wholesale funding with the Group targeting £150 billion by 2013. In addition, the Group will continue to make progress in terming out its remaining wholesale funding. The Group will continue to reduce reliance on government supported schemes and be governed by the state of the markets and economies in which it operates. These strategies will ensure that the Group will be more resilient to any further disruptions in the market and will be better placed to take advantage of favourable trading conditions as they return.

Regulatory environment*

The Group operates in multiple jurisdictions across the globe and is subject to a number of regulatory regimes. The Group's lead regulator is the UK FSA, with other authorities such as the De Nederlandsche Bank and the US Federal Reserve Bank playing key roles. The liquidity framework applied by the FSA is the Sterling Stock regime. In line with the FSA policy statement PS09/16, the Group will be subject to a new liquidity risk regulatory framework in the future. The Group has been working towards this new framework and will meet the requirements as they come into force.

In the US the Group is required to meet the liquidity requirements set out by all relevant regulatory authorities, including the Federal Reserve Bank, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation and Financial Industry Regulatory Authority. In the Netherlands, ABN AMRO is subject the De Nederlandsche Bank liquidity regulation regime.

* unaudited

Business review continued

Funding and liquidity risk continued

Net stable funding ratio*

The net stable funding ratio shown below is assessed using the proposed Basel measure. 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. Through the course of 2009, the measure has improved from 79% at 31 December 2008 to 90% at 31 December 2009. Over time this will be reviewed as proposals are developed and industry standards implemented.

	2009		2008		
		ASF (1)		ASF (1)	Weighting
Structural term liabilities	£bn	£bn	£bn	£bn	%
Equity	80	80	62	62	100
Wholesale lending > 1 year	144	144	149	149	100
Wholesale lending < 1 year	249	—	343	—	—
Derivatives	422	—	969	—	—
Repos	106	—	142	—	—
Customer deposits	415	353	460	391	85
Others (deferred tax, insurance liabilities, etc)	106	—	94	—	—
Total liabilities and equity	1,522	577	2,219	602	

Structural term assets					
Cash	52	—	12	—	—
Inter bank lending	49	—	71	—	—
Government and corporate bonds	249	50	253	51	20
Derivatives	438	—	991	—	—
Reverse repos	76	—	98	—	—
Advances < 1 year	139	69	173	87	50
Advances >1 year	416	416	518	518	100
Others (prepayments, accrued income, deferred taxation)	103	103	103	103	100
	1,522	638	2,219	759	
Net stable funding ratio		90%		79%	

Note:

(1)ASF means available stable funding.

* unaudited

Market risk
All the disclosures in this section (pages 114 to 121) are audited unless indicated otherwise with an asterisk (*).

Market risk arises from changes in interest rates, foreign currency, credit spread, 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 framework includes limits based on, but not limited to VaR, scenario analysis, position and sensitivity analyses.

Measurement
At the Group level, the risk appetite is expressed in the form of a combination of VaR, sensitivity and scenario limits. VaR is a technique that produces estimates of the potential change in the market value of a portfolio over a specified time horizon at given confidence levels. For internal risk management purposes, the Group's VaR assumes a time horizon of one trading day and in June 2009 the Group changed its VaR confidence level from 95% to 99% as it considers this provides greater clarity in respect of more severe potential economic outcomes. The Group's VAR model is based on a historical simulation model utilising data from the previous two years trading results.

The Group continued to update and enhance its market risk management framework during 2009. In addition to the move to a VaR based on a 99% confidence level, the Group has improved and strengthened its market risk limit framework increasing the transparency of market risk taken across the Group's businesses in both the trading and non-trading portfolios.

The Group's market risk appetite is defined within this limit framework which is cascaded down through legal entity, division, business and ultimately trader level market risk limits.

The VaR disclosure is broken down into trading and non-trading, where trading VaR relates to the main trading activities of the Group and non-trading reflects the VaR associated with reclassified assets, money market business and the management of internal funds flow within the Group's businesses.

As part of the strategic review, the designation of assets between Core and Non-Core divisions was completed during 2009. As the Non-Core division was not established until conclusion of the strategic review in the first quarter of 2009, constitution of the average, maximum and minimum VaR for Core and Non-Core has been prepared on a best efforts basis as these measures require daily data.

The Group calculates VaR using historical simulation models but does not make any assumption about the nature or type of underlying loss distribution other than implied by history. The methodology uses the previous 500 trading days of market data and calculates both general market risk (the risk due to movement in general market benchmarks) and idiosyncratic market risk (the risk due to movements in the value of securities by reference to specific issuers). The Group 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 time series horizon. Therefore, events that are more severe than those in the historical data series cannot be predicted;

•VaR that uses a 99% confidence level does not reflect the extent of potential losses beyond that percentile;

•VaR that uses 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; and

•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 intra-day profit and losses will be incurred.

A 'Risks not in VaR' framework has been developed to address 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, position monitoring, sensitivity limits, triggers or stress limits) are in place.

These limitations mean that the Group cannot guarantee that losses will not exceed the VaR.

Traded portfolios
The primary focus of the Group's trading activities is client facilitation. The Group also undertakes activities within the Core division of the wholesale bank, built around clients in chosen markets, including:

•Market making – quoting firm bid (buy) and offer (sell) prices with the intention of profiting from the spread between the quotes.

•Arbitrage – entering into offsetting positions in different, but closely related markets in order to profit from market imperfections.

•Proprietary activity – taking positions in financial instruments as principal in order to take advantage of anticipated market conditions.

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 (futures, forwards, swaps and options).

The Group participates in exchange traded and over-the-counter (OTC) derivatives markets. The Group buys and sells financial instruments that are traded or cleared on an exchange, including interest rate swaps, futures and options. Holders of exchange traded instruments provide daily margins with cash or other security at the exchange, to which the holders look for ultimate settlement.

The Group also buys and sells financial instruments that are traded 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 the requirements of the Group's customers. In many cases, industry standard documentation is used, most commonly in the form of a master agreement, with individual transaction confirmations.

Market risk continued

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 between willing parties. The fair values are determined following IAS 39 guidance, which requires banks to use quoted market prices or valuation techniques (models) that make the maximum use of observable inputs. When marking to market using a model, the valuation methodologies are reviewed and approved by the market risk function. Group Risk provides an independent evaluation of the model for transactions deemed by the Group Model Product Review Committee (GMPRC) to be large, complex and/or innovative. Any profits or losses on the revaluation of positions are recognised in the daily profit and loss.

The VaR for the Group's 2009 trading portfolios segregated by type of market risk exposure is shown below.

Daily VaR graph*

Note:

(1) The traded market risk VaR excludes super senior tranches of asset backed CDOs and credit derivative product company exposures.

Key points

- The average total VaR utilisation increased in 2009 compared with 2008 largely as a result of increased market volatility experienced since the credit crisis began in August 2007 being more fully incorporated into the two year time series used by the VaR model. This volatility had a marked impact on the credit spread VaR. This increase is partially off-set by a reduction in trading book exposure throughout the period, due to a reduction in the size of the inventory held on the balance sheet as a result of sales, reclassification of assets to the non-trading book and write-downs.

- The credit spread VaR increased significantly during May 2009 due to the purchasing of additional protection against the risk of counterparty failure on CDPCs exposures. As this counterparty risk is itself not in VaR these hedges have the effect of increasing the reported VaR.

- The credit spread VaR decreased significantly at the end of August 2009 due to the positions relating to CDPCs being capitalised under the Pillar II approach and hence excluded from the VaR measure from that date.

* unaudited

Business review

Risk, capital and liquidity management

Market risk continued
Key points continued

•The Counterparty Exposure Management (CEM) trading book exposure and the exposure of Core without CEM have been disclosed separately. CEM manages the OTC derivative counterparty credit risk in GBM, by actively controlling risk concentrations and reducing unwanted risk exposures. The hedging transactions CEM enters into are recorded in the trading book, and therefore contribute to the market risk VaR exposure of the Group.

The counterparty exposures themselves are not captured in VaR for regulatory capital. In the interest of transparency CEM trading book exposure is disclosed separately.

•The average total non-trading VaR utilisation was higher in 2009 at £207 million, compared with £15 million in 2008. This is primarily due to assets from the Group's now dissolved securitisation arbitrage conduit, which transferred from ABN AMRO to RBS, being included in the Group's VaR measure from January 2009 and the increased market volatility being incorporated into the two year time series as previously noted. If both of these factors are excluded, the non-trading VaR would decrease to reflect actions taken through the course of the year to dynamically reduce the underlying risk sensitivity.

Trading VaR Summary (2008 and 2009)	2009 (99%ile) Average £m	Period end £m	Maximum £m	Minimum £m	2008 (99%ile) Average £m	Period end £m	Maximum £m	Minimum £m
Interest rate	57.0	50.5	112.8	28.1	38.7	54.4	94.0	18.2
Credit spread	148.3	174.8	231.2	66.9	71.5	61.5	130.8	51.7
Currency	17.9	20.7	35.8	9.2	7.6	17.0	18.0	3.5
Equity	13.0	13.1	23.2	2.7	22.4	18.3	42.6	11.0
Commodity	14.3	8.9	32.1	6.5	9.9	10.0	25.8	0.2
Diversification	—	(86.1)	—	—	—	(52.4)	—	—
	155.2	181.9	229.0	76.8	82.3	108.8	155.7	49.3
Core	101.5	127.3	137.8	54.8				
CEM	29.7	38.6	41.3	11.5				
Core excluding CEM	86.7	97.4	128.5	54.9				
Non-Core	86.3	84.8	162.1	29.3				

Trading VaR (2007)	2007 (scaled to 99%ile) Average £m	Period end £m	Maximum £m	Minimum £m	2007 (95%ile) Average £m	Period end £m	Maximum £m	Minimum £m
Interest rate	17.7	21.2	30.9	10.8	12.5	15.0	21.8	7.6
Credit spread	26.6	59.3	63.9	17.8	18.8	41.9	45.2	12.6
Currency	3.7	4.2	9.8	1.6	2.6	3.0	6.9	1.1
Equity	7.6	19.8	31.1	2.0	5.4	14.0	22.0	1.4

Commodity	0.3	0.7	2.2	—	0.2	0.5	1.6	—
Diversification	—	(40.6)	—	—	—	(28.7)	—	—
	30.6	64.6	70.8	18.7	21.6	45.7	50.1	13.2

	2009 (99%ile)				2008 (99%ile)			
Non-trading VaR (2008 and 2009)	Average £m	Period end £m	Maximum £m	Minimum £m	Average £m	Period end £m	Maximum £m	Minimum £m
Interest rate	15.5	16.5	26.1	9.5	10.6	24.4	32.9	5.2
Credit spread	211.2	213.3	270.3	65.4	10.5	65.2	65.2	5.5
Currency	1.4	0.6	7.0	0.2	0.6	2.2	5.7	0.1
Equity	3.6	2.3	7.2	1.7	3.4	7.0	8.0	0.8
Diversification	—	(26.0)	—	—	—	(22.7)	—	—
	207.1	206.7	274.9	76.1	14.8	76.1	76.1	7.7
Core	105.1	129.4	142.7	55.0				
Non-Core	112.6	87.6	145.3	20.2				

	2007 (scaled to 99%ile)				2007 (95%ile)			
Non-trading VaR (2007)	Average £m	Period end £m	Maximum £m	Minimum £m	Average £m	Period end £m	Maximum £m	Minimum £m
Interest rate	4.5	5.9	6.9	1.8	3.2	4.1	4.9	1.3
Credit spread	2.5	6.3	7.3	0.5	1.8	4.5	5.1	0.4
Currency	0.2	0.9	1.8	—	0.2	0.6	1.2	—
Equity	0.1	0.9	1.1	—	0.1	0.6	0.8	—
Diversification	—	(6.1)	—	—	—	(4.3)	—	—
	5.2	7.9	9.1	1.9	3.7	5.5	6.4	1.3

Market risk continued

The 2008 and 2009 data on trading VaR in the tables on the previous page excludes exposures to super-senior tranches of asset backed CDOs, as VaR does not produce an appropriate measure of risk for these exposures due to the illiquidity and opaqueness of the pricing of these instruments over an extended period. For these exposures, the maximum potential loss is equal to the aggregate net exposure, which was £910 million as at 31 December 2009.

The 2009 data in the tables on the previous page also excludes the exposures relating to CDPCs from the end of August 2009 when they were excluded from VaR and were capitalised under a Pillar II approach.

RBS Sempra Commodities LLP (Sempra), the commodities-marketing joint venture between RBS and Sempra Energy, was formed on 1 April 2008, and its trading risks were included in the disclosed VaR from that date. Sempra is designated as Non-Core in the 2009 data.

The trading and non-trading VaR for 2007 is shown on the basis it was previously disclosed at a 95% confidence level and using a normalised scaling factor to convert to 99% confidence level.

Non trading VaR in the tables on the previous page does not include structural interest rate risk which is covered on page 118.

Back-testing, stress testing and sensitivity analysis

The Group undertakes a programme of daily back-testing, which compares the actual profit or loss realised in trading activity to the VaR estimation. The results of the back-testing process are one of the methods by which the Group monitors the ongoing suitability of its VaR model.

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 exceptional, but plausible market events. Stress testing measures the impact of abnormal changes in market rates and prices on the fair value of the Group’s trading portfolios. The Group calculates historical stress tests and hypothetical stress tests.

Historical stress tests calculate the loss that would be generated if the market movements that occurred during historical market events were repeated. Hypothetical stress tests calculate the loss that would be generated if a specific set of adverse market movements were to occur.

Stress testing is also undertaken at key trading strategy level, for those strategies where the associated market risks are not adequately captured by VaR. Stress test exposures are discussed with senior management and are reported to GRC, ERF and the Board. Breaches in the Group’s market risk stress testing limits are monitored and reported.

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.

Model validation governance

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 all subject to independent review and sign-off. Models are assessed by GMPRC as having either immaterial or material model risk (valuation uncertainty arising from choice of modelling assumptions), the assessment being made on the basis of expert judgement.

Those models assessed by the GMPRC as having material model risk are prioritised for independent quantitative review. Independent quantitative review aims to quantify model risk (i.e. the impact of missing risk factors in the front office model or the possibility that we may be mismarking these products relative to other market participants who may be using an alternative model) by comparing model outputs against alternative independently developed models. The results of independent quantitative reviews are used by market risk to inform risk limits and by finance to inform reserves. Governance over this process is provided by GMPRC, a forum which brings together front office quantitative analysts, market risk, finance and QuaRC (Quantitative Research Centre, Group Risk's independent quantitative model review function). Risk (market risk, incremental default risk, counterparty credit risk) models are developed both within business units and by Group functions. Risk models are also subject to independent review and sign-off. Meetings are held with the FSA every quarter to discuss the traded market risk, including changes in models, management, back testing results, other risks not included in the VaR framework and other model performance statistics.

Risk control

All divisions that are exposed to market risk in the course of their business are required to comply with the Group's Market Risk Policy Standards (MRPS). The main risk management tools are delegated authorities, hard limits and discussion triggers, independent model valuation, a robust and efficient risk system and timely and accurate management information.

Limits form part of the dealing authorities and constitute one of the cornerstones of the market risk management framework. Upon notification of a limit breach, the appropriate body must take one of the following actions:

•Instructions can be given to reduce positions so as to bring the Group within the agreed limits;

•A temporary increase in the limit can be granted to pursue an agreed short-term strategy; and

•A permanent increase in the limit can be granted if consistent with the strategy and supported by the business and Risk Management.

Non-traded portfolios

Risks in non-traded portfolios mainly arise in retail and commercial banking assets and liabilities and financial investments designated as available-for-sale and held-to-maturity.

Group Treasury is responsible for setting and monitoring the adequacy and effectiveness of management, using a framework that identifies, measures, monitors and controls the underlying risk. GALCO approves the Group's non-traded market risk appetite, expressed as statistical and non-statistical risk limits, which are delegated to the businesses responsible.

Market risk continued
Non-traded portfolios continued
Various banking regulators review non-trading market risks as part of their regulatory oversight. As home country regulator, the FSA has responsibility for reviewing non-trading market risk at a Group consolidated level.

The Group is exposed to the following non-traded risks:

Interest Rate Risk in the Banking Book (IRRBB) represents exposures to instruments whose values vary with the level or volatility of interest rates. These instruments include, but are not limited to, loans, debt securities, equity shares, deposits, certificates of deposits, loan capital and derivatives. Hedging instruments used to mitigate these risks include related derivatives such as options, futures, forwards and swaps. Interest rate risk arises from the Group's non-trading activities in four principal forms:

- Re-pricing risk – arises from differences in the re-pricing terms of the Group's assets and liabilities;
- Optionality – arises where a customer has an option to exit a deal early;
- Basis risk – arises, for example where liabilities, the interest on which is linked to LIBOR, is used to fund assets bearing interest linked to the base rate; and
- Yield curve risk – arises as a result of non-parallel changes in the yield curve.

It is the Group's policy to minimise the sensitivity to changes in interest rates in its retail and commercial businesses and, where interest rate risk is retained, to ensure that appropriate resources, measures and limits are applied.

Non-trading interest rate risk is calculated in each business on the basis of establishing the re-pricing behaviour of each asset, liability and off-balance sheet product. For many retail and commercial products, the actual interest rate re-pricing characteristics differ from the contractual re-pricing. In most cases, the re-pricing maturity is determined by the market interest rate that most closely fits the historical behaviour of the product interest rate. For non-interest bearing current accounts, the re-pricing maturity is determined by the stability of the portfolio. The re-pricing maturities used are approved by Group Treasury and divisional asset and liability committees at least annually. Key conventions are reviewed annually by GALCO.

Non-trading interest rate exposures are controlled by limiting repricing mismatches in the individual business balance sheets. Potential exposures to interest rate movements in the medium to long-term are measured and controlled using a version of the same VaR methodology that is used for the Group's trading portfolios. Net accrual income exposures are measured and controlled in terms of sensitivity over time to movements in interest rates.

Risk is managed within VaR limits approved by GALCO, through the execution of cash and derivative instruments (see Note 13 on the accounts, on page 250). Execution of the hedging is carried out by the relevant division through the Group's treasury functions. The residual risk position is reported to divisional asset and liability committees, GALCO and the Board.

Foreign Exchange Risk in the Banking Book (FXRBB) represents exposures to changes in the values of current holdings and future cash flows denominated in other currencies. Hedging instruments used to mitigate these risks include foreign currency options, currency swaps, futures, forwards and deposits. Foreign exchange risk results from the Group’s investments in overseas subsidiaries, associates and branches in three principal forms:

- Structural foreign currency exposures that arise from net investment in overseas subsidiaries, associates and branches;
- Transactional/commercial foreign currency exposures that arise from mismatches in the currency balance sheet; and
- Foreign currency profit streams.

Equity Risk in the Banking Book (ERBB) is defined as the potential variation in the Group’s non-trading income and reserves arising from changes in equity prices/income. This risk may crystallise during the course of normal business activities or in stressed market conditions. Equity positions in the Group’s banking book are retained to achieve strategic objectives, support venture capital transactions or in respect of customer restructuring arrangements.

The commercial decision to invest in equity holdings, including customer restructurings, is taken by authorised persons with delegated authority under the Group credit approval framework. Investments or disposals of a strategic nature are referred to the Group Acquisitions and Disposal Committee (ADCo), Group Executive Committee (ExCo) and where appropriate the Board for approval; those involving the purchase or sale by the Group of subsidiary companies also require Board approval, after consideration by ExCo and ADCo.

Structural interest rate risk
Non-trading interest rate VaR for the Group’s retail and commercial banking activities at a 99% confidence level was £101.3 million at 31 December 2009 (2008 – £76.7 million). During 2009, the maximum VaR was £123.2 million (2008 – £197.4 million), the minimum was £53.3 million (2008 – £76.7 million) and the average was £85.5 million (2008 – £130.0 million).

A breakdown of the Group’s non-trading VaR (including RFS Holdings minority interests) by currency is shown below.

	2009	2008
	£m	£m
EUR	32.2	30.9
GBP	111.2	26.0
USD	42.1	57.9
Other	9.0	14.0

At year end the GBP VaR was increased by the impact of the B share issuance.

Market risk continued

Structural interest rate risk continued

Citizens Economic Value of Equity (EVE)*

Generally, Citizens is the main contributor to overall non-trading interest rate VaR. Citizens aims, through its management of market risk in non-trading portfolios, to mitigate the effect of prospective interest movements which could reduce future net interest income, whilst balancing the cost of such hedging activities on the current net revenue stream. To do so it uses a variety of income simulation and valuation risk measures that more effectively capture the risk to earnings due to mortgage prepayment and competitive deposit pricing behaviour than a VaR-based methodology. IRRBB is managed within approved limits on interest rate risk, liquidity and capitalisation, with a goal of optimising yield.

In addition to net interest income sensitivity Citizens also measures the sensitivity of the value of the net interest margin to changes in interest rates on a monthly basis. This measure is called EVE sensitivity. The table below details this sensitivity at the end of 2009 and the maximum and minimum month-end figures.

	Percent increase/(decrease) in CFG EVE(1)	
	2% parallel upward movement in US interest rates	2% parallel downward movement in US interest rates(2)
Period end	(4.3)	(23.4)
Maximum	(4.3)	(24.6)
Minimum	4.6	(18.4)
Average	(0.8)	(22.2)

Notes:

(1) Economic value of equity is the net present value (NPV) of assets and liabilities calculated by discounting expected cash flows of each instrument over its expected life. Risk to EVE is quantified by calculating the impact of interest rate changes on the net present value of equity and is expressed as a percentage of CFG regulatory capital.

(2) No negative rates allowed.

Sensitivity of net interest income*

There have been no material changes to the Group’s measurement of, and management philosophy towards, sensitivity of net interest income to movement in interest rates. The Group aims to be relatively neutral to directional shifts in interest rates. It seeks to mitigate the effect of prospective interest movements which could reduce future net interest income, whilst balancing the cost of such hedging activities on the current net revenue stream.

The following table shows the sensitivity of net interest income over the next twelve months to an immediate up and down 1% change to all interest rates.

	2009 £m	2008 £m
+ 100bp shift in yield curves	510	139
– 100bp shift in yield curves	(687)	(234)

The base case projected net interest income is based on the Group's current balance sheet, forwards rate paths implied by the yield curve as at 31 December 2009 and using contractual repricing dates. Where contractual repricing dates are not held an estimate of the likely timing and extent of any rate change is used. The projection also includes the expected effects of behavioural options such as the prepayment of residential mortgages.

The above sensitivities show how this projected net interest income would change in response to an immediate parallel shift to all market rates.

The scenarios used are simplified in that they assume all interest rates for all currencies and maturities move at the same time and by the same amount and therefore do not reflect the potential effect on net interest income of some rates changing whilst others remain the same. The scenarios also do not incorporate actions that would be taken by the business units to mitigate the effect of this interest rate risk.

The Group's asset sensitive position has increased in 2009. The primary contributors to the change are enhanced modelling of embedded deposit floors, active position management to benefit from the impact of a tightening US monetary policy regime by Citizens Financial Group and the impact of not fully hedging the interest rate exposure related to the APS capital proceeds which were received in late December.

The projections do not take into account the effect on net interest income of anticipated differences in changes between interest rates and interest rates linked to other bases (such as central bank rates or product rates for which the entity has discretion over the timing and extent of rate changes). The projections make other simplifying assumptions, including that all positions run to maturity and that there are no negative interest rates.

* unaudited

Market risk continued

Currency risk

The Group does not maintain material non-trading open currency positions other than the structural foreign currency translation exposures arising from its investments in foreign subsidiaries and associated undertakings and their related currency funding. The Group's policy in relation to structural positions is to match fund the structural foreign currency exposure arising from net asset value, including goodwill in foreign subsidiaries, equity accounted investments and branches, except where doing so would materially increase the sensitivity of either the Group's or the subsidiary's regulatory capital ratios to currency movements. The policy requires structural foreign exchange positions to be reviewed regularly by the Group Asset and Liability Committee.

Foreign exchange differences arising on the translation of foreign operations are recognised directly in equity, together with the effective portion of foreign exchange differences arising on hedging instruments.

Equity classification of foreign currency denominated preference share issuances means that these shares are recorded on the balance sheet at historical cost. Consequently, these share issuances have the effect of increasing the Group's structural foreign currency position.

The tables below set out the Group's structural foreign currency exposures:

2009	Net assets of overseas operations £m	Minority interests £m	Net investments in foreign operations £m	Net investment hedges £m	Structural foreign currency exposures £m
US dollar	15,589	(2)	15,591	(3,846)	11,745
Euro	21,900	13,938	7,962	(2,351)	5,611
Other non-sterling	5,706	511	5,195	(4,001)	1,194
	43,195	14,447	28,748	(10,198)	18,550
2008					
US dollar	17,480	(19)	17,499	(3,659)	13,840
Euro	26,943	15,431	11,512	(7,461)	4,051
Chinese Renminbi	3,928	1,898	2,030	(1,082)	948
Other non-sterling	5,088	621	4,467	(3,096)	1,371
	53,439	17,931	35,508	(15,298)	20,210
2007					
US dollar	14,819	303	14,516	(2,541)	11,975
Euro	46,629	28,647	17,982	(8,818)	9,164
Chinese Renminbi	2,600	—	2,600	(1,939)	661
Brazilian Real	3,755	3,755	—	—	—
Other non-sterling	3,905	519	3,386	(1,219)	2,167
	71,708	33,224	38,484	(14,517)	23,967

Key points

•Retranslation gains and losses on the Group’s net investment in operations together with those on instruments hedging these investments are recognised directly in equity.

•Changes in foreign currency exchange rates will affect equity in proportion to the structural foreign currency exposure. A 5% strengthening in foreign currencies against sterling would result in a gain of £980 million (2008 – £1,010 million) recognised in equity, while a 5% weakening in foreign currencies would result in a loss of £880 million (2008 – £960 million) recognised in equity.

•These movements in equity would off-set retranslation effects on the Group's foreign currency denominated RWAs, reducing the sensitivity of the Group's Tier 1 capital ratio to movements in foreign currency exchange rates.

Market risk continued
Equity risk
Equity positions are measured at fair value. Fair value calculations are based on available market prices wherever possible. In the event that market prices are not available, fair value is based on appropriate valuation techniques or management estimates.

The types, nature and amounts of exchange-traded exposures, private equity exposures, and other exposures vary significantly. Such exposures may take the form of listed and unlisted equity shares, linked equity fund investments, private equity and venture capital investments, preference shares classified as equity and Federal Home Loan Stock.

The table below sets out the Group’s banking book equity exposures at 31 December 2009.

	Listed	Unlisted	Total
Equity exposures (1)	£m	£m	£m
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) Excludes equity exposures held-for-trading purposes and by insurance/assurance entities.

Risk control*
The prime risk control mechanism for non-traded market risk exposures is the completion of monthly or quarterly IRRBB and quarterly FXRBB returns by the Group’s business units, collated as part of month-end reporting by Group Treasury to GALCO.

Financial control functions are required to confirm to Group Treasury that returns materially capture all balance sheet items and thus reconcile to core source systems.

Monthly or quarterly returns by the Group’s business units, collated as part of regular reporting by Group Treasury to GALCO, are used to build a Group IRRBB VaR position and to ensure businesses comply with materiality limits on a pre and post hedge basis for interest rates, as stipulated by Group Treasury. For FXRBB, the Group policy states that any foreign currency exposure is managed to de-minimus limits. Group Treasury monitors adherence to this policy by way of a quarterly return.

For both IRRBB and FXRBB, information is included in regulatory and statutory returns.

Group Market Risk exercise independent oversight and governance of the interest rate and foreign exchange exposures managed in Group Treasury by granting market risk limits in addition to authorising Group Treasury to deal in specific instruments for the purpose of managing the Group's non-trading interest rate and foreign exchange exposures. All market risk methodologies that relate to limits specified under this delegated authority are applied under the direction of Group Market Risk.

* unaudited

Insurance risk*
All the disclosures in this section are unaudited and indicated with an asterisk (*). The Group is exposed to insurance risk directly through its general insurance and life insurance businesses.

Insurance risk arises through fluctuations in the timing, frequency and/or severity of insured events, relative to the expectations at the time of underwriting. Insurance risk is managed in four distinct ways:

•Underwriting and pricing risk management: is managed through the use of underwriting guidelines which detail the class, nature and type of business that may be accepted, pricing policies by product line and brand and centralised control of wordings and any subsequent changes;

•Claims risk management: is handled using a range of automated controls and manual processes;

•Reserving risk management: is applied to ensure that sufficient funds have been retained to handle and pay claims as the amounts fall due, both in relation to those claims which have already occurred or will occur in future periods of insurance. Reserving risk is managed through detailed analysis of historical and industry claims data and robust control procedures around reserving models; and

•Reinsurance risk management: is used to protect against adverse claims experience on business which exceeds internal risk appetite. The Group uses various types of reinsurance to transfer risk that is outside the Group’s risk appetite, including individual risk excess of loss reinsurance, catastrophe excess of loss reinsurance and quota share reinsurance.

Overall, insurance risk is predictable over time, given the large volumes of data. However, uncertainty does exist, especially around predictions such as the variations in weather for example. Risk is minimised through the application of documented insurance risk policies, coupled with risk governance frameworks and the purchase of reinsurance.

General insurance business
RBS Insurance underwrites retail and SME insurance with a focus on high volume, relatively straightforward products. The key insurance risks are as follows:

•Motor insurance contracts (private and commercial): claims experience varies due to a range of factors, including age, gender and driving experience together with the type of vehicle and location;

•Property insurance contracts (residential and commercial): the major causes of claims for property insurance are weather (flood, storm), theft, fire, subsidence and various types of accidental damage; and

•Other commercial insurance contracts: risk arises from business interruption and loss arising from the negligence of the insured (liability insurance).

Most general insurance contracts are written on an annual basis, which means that the Group’s liability extends for a twelve month period, after which the Group is entitled to decline to renew the policy or can impose renewal terms by amending the premium, terms and conditions.

An analysis of gross and net insurance claims can be found in the financial statements (see page 266).

Life assurance business

The Group's three regulated life companies, National Westminster Life Assurance Limited, Royal Scottish Assurance plc and Direct Line Life Insurance Company Limited underwrite life insurance products within the UK retail insurance market. The key assurance risks are as follows:

- Term assurance contracts: mortality claims experience varies due to a range of factors, including age, gender and smoker status. The key factors that increase the level of claims are disease pandemics and adverse lifestyle changes; and

- Critical illness insurance contracts: morbidity claims experience varies due to a range of factors, including age, gender and past medical history. The key factors that can increase the level of claims are adverse lifestyle changes and improvements in medical diagnosis methods.

These are long-term contracts with long-term business provisions that are calculated in accordance with the UK accounting standard FRS 27 'Life Assurance'.

Estimations (assumptions) including future mortality, morbidity, persistency and levels of expenses are made in calculating reserves. The Group uses standard mortality and morbidity tables appropriate to the type of contract being written. These are adjusted as appropriate to reflect historical experience and future expectations. Sample mortality rates, expressed as deaths per million per annum, for term assurance products (age 40) are:

Mortality (per million)	2009 per annum	2008 per annum
Male non-smoker	674	723
Male smoker	1,542	1,590
Female non-smoker	497	568
Female smoker	1,136	1,277

* unaudited

Operational risk*

All the disclosures in this section (pages 123 to 125) are unaudited and indicated with an asterisk (*). Operational risk is the potential for financial loss, damage to reputation, or impact upon customers resulting from fraud; human error; ineffective or inadequately designed processes or systems; improper behaviour; or external events. Operational risk 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 generate profit for shareholders.

An objective of operational risk management is not to remove operational risk altogether, but to manage the risk to an acceptable level, taking into account the cost of minimising the risk as against the resultant reduction in exposure. Strategies to manage operational risk include avoidance, transfer, acceptance and mitigation by controls.

To ensure appropriate responsibility is allocated for the management, reporting and escalation of operational risk, the Group operates a three lines of defence model which outlines principles for the roles, responsibilities and accountabilities for operational risk management.

Operational risk – three lines of defence model

1st line of defence	2nd line of defence	3rd line of defence
The Business	Operational Risk	Group Internal Audit
Accountable for the ownership and day-to-day management and control of operational risk.	Responsible for the implementation and maintenance of the operational risk framework, tools and methodologies.	Responsible for providing independent assurance on the design, adequacy and effectiveness of the Group's system of internal controls.
Responsible for implementing processes in compliance with Group policies.	Responsible for oversight and challenge on the adequacy of the risk and control processes operating in the business.	
Responsible for testing key controls and monitoring compliance with Group policies.		

The three lines of defence model and the Operational Risk Policy Standards apply throughout the Group and are implemented taking into account the nature and scale of the underlying business. The standards provide the direction for delivering effective operational risk management. They comprise principles and processes that enable the consistent identification, assessment, management, monitoring and reporting of operational risk across the Group. The objectives of the standards are to protect the Group from financial loss or damage to its reputation, its customers or staff and to ensure that it meets all necessary regulatory and legal requirements.

The Operational Risk Policy Standards are supported by the following key operational risk management techniques:

•Risk and control assessments: business units identify and assess operational risks to ensure that they are effectively managed, prioritised, documented and aligned to risk appetite;

•Scenario analysis: scenarios for operational risk are used to assess the possible impact of extreme but plausible operational risk loss events. Scenario assessments provide a forward looking basis for managing exposures that are beyond the Group's risk appetite;

•Loss data management: each business unit's internal loss data management process captures all operational risk loss events above certain minimum thresholds. The data is used to enhance the adequacy and effectiveness of controls, identify opportunities to prevent or reduce the impact of recurrence, identify emerging themes, enable formal loss event reporting and inform risk and control assessments and scenario analysis. Escalation of individual events to senior management is determined by the seriousness of the event. Operational loss events are categorised under the following headings:

– Clients, products and business practices;
– Technology and infrastructure failures;
– Employment practices and workplace safety;
– Internal fraud;
– External fraud;
– Execution, delivery and process management;
– Malicious damage; and
– Disaster and public safety.

•Key risk indicators: business units monitor key risk indicators against their material risks. These indicators are used to monitor the operational risk profile and exposure to losses against thresholds which trigger risk management actions;

* unaudited

Operational risk* continued

- New product approval process: this process ensures that all new products or significant variations to existing products are subject to a comprehensive risk assessment. Products are evaluated and approved by specialist areas and are subject to executive approval prior to launch; and

- Self Certification Process: this requires management to monitor and report regularly on the internal control framework for which they are responsible, confirming its adequacy and effectiveness. This includes certifying compliance with the requirements of Group policies.

Each business unit must manage its operational risk exposure within an acceptable level, testing the adequacy and effectiveness of controls and other risk mitigants (for example, insurance) regularly and documenting the results. Where unacceptable control weaknesses are identified, action plans must be produced and tracked to completion.

The Group purchases insurance to provide the business with financial protection against specific losses and to comply with statutory or contractual requirements. Insurance is primarily used as an additional risk mitigation tool in controlling the Group's exposures. However, insurance only provides protection against financial loss once a risk has crystallised.

Operational risk metrics

Reporting forms an integral part of operational risk management. The Group's risk management processes are designed to ensure that 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.

Events that have a material, actual or potential impact on the Group's finances, reputation or customers, are escalated and reported to divisional and Group executive.

Operational risk events by risk category – % of total risk events by count

The chart below shows that as at 31 December 2009 execution, delivery and process management, together with external fraud, accounted for circa 90% of losses by value during 2009.

* unaudited

Operational risk* continued

Operational risk events by category – % of total by value

The charts below show a similar distribution of losses by value across the risk categories, captured at the date the event occurred and updated as losses crystallise.

Fraud prevention

Fraud remains a big challenge to the Group, and the rest of the financial services industry. The Group continues to respond to this threat, continually investing in people and processes for both detective and preventative measures, especially in relation to the impact of organised crime against the Group. Key initiatives are focused on solutions for payment fraud, ATM security, identification of counterfeit documentation and online banking protection for our customers. This has resulted in multi-million pound savings and, through close working ties with law enforcement agencies, handing down of significant custodial sentences.

Physical security

The Group has implemented strong measures to protect our customers, our staff and our assets from physical harm. These measures are kept under constant review in response to changing threats. In particular, in 2009 there has been a significant rise in demonstrations against the Group in relation to the increased media attention the Group has received. Robust processes are in place to ensure the safety of customers and staff during these demonstrations.

Information security

The Group is committed to protecting customer and Group information with regard to loss of confidentiality, integrity and availability. All employees and agents of the Group are responsible for the protection of Group assets, systems and information. All customer information is treated as confidential and appropriate security is applied to protect the information.

Additionally, the Group's Information Security Policy is reviewed regularly and includes processes for managing and monitoring compliance with the policy. The same standards apply to information controlled by the Group or managed by authorised third parties. The Group continues to invest in programmes to enhance and maintain information security controls and systems. For example, during 2009, we completed security reviews on all of our high risk third parties as well as externally facing and hosted websites.

Business continuity

The need to ensure the continuity of business across the Group and the management of crisis situations is a key activity within the risk function.

Key risks and threats that the Group is consistently monitoring from a business continuity perspective include pandemics, terrorism, environmental impacts and technology disruptions. Business continuity plans are in place to ensure that the Group can continue key products, services, and operations.

A consistent crisis management framework has been developed that includes a six step methodology and allows incidents to be managed and resolved through skilled divisional, country, regional and global teams.

Other risks*

All the disclosures in this section (pages 125 to 126) are unaudited and indicated with an asterisk (*).

Regulatory risk

Regulatory risk is managed by designing, maintaining and implementing policies and systems in order to ensure effective compliance with all regulatory and legal requirements in all the jurisdictions in which the Group operates.

The Group's approach to regulatory risk has three distinct elements:

•The review of potential changes in regulation to ensure that the Group addresses the risks arising from such changes and responds appropriately;

•The monitoring of compliance with existing rules and regulations and the mitigation of the consequences of any inadvertent non-compliance; and

•The management of effective relationships with regulators to ensure constructive engagement.

* unaudited

Other risks* continued
Under a Group-wide framework of high-level policies, the Group and its subsidiaries engage co-operatively with all regulatory authorities in all the relevant jurisdictions, whether in response to regulatory change, ongoing supervisory requirements or regulatory investigations.

The scale and pace of regulatory change continues, focused across a range of topics, including Systemically Important Firms, Prudential (Basel Capital & Liquidity requirements) and Conduct issues. Of particular interest is the cumulative impact of proposals across the financial services industry. Globally, regulators have expanded their focus across a range of issues, notably strategic, governance, capital, liquidity, systems, people issues, remuneration, Anti Money Laundering/sanctions and terrorist financing and Treating Customers Fairly. This is particularly the case in the UK, where the FSA (as the Group's lead regulator) has implemented an enhanced supervisory framework.

The Group has a well developed regulatory developments framework, which assigns Senior Executive responsibility for all material risks facing the Group on a global basis. The Group engages with standard setters, rule makers, regulators and trade bodies to deliver effective and proportionate rule making.

Reputation risk
Reputation is the body of perceptions and opinions held by the stakeholders of an organisation; customers, suppliers, employees, investors, interest groups, regulators and government. Reputation determines how stakeholders are likely to behave towards an organisation. Reputation risk arises from any activity that could have an adverse impact on the reputation of the Group.

There are several important drivers of the reputation of a company (and reputation risk) including: financial performance; corporate governance and quality of management; ethical, social and environmental performance; marketing, innovation and customer relationships; and regulatory compliance and litigation.

The Group protects its reputation by understanding and managing reputation risks, including failure to meet the expectations of stakeholders. The Group will only enter into a commercial transaction or customer relationship which is legal and complies with regulatory requirements, has economic substance or business purpose and is not designed or used for inappropriate accounting or tax purposes. The Group takes care to understand the issues that matter most to stakeholders, balance the views of all stakeholders and address them coherently. Risks to the reputation of the Group are identified, assessed, managed, monitored and reported. The Group pays particular attention to the reputation risks associated with the introduction of new products or customer relationships.

It is the responsibility of the management of all Group companies, acting through individual business units, to ensure that appropriate controls and procedures are in place to identify and manage the risks to the reputation of the Group arising from their activity.

The Board has ultimate responsibility for managing any impact on the reputation of the Group arising from its operations. The Group Corporate Sustainability Committee was established in January 2010, chaired by one of our Non-Executive Directors to enhance governance in this area. However, all parts of the Group take responsibility for reputation management.

Pension risk

The Group is exposed to risk to its defined benefit pension schemes as assets comprise investment portfolios which are held to meet projected liabilities to scheme members. Risk arises because returns from these investments may be less than expected or there may be greater than expected increases in the estimated value of the schemes' liabilities. In such circumstances, the Group could be obliged, or may choose, to make additional contributions to the schemes.

The largest of the schemes, and the main source of pension obligation risk, is the RBS Group Pension Fund. In October 2006, this scheme was closed to new employees. In November 2009, the Group confirmed that it was making changes, proposed in August 2009, to the RBS Group Pension Fund and a number of other defined benefit schemes, with a view to controlling the cost and the risk of operating these pension plans. The main change was the introduction of a yearly limit of 2% (or inflation if lower) to the amount of any salary increase that will count for pension purposes.

Risk appetite and investment policy are agreed by the Board of Trustees with quantitative and qualitative input from the scheme actuaries and investment advisers. The Board of Trustees also consults with the Group to obtain its view on the appropriate level of risk within the pension fund.

The Group maintains an independent review of risk within the pension funds.

GALCO monitors pension obligation risk which is assessed by estimating the funding position of the scheme with a twelve month risk horizon, and with a number of different confidence levels. Monte Carlo simulations are used, based on assumptions of statistical distribution of future equity returns, future real and nominal interest rates, sensitivity of asset and liability values to changes in equity returns and real and nominal interest rates, the impact of an adverse change in longevity assumptions and mitigation available to the Group.

Every three years the Group and Trustees meet to formally agree the appropriate basis for calculating the funding valuation. The most recent funding valuation was carried out as at 31 March 2007. This showed the fund to be in surplus, and therefore there was no need in 2008 or 2009 for additional payments over and above the regular contributions.

The next valuation is due as at 31 March 2010 and the Group expects this valuation to show that liabilities exceed the value of the assets. Following this valuation the Group and the Trustees will agree the level of contributions to be paid to the scheme. This could result in the amount of contributions payable in 2010 and subsequent years being materially different from the current estimate for 2010.

* unaudited

Asset Protection Scheme*

All the disclosures in this section (pages 127 to 136) are unaudited and indicated with an asterisk (*). References to 'Group' in this section relate to 'Group before RFS Holdings minority interest'.

Key aspects of the Scheme

On 22 December 2009, the Group acceded to the Asset Protection Scheme ('APS' or 'the Scheme') with HM Treasury (HMT) 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 HMT. The portfolio of covered assets had a par value of approximately £282 billion as at 31 December 2008 and the protection is subject to a first loss of £60 billion and covers 90% of subsequent losses. Once through the first loss, when a covered asset has experienced a trigger event(1) losses and recoveries in respect of that asset are included in the balance receivable under the APS. Receipts from HMT 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 HMT that it has no objection to the proposed termination. On termination, the Group is liable to pay HMT a termination fee. The termination fee would be the difference between £2.5 billion (or, if higher, a sum related to the economic benefit of regulatory capital relief obtained as a result of having entered the APS) and the aggregate fees paid. In addition, the Group would have to repay any amounts received from HMT under the terms of the APS (or as otherwise agreed with HMT). In consideration for the protection provided by the APS, the Group paid an initial premium of £1.4 billion on 31 December 2009 for the years 2009 and 2010. A further premium of £700 million is payable on 1 January 2011 and subsequently annual premiums of £500 million until the earlier of 31 December 2099 or the termination of the agreement.

The APS is a single contract providing credit protection in respect of a portfolio of financial assets: the unit of account is the contract as a whole. Under IFRS, credit protection is either treated as a financial guarantee contract ('FGC') or a derivative depending on the terms of the agreement and the nature of the protected assets and exposures. The portfolio contains more than an insignificant element of derivatives and limited recourse assets, and hence the contract does not meet the definition of an FGC. The APS contract is therefore treated as a derivative and is recognised at fair value, with changes in fair value recognised in profit or loss. The APS derivative did not have any effect on the Group's 2009 income statement; however in future period's changes in value of the APS derivative will have an effect on the Group's profit or loss.

There is no change in the recognition and measurement of the covered assets as a result of the APS. Impairment provisions on covered assets measured at amortised cost are assessed and charged in accordance with the Group's accounting policy; held-for-trading assets, assets designated at fair value and available-for-sale assets within the APS portfolio continue to be measured at fair value with no adjustments to reflect the protection provided by the APS. There is no change in how gains and losses on the covered assets are recognised in the income statement or in other comprehensive income.

Trigger events (subject to specific rules detailed in the terms of the APS) comprise:

- failure to pay: the counterparty to the covered asset has (subject to specified grace periods) failed to pay an amount due under the terms of its agreement with the Group.

- bankruptcy: the counterparty is subject to a specified insolvency or bankruptcy-related event.

- restructuring: a covered asset which is individually impaired and is subject to a restructuring.

The selection of assets was carried out primarily between February and April 2009 and was driven by three principal criteria:

(1)Risk and degree of impairment in base case and stressed scenarios;

(2)Liquidity of exposure; and

(3)Capital intensity under procyclicality.

* unaudited

Business review

Risk, capital and liquidity management

Asset Protection Scheme* continued
The approach for high volume commercial and retail exposures was on a portfolio basis. Selection for large corporates and GBM was at the counterparty/asset level. Set out below are the selection criteria for the contributing divisions.

Global Banking Markets (GBM) (1)	Banking book: selection by individual asset pool (corporate loans, real estate finance, and leveraged finance), Global Restructuring Group work-out unit counterparties/assets and high risk counterparties/assets. Additional counterparties/assets were selected through an individual risk review of the total portfolio. Trading book: selection by individual assets (monolines, derivatives, mortgage trading).
UK Corporate (1)	Commercial & corporate real estate: all defaulted assets in the work-out/restructuring unit or in high risk bands. Corporate: all defaulted assets in the work-out/restructuring unit. Corporate banking clients in high risk sectors or with high concentration risk. Business Banking: portfolios in the work out/restructuring unit or in high risk bands.
UK Retail (1)	Mortgages: assets with a higher loan-to-value (LTV) and in higher risk segments (e.g. LTV >97% on general book, LTV >85% on buy-to-let book), and those assets in arrears (at 31 December 2008). Loans and overdrafts: higher risk customers based on internal bandings, and those assets in arrears (at 31 December 2008).
Ulster Bank (1) (Corporate & Retail)	Mortgages: assets with greater than 85% LTV, broker mortgages and interest only with a higher probability of default. Retail: portfolios of accounts in default, >1 month arrears, <2 years old and a higher probability of default. Corporate: counterparties/assets in work-out/restructuring groups or in high risk bands, and other assets identified as part of an individual review of cases.

Note:

(1) Including assets transferred to Non-Core division.

Covered assets
Roll forward to 31 December 2009
The table below details the movement in covered assets in the year.

£bn

Covered assets at 31 December 2008 – at accession to the Scheme	282.0
Disposals	(3.0)
Non-contractual early repayments	(8.9)
Amortisations	(9.4)
Maturities	(16.7)
Rollovers and covered amount cap adjustments	(1.7)
Effect of foreign currency movements	(11.8)
Covered assets at 31 December 2009(1)	230.5

Note:

(1) The covered amount at 31 December 2009 above includes approximately £2.1 billion of assets in the derivatives and structured finance asset classes which, for technical reasons, do not currently satisfy, or are anticipated at some stage not to satisfy, the eligibility requirements of the Scheme. HMT and the Group continue to negotiate in good faith whether (and, if so, to what extent) coverage should extend to these assets. Also, the Group and HMT are in discussion over the HMT classifications of some structured credit assets and this may result in adjustments to amounts for some asset classes; however underlying risks will be unchanged.

Key points

- The majority of the reduction (68%) in the covered assets reflects repayments by customers.

- Additionally the Group took advantage of market conditions and executed a number of loan sales.

* unaudited

Asset Protection Scheme* continued

Covered assets continued

Credit impairments and write downs

The table below analyses the cumulative credit impairment losses and adjustments to par value (including AFS reserves) relating to covered assets:

	2009	2008
	£m	£m
Loans and advances	14,240	7,705
Debt securities	7,816	7,942
Derivatives	6,834	6,575
	28,890	22,222
By division:		
UK Retail	2,431	1,492
UK Corporate	1,007	285
Global Banking & Markets	1,628	1,640
Ulster Bank	486	234
Non-Core	23,338	18,571
	28,890	22,222

Note:

(1)Total available-for-sale reserves on debt securities of £1,113 million at 31 December 2009 (£1,315 million as at 31 December 2008 was previously included in undrawn commitments and other adjustments).

Key point

- Of the increase in cumulative losses of £6,668 million, the largest was loan impairments in Non-Core.

First loss utilisation

The triggered amount is equivalent to the aggregate outstanding principal amount on the trigger date excluding interest, fees, premium or any other non-principal sum that is accrued or payable, except where it was capitalised on or before 31 December 2008. At the trigger date, in economic terms, there is an exchange of assets, with the Group receiving a two year interest bearing government receivable in exchange for the asset.

APS recoveries include any return of value on a triggered asset, although these are only recognised for Scheme reporting purposes when they are realised in cash. The net triggered amount at any point in time, only takes into account cash recoveries to date. The capturing of triggered amounts has required extensive new processes and controls to be put in place. These continue to be work in progress. Additionally, as with any bespoke and highly complex legal agreement there are various areas of interpretation which still need to be clarified and agreed between the Group and the Asset Protection Agency ('APA'), some of which could have a material impact on the triggered amount identified to date. Also as part of the APS terms and conditions it was agreed to re-characterise certain assets and their closely related hedges under the scheme and the Group continues to negotiate with APA in good faith to finalise this.

The Scheme rules are designed to allow for data correction over the life of the Scheme, and the Group has a grace period during 2010 to implement processes to capture triggers and restate quarterly claims statements to HMT retrospectively.

* unaudited

Business review

Risk, capital and liquidity management

Asset Protection Scheme* continued
continued
First loss utilisation continued
The table below summarises the total triggered amount and related cash recoveries by division at 31 December 2009.

	Triggered amount £m	Cash recoveries to date £m	Net triggered amount £m
UK Retail	3,340	129	3,211
UK Corporate	3,570	604	2,966
Global Banking & Markets	1,748	108	1,640
Ulster Bank	704	47	657
Non-Core	18,905	777	18,128
	28,267	1,665	26,602

Note:

(1)The triggered amount on a covered asset is calculated when an asset is triggered (due to bankruptcy, failure to pay after a grace period, and restructuring with an impairment) and is the lower of the covered amount and the outstanding amount for each covered asset. Given the grace period for triggering assets, the Group expects additional assets to trigger based on the current risk rating and level of impairments on covered assets.

Key points

- APS recoveries include almost any return of value on a triggered asset but are only recognised when they are realised in cash, hence there will be a time lag for the realisation of recoveries.

- The Group expects recoveries on triggered amounts to be approximately 45% over the life of the relevant assets.

- On this basis, expected loss on triggered assets at 31 December 2009 is approximately £15 billion (25%) of the £60 billion first loss threshold under the APS.

- In case the net triggered amount exceeds a specified threshold level for each covered asset class, HMT retains step-in rights as defined in the Scheme rules.

Risk-weighted assets
Risk-weighted assets were as follows:

	2009 £bn	2008 £bn
APS	127.6	158.7
Non-APS	438.2	419.1
Group before APS benefit	565.8	577.8

	2009		
	APS	Non-APS	Total
Risk-weighted assets by division	£bn	£bn	£bn
UK Retail	16.3	35.0	51.3
UK Corporate	31.0	59.2	90.2
Global Banking & Markets	19.9	103.8	123.7
Ulster	8.9	21.0	29.9
Non-Core	51.5	119.8	171.3
Other divisions	n/a	99.4	99.4
Group before APS benefit	127.6	438.2	565.8

Key point

- Over the year RWAs covered by the APS declined overall due to the restructuring of certain exposures, including monoline related assets, and decrease in the covered amount partly off-set by credit downgrade and procyclicality.

* unaudited

Asset Protection Scheme* continued

Covered assets continued

Divisional analysis

The following table analyses covered assets by the asset classes defined by the Scheme conditions and by division:

	UK Retail £m	UK Corporate £m	Global Banking & Markets £m	Ulster Bank £m	Non-Core £m	Covered amount £m
2009						
Residential mortgages	9,646	—	113	2,512	1,934	14,205
Consumer finance	11,596	24,818	—	5,538	11,309	53,261
Commercial real estate finance	—	9,143	—	1,073	21,921	32,137
Leveraged finance	—	4,899	621	291	17,465	23,276
Lease finance	—	449	—	—	1,080	1,529
Project finance	—	—	255	—	1,562	1,817
Structured finance	—	—	4,114	—	11,061	15,175
Loans	—	9,918	25,815	2,237	16,972	54,942
Bonds	—	—	153	—	545	698
Derivatives	—	—	12,946	218	20,326	33,490
	21,242	49,227	44,017	11,869	104,175	230,530
2008						
Residential mortgages	10,280	—	128	2,837	2,182	15,427
Consumer finance	11,609	25,031	—	5,776	12,127	54,543
Commercial real estate finance	—	12,436	—	1,268	26,146	39,850
Leveraged finance	—	4,978	993	329	21,434	27,734
Lease finance	—	594	—	—	1,844	2,438
Project finance	—	—	425	—	1,818	2,243
Structured finance	—	—	6,897	-	12,294	19,191
Loans	—	9,097	45,610	2,663	22,607	79,977
Bonds	—	—	455	—	1,108	1,563
Derivatives	—	—	16,349	229	22,415	38,993
	21,889	52,136	70,857	13,102	123,975	281,959
Movements						
Residential mortgages	(634)	—	(15)	(325)	(248)	(1,222)
Consumer finance	(13)	(213)	—	(238)	&#	