ROYAL BANK OF SCOTLAND GROUP PLC
Form 20-F
April 29, 2009

As filed with the Securities and Exchange Commission on April 29, 2009

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 20-F

(Mark One)

o REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE SECURITIES EXCHANGE ACT OF 1934

OR

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2008

OR

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

OR

o SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Date of event requiring this shell company report ___________
For the transition period from ___________ to ___________

Commission file number 001-10306

THE ROYAL BANK OF SCOTLAND GROUP plc
(Exact name of Registrant as specified in its charter)

United Kingdom
(Jurisdiction of incorporation or organization)

RBS Gogarburn, PO Box 1000, Edinburgh EH12 1HQ
(Address of principal executive offices)

Miller McLean, Group General Counsel and Group Secretary, Tel: +44 (0) 131 523 2333, Fax: +44 (0) 131 626 3081,

PO Box 1000, Gogarburn, Edinburgh EH12 1HQ
(Name, Telephone, E-mail and/or Facsimile number and Address of Company Contact Person)

Securities registered or to be registered pursuant to Section 12(b) of the Act:

| Title of each class | Name of each exchange on which registered |
|---|---|
| American Depositary Shares, each representing 20 ordinary shares, nominal value £0.25 per share | New York Stock Exchange |
| Ordinary shares, nominal value £0.25 per share | New York Stock Exchange* |
| American Depositary Shares Series F, H, L, M, N, P, Q, R, S, T and U each representing one Non-Cumulative Dollar Preference Share, Series F, H, L, M, N, P, Q, R, S, T and U respectively | New York Stock Exchange |
| Dollar Perpetual Regulatory tier one securities, Series 1 | New York Stock Exchange |

* Not for trading, but only in connection with the registration of American Depositary Shares representing such ordinary shares pursuant to the requirements of the Securities and Exchange Commission.

Securities registered or to be registered pursuant to Section 12(g) of the Act:
None

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act:
None

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of December 31, 2008, the close of the period covered by the annual report:

| | | | |
|---|---|---|---|
| Ordinary shares of 25 pence each | 39,456,004,899 | Non-cumulative dollar preference shares, Series F, H and L to U | 308,015,000 |
| Non-voting Deferred Shares | 2,660,556,304 | Non-cumulative convertible dollar preference shares, Series 1 | 1,000,000 |
| 11% cumulative preference shares | 500,000 | Non-cumulative euro preference shares, Series 1 to 3 | 2,526,000 |
| 5½% cumulative preference shares | 400,000 | Non-cumulative convertible sterling preference shares, Series 1 | 200,000 |
| | | Non-cumulative sterling preference shares, Series 1 and 2 | 5,750,000 |

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act
Yes x No o

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.
Yes o No x

Note — checking the box above will not relieve any registrant required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 from their obligations under those Sections.

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was

required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
Yes x No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
Yes o No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

| Large accelerated filer x | Accelerated filer o | Non-accelerated filer o |
|---|---|---|

Indicate by check mark which basis of accounting the registrant has used to prepare the financial statements included in this filing:

U.S. GAAP o International Financial Reporting Standards as issued by the International Accounting Standards Board x Other o

If "Other" has been checked in response to the previous question, indicate by check mark which financial statement item the registrant has elected to follow.
Item 17 o Item 18 o

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes o No x

(APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY PROCEEDINGS DURING THE PAST FIVE YEARS)
Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court.
Yes o No o

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SEC Form 20-F cross reference guide

Business Review

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Presentation of information

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

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

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

The geographic analysis in the 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 1985 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. It also complies with IFRS as issued by the IASB. On implementation of IFRS on 1 January 2005, the Group took advantage of the option in IFRS 1 'First-time Adoption of International Financial Reporting Standards' to implement IAS 39 'Financial Instruments: Recognition and Measurement', IAS 32 'Financial Instruments: Disclosure and Presentation' and IFRS 4 'Insurance Contracts' from 1 January 2005 without restating its 2004 income statement and balance sheet. The date of transition to IFRS for the Group and the company and the date of their opening IFRS balance sheets was 1 January 2004.

Acquisition of ABN AMRO
On 17 October 2007, RFS Holdings B.V. ('RFS Holdings'), a company jointly owned by RBS, Fortis Bank Nederland (Holding) N.V. ('Fortis') and Banco Santander S.A. ('Santander') (together the 'consortium members') and controlled by RBS, completed the acquisition of ABN AMRO Holding N.V. ('ABN AMRO').

On 3 October 2008, the State of the Netherlands acquired Fortis Bank Nederland (Holding) N.V. including the Fortis participation in RFS Holdings that represents the acquired activities of ABN AMRO and their participation in Dutch insurance activities.

RFS Holdings is implementing an orderly separation of the business units of ABN AMRO with RBS retaining the following ABN AMRO business units:

- Continuing businesses of Business Unit North America;
- Business Unit Global Clients and wholesale clients in the Netherlands (including former Dutch wholesale clients) and Latin America (excluding Brazil);
- Business Unit Asia (excluding Saudi Hollandi); and
- Business Unit Europe (excluding Antonveneta).

Certain other assets will continue to be shared by the consortium members.

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 for the year ended 31 December 2007 and 2008 include the results of ABN AMRO for 76 days and the full year respectively. The interests of Fortis, and its successor the State of the Netherlands, and Santander, in RFS Holdings are included in minority interests.

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## 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 potential exposures to various types of market risks, such as interest rate risk, foreign exchange rate risk and commodity and equity price risk. Such statements are subject to risks and uncertainties. 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: general economic conditions in the UK and in other countries in which the Group has significant business activities or investments, including the United States; 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; inflation; deflation; unanticipated turbulence in interest rates, foreign currency exchange rates, commodity prices and equity prices; changes in UK and foreign laws, regulations and taxes; changes in competition and pricing environments; natural and other disasters; the inability to hedge certain risks economically; the adequacy of loss reserves; acquisitions or restructurings; technological changes; changes in consumer spending and saving habits; 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 13 to 20.

## Business review

### 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.

Following a placing and open offer in December 2008, referred to herein as the First Placing and Open Offer, Her Majesty's Treasury in the United Kingdom (HM Treasury) owned approximately 58% of the enlarged ordinary share capital of the company and £5 billion of non-cumulative sterling preference shares. In April 2009, the company issued new ordinary shares by way of a second placing and open offer, referred to herein as the Second Placing and Open Offer, the proceeds from which were used in full to fund the redemption of the preference shares held by HM Treasury at 101% of their issue price together with the accrued dividend and the commissions payable to HM Treasury under the Second Placing and Open Offer Agreement. The Second Placing and Open Offer was underwritten by HM Treasury and as a result, HM Treasury currently owns approximately 70% of the enlarged ordinary share capital of the company.

The Group had total assets of £2,401.7 billion and owners' equity of £58.9 billion at 31 December 2008. The Group's capital ratios, which include the equity minority interest of The State of the Netherlands and Santander in ABN AMRO, were a total capital ratio of 14.1 per cent., a core Tier 1 capital ratio of 6.8 per cent. and a Tier 1 capital ratio of 10.0 per cent., as at 31 December 2008.

#### Organisational structure and business overview

The Group's activities are organised in the following business divisions: Global Markets (comprising Global Banking & Markets and Global Transaction Services), Regional Markets (comprising UK Retail & Commercial Banking, US Retail & Commercial Banking, Europe & Middle East Retail & Commercial Banking and Asia Retail & Commercial Banking), RBS Insurance and Group Manufacturing. A description of each of the divisions is given below.

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. In 2008 the division was organised along four principal business lines: rates, currencies, and commodities, including RBS Sempra Commodities LLP (the commodities-marketing joint venture between RBS and Sempra Energy which was formed on 1 April 2008); equities; credit markets; and asset and portfolio management.

Following RBS's strategic review, GBM is planning to re-focus its business around its core corporate and institutional clients, concentrating its activities in major financial centres and scaling back its presence elsewhere. It will exit illiquid proprietary trading and balance sheet-heavy niche products segments.

Globally, the intention is for GBM to move increasingly towards a "hub-and- spoke" model. Risk will be managed from regional hubs. It is intended that distribution and coverage will be delivered from a mix of hub countries and a scaled-back presence in some local offices. The aim, over time, will be to reduce much of the on-shore trading activity outside the key financial centres.

Assets, products and geographies that fit GBM’s new client-focused proposition will be defined as “core” and will remain within the division. Assets, business lines and some geographies that are non-core will be transferred to the new Non-Core Bank. These non-core activities accounted for approximately £205 billion of third party assets at end 2008.

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

Following RBS’s strategic review, Global Transaction Services intends to reduce its international network while retaining the capability to serve multinational clients globally.

The business also plans to increase efficiency through development of a lower cost front and back-office operating model and explore joint ventures for growth and selective disposals.

UK Retail & Commercial Banking (RBS UK) comprises retail, corporate and commercial banking and wealth management services. It supplies financial services through both the RBS and NatWest brands.

UK Retail Banking offers a full range of banking products and related financial services to the personal market. It serves customers through two of the largest networks of branches and ATMs in the United Kingdom, and also through telephone and internet channels and, according to Gfk NOP, is the second largest provider of personal current accounts. The division also issues credit and charge cards, including through other brands such as MINT.

UK Business & Commercial Banking is the largest provider of banking, finance, and risk management services to the 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, in which, according to the Finance Lease Association, it has a strong market presence through the Lombard brand.

According to Ph. Group, UK Corporate Banking holds the largest market share in the United Kingdom of relationships with larger companies, offering a full range of banking, finance, and risk management services.

UK Wealth Management provides private banking and investment services through Coutts, Adam & Co., RBS International and NatWest Offshore.

US Retail & Commercial Banking provides financial services primarily through the Citizens and Charter One brands.

Citizens 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. Citizens is a large commercial banking organization.

Following RBS’s strategic review, Citizens intends to invest in its core business through increased marketing activity and targeted technology investments while reducing activity in its out-of-footprint national businesses in consumer and commercial finance.

This strategy will allow Citizens to become fully funded from its own customer deposits over time, and will support a low risk profile.

Europe & Middle East Retail & Commercial Banking comprises Ulster Bank and the Group's combined retail and commercial businesses in Europe and the Middle East.

Ulster Bank provides a comprehensive range of financial services across the island of Ireland. Its retail banking arm has a network of branches and operates in the personal, commercial and wealth management sectors, while its corporate markets operations provides services in the corporate and institutional markets.

The retail and commercial businesses in Europe and the Middle East have smaller activities in Romania, Kazakhstan and the United Arab Emirates. Following RBS's strategic review, RBS has decided to exit sub-scale retail and commercial activities outside its core markets in the United Kingdom, Europe and the United States.

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Asia Retail & Commercial Banking is present in markets including India, Pakistan, China, Taiwan, Hong Kong, Indonesia, Malaysia and Singapore. It provides financial services across four segments: affluent banking, cards and consumer finance, business banking and international wealth management, which offers private banking and investment services to clients in selected markets through the RBS Coutts brand.

Following RBS's strategic review, RBS has decided to exit sub-scale retail and commercial activities outside its core markets in the United Kingdom, Europe and the United States.

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 Spain, Germany and Italy. The Intermediary and Broker division sells general insurance products through independent brokers.

Following RBS's strategic review, RBS has decided to retain RBS Insurance.

Group Manufacturing comprises the Group's worldwide manufacturing operations. It 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. Group Manufacturing 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 has become the centre of excellence for managing large-scale and complex change.

The Centre comprises group and corporate functions, such as capital raising, 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.

RFS Holdings minority interest comprises those activities of ABN AMRO that are attributable to the other consortium members.

Share of shared assets comprises the Group's share of the unallocated assets of ABN AMRO.

Non-core division

RBS intends to create during the second quarter of 2009 a non-core division to manage separately approximately £240 billion of third party assets, £145 billion of derivative balances and £155 billion of risk weighted assets that it intends to run off or dispose of over the next three to five years. The division will contain primarily assets from the GBM division linked to proprietary trading portfolios, excess risk concentrations and other illiquid portfolios. It will also include excess risk concentrations from other divisions as well as a number of small Regional Markets businesses that RBS has concluded are no longer strategic.

## Recent developments

### HM Treasury Asset Protection Scheme and additional capital raising

On 26 February 2009, RBS confirmed its intended participation in the Asset Protection Scheme (“APS”). The arrangements between RBS and HM Treasury will, if completed, allow RBS to secure asset protection in respect of some of its riskiest assets that enhances its financial strength and provides improved stability for customers and depositors, and also enhances RBS’s ability to lend into the UK market.

### Issuance of capital

On or after the proposed implementation of the APS, HM Treasury will subscribe for £13 billion of B Shares. The arrangements for the subscription of these B Shares are to be determined and the proceeds of such issue will, if such B Shares are issued, be used to increase further the Group’s Core Tier 1 capital. A summary of the expected terms of the B Shares is set out below. HM Treasury will also commit to subscribe for an additional £6 billion of B Shares at RBS’s option. The detailed terms of such option remain to be agreed between RBS and HM Treasury.

### Scheme amount

RBS intends to participate in the APS in respect of assets with a par value of approximately £325 billion and a carrying value net of impairments and write downs of approximately £302 billion as at 1 January 2009.

### First loss

The agreement would see RBS bear the first loss amount relating to the assets in the APS up to £19.5 billion (after taking into account historic impairments and write downs). Losses arising in respect of the assets after the first loss amount would be borne 90 per cent. by HM Treasury and 10 per cent. by RBS. The APS will, if entered into, apply to losses incurred on the protected assets on or after 1 January 2009.

### Fee and issuance of capital

If it enters into the APS, RBS will pay a participation fee of £6.5 billion to HM Treasury. On 26 February 2009, RBS announced that it would issue £6.5 billion of B Shares, and the participation fee may be funded through the proceeds of such issuance. The £6.5 billion of B Shares, which will be issued if RBS enters into the APS, will be in addition to, and on the same terms as, the B Shares referred to above and will constitute Core Tier 1 capital. In addition, RBS has agreed in principle that, if it enters into the APS, it would not claim certain UK tax losses and allowances.

### Assets

Specific assets to be included in the APS will be subject to the approval of HM Treasury. The assets would be drawn from RBS’s and certain of its affiliates’ portfolios of corporate and leveraged loans, commercial and residential property loans, structured credit assets and such other assets as HM Treasury and RBS agree are to be included in the APS. It is also envisaged that the APS may include structured synthetic assets and counterparty risk exposures associated with certain derivatives transactions with monoline insurers and credit derivative product companies. RBS expects that the APS will protect: £225 billion of third party assets, £44 billion of undrawn commitments, and £33 billion in other counterparty risk exposures.

Capital ratios

The APS and proceeds of the issue of B Shares are expected to improve the consolidated capital ratios of RBS by (i) substituting risk weight applicable to the UK Government for that of the protected assets; and (ii) the subscription for the B Shares by HM Treasury (being both the £6.5 billion of B Shares, the proceeds of which may be used to fund the fee for the APS and the additional £13 billion of B Shares to be issued on or after the implementation of the APS). Based on total covered assets of approximately £325 billion, risk weighted assets would reduce by approximately £144 billion. As an illustration, if the Company had issued £19.5 billion of B Shares on 31 December 2008 offset by the expected £6 billion reduction of first loss exposure under the APS from Core Tier 1 capital in accordance with the FSA Handbook, and with the redemption of the preference shares issued to HM Treasury ("Preference Share Redemption"), RBS expects there would have been a significant increase to the Core Tier 1 ratio.

In addition, RBS will continue to look at various market based and/or internal capital management opportunities to generate and further strengthen Core Tier 1 capital.

Term

While it is intended that the APS would apply to the protected assets until their maturity, RBS's participation in the APS would be capable of termination in whole or in part by mutual agreement of RBS and HM Treasury.

Management of the assets

RBS would be required under the APS to manage the assets in accordance with certain asset management requirements as referred to in the APS. These would include, amongst others, (i) reporting requirements to provide financial, risk and performance data in respect of the protected assets and to monitor compliance with the APS, (ii) the adoption of oversight and control procedures with respect to the management of the protected assets, (iii) requirements in relation to organisational structure, staffing, resourcing, systems and controls required for implementation, administration and monitoring compliance with the APS and (iv) the monitoring and management of conflicts of interest and potential conflicts of interest. As the APS is intended to apply to losses on protected assets arising from 1 January 2009, RBS has agreed with HM Treasury certain interim arrangements (in force with immediate effect) relating to the management of those assets likely to be part of the APS.

Impact on the capital structure of the Company

If the additional £6 billion of B Shares are subscribed for by HM Treasury and £25.5 billion of B Shares convert mandatorily, or are converted by HM Treasury, into ordinary shares in the hands of HM Treasury, the percentage of HM Treasury's ownership of RBS's ordinary shares will be 84.4 per cent., with shareholders experiencing a corresponding dilution to their interests in the company. However, without prejudice to rights arising on the mandatory conversion into ordinary shares, HM Treasury shall not be entitled to exercise its option to convert B Shares into ordinary shares for as long as it holds 75 per cent. or more of the ordinary shares or if the exercise of such option would result in it holding 75 per cent. or more of the ordinary shares. Further details regarding the effect of the B Shares on the dividends payable are set out below.

Conditions to accession to the Scheme

Implementation of the APS for RBS will be subject to further due diligence by HM Treasury and its advisers, documentation and satisfaction of applicable conditions (including the application criteria and asset eligibility criteria of the APS), adoption of a prescribed remuneration policy in respect of assets managed under the APS and conditions precedent to accession in the APS, including state aid, regulatory and shareholder approvals. RBS has agreed to provide certain information to HM Treasury in the period prior to RBS's proposed accession, including

(i) an indicative list of the Proposed Assets, with a view to agreeing such list by 30 April 2009;

(ii) information and data relating to the Proposed Assets for the purposes of HM Treasury's due diligence; and

(iii) access to RBS's premises, books, records, senior executives, relevant personnel and professional advisers.

As at the date of this document, the timing for the implementation of the APS is still to be determined. The proposed entry by the Company into the APS and any associated capitalisation would constitute a related party transaction for the purposes of the Listing Rules requiring the approval of Independent Shareholders. Therefore if the Company is to participate in the APS, it will convene a further general meeting to seek Independent shareholder approval and a circular explaining the proposals and containing the relevant general meeting notice will be sent to Shareholders in due course, although no prospectus will be required.

Terms and conditions of the B Shares

At the same time as it announced RBS plc's intended participation in the APS, RBS announced that it expected to issue to HM Treasury (i) £6.5 billion of B Shares at the time of entering into the APS and (ii) a further £13 billion of B Shares on or after implementation of the APS. RBS also announced that it had been agreed with HM Treasury that, at RBS's option, a further £6 billion of B Shares could be issued to HM Treasury. The detailed terms of this option remain to be agreed between RBS and HM Treasury. All of these B Shares are expected to constitute Core Tier 1 capital and will be issued on the same terms. Key terms of the B Shares are expected to include the following:

• Nominal value and issue price: £0.50 per B Share.

• Ranking: on a winding-up, holders of the B Shares will rank pari passu with the holders of any other classes of Ordinary Shares and junior to preference shareholders. For these purposes, on a winding-up each holder of a B Share will be deemed to hold one Ordinary Share of RBS for every B Share held at the date of the commencement of such winding-up (the "Winding Up Ratio").

• Dividend entitlement: non-cumulative dividends will be declared at the discretion of RBS, which dividends shall be paid in priority to any dividend on any other class of ordinary share capital. If declared, dividends on the B Shares will be paid semi-annually in arrear. The first such semi-annual dividend in respect of any financial year shall be payable on the date that is three business days after the record date in respect of the interim dividend payable on the Ordinary Shares in respect of such financial year, if such interim dividend on the Ordinary Shares is to be paid. The second such semi-annual dividend in respect of any financial year shall be payable on the date that is three business days after the record date in respect of the final dividend payable on the Ordinary Shares in respect of such financial year, if such final dividend on the Ordinary Shares is to be paid. If no interim dividend on the Ordinary Shares is to be paid in respect of any financial year, the first semi-annual dividend on the B Shares in respect of such financial year, if to be paid, shall be payable on 31 October in such financial year, and if no final dividend on the Ordinary Shares is to be paid in respect of any financial year the second semi-annual dividend on the B Shares in respect of such financial year, if to be paid, shall be payable on 31 May in the immediately following financial year.

• If to be paid, the dividend per B Share will be equivalent to (i) 7 per cent. of the issue price of each B Share multiplied by the number of days in the period from (and including) the immediately preceding Relevant Date (as defined below) or, in the case of the first semi annual dividend in 2009, the date of issue to (but excluding) the current Relevant Date divided by 365 (or 366 in a leap year) or (ii) in the case of any second semi-annual dividend in respect of any financial year, if greater and if a dividend or dividends or other distribution(s) is/are paid or made (whether interim or final) on the Ordinary Shares in respect of the period from (but excluding) the Relevant Date falling on (or nearest to) one year prior to the current Relevant

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Date to (and including) the current Relevant Date, 250 per cent. (the "Participation Rate") of the aggregate amount of such dividend(s) or distribution(s) per Ordinary Share less the amount of the first semi-annual dividend (if any) paid in respect of such financial year. "Relevant Date" means each date on which RBS pays a semi-annual dividend or, if no such payment has been made, 31 October in respect of the first semi-annual dividend in respect of any financial year and 31 May in the immediately following financial year in respect of the second semi-annual dividend in respect of any financial year.

- Scrip dividends: if RBS decides to pay a dividend on the B Shares in respect of a semi-annual period and either (i) no dividend has been paid on the Ordinary Shares and/or distribution made thereon in respect of the same period or (ii) a dividend has been paid and/or a distribution has been made thereon otherwise than in cash in respect of the same period, RBS may in its discretion determine that the dividend on the B Shares in respect of the corresponding period shall be paid in whole or in part by RBS issuing further B Shares to the holders of B Shares. The number of further B Shares to be issued to each holder shall be such number of B Shares as shall be certified by an independent investment bank (acting as expert) to equal the value in cash of the dividend otherwise payable on the B Shares in respect of the relevant period.

- Restrictions following non-payment of dividend: if RBS decides not to pay any semi-annual dividend on the B Shares in cash or otherwise, then until such time as semi-annual dividends on the B Shares have been resumed in full RBS will be prohibited from paying dividends or other distributions (whether in cash or otherwise) on, or redeeming, purchasing or otherwise acquiring, (i) its Ordinary Shares or (ii) any other securities of RBS or any other member of the Group ranking or expressed to rank pari passu with the Ordinary Shares and the B Shares on a winding-up, either issued by RBS or, where issued by another member of the Group, where the terms of the securities benefit from a guarantee or support agreement entered into by RBS which ranks or is expressed to rank pari passu with the Ordinary Shares and the B Shares on a winding-up.

- Redemption rights: none, but RBS may purchase the B Shares subject to applicable laws and FSA consent.

- Conversion rights: at any time a holder of a B Share may deliver a notice to RBS requesting conversion of B Shares into Ordinary Shares of RBS. All B Shares shall automatically and mandatorily convert into Ordinary Shares if the volume weighted average trading price of the Ordinary Shares for 20 complete trading days in any 30 trading day period equals or exceeds £0.65 per Ordinary Share. The number of Ordinary Shares to be issued upon conversion will be determined by dividing the aggregate issue price (£0.50 per B Share) of the B Shares being converted by the Conversion Price. The conversion price of the B Shares will be £0.50 (the "Conversion Price").

- Limitations on optional conversion: without prejudice to the provisions above concerning the mandatory conversion of the B Shares, HM Treasury shall not be entitled to exercise its option to convert B Shares into Ordinary Shares to the extent that it holds 75 per cent. or more of the Ordinary Shares or to the extent that the exercise of such option would result in it holding 75 per cent. or more of the Ordinary Shares.

- Voting rights before conversion: holders of the B Shares will only have voting rights in limited circumstances (resolutions varying/abrogating class rights and resolutions to wind up, or in relation to the winding-up of, RBS). If entitled to vote, on a poll holders of B Shares will have two votes for each B Share held. HM Treasury shall not be so entitled to vote the B Shares to the extent the votes cast on such B Shares, together with any other votes which HM Treasury is entitled to cast in respect of any 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 proposed at a general meeting of RBS.

- Voting rights after conversion: HM Treasury shall not be entitled to vote in respect of Ordinary Shares acquired by it as a result of the conversion of B Shares into Ordinary Shares to the extent that votes cast on such Ordinary Shares, 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 proposed at a general meeting of RBS.

- Pre-emption rights: HM Treasury shall agree that it shall not exercise any pre-emption rights it may be entitled to as a holder of B Shares in respect of future issues of Ordinary Shares.

- Ordinary Share buy-back: for as long as any B Shares remain outstanding, RBS may not purchase any of its Ordinary Shares.

- Listing: the B Shares will not initially be listed. HM Treasury is entitled to require RBS to seek a listing of the B Shares.

- Adjustment events: the Winding Up Ratio and Participation Rate shall be subject to anti-dilution adjustments. The Conversion Price shall be adjusted in accordance with standard Euro-market anti-dilution adjustments other than customary change of control adjustments or extraordinary dividend adjustments (to the extent compensated by dividends paid at the Participation Rate).

## Second Placing and Open Offer

### Background to the Second Placing and Open Offer

In 2008 the Board concluded that the Group needed to strengthen its capital base and to accomplish this two capital raisings were carried out. A £12 billion rights issue was completed in June 2008. Then, due to a severe deterioration in financial markets and economic conditions, a further capital raising totalling £20 billion was completed in December 2008. Of the £20 billion raised in December, £15 billion was in the form of Ordinary Shares, and £5 billion was in the form of Preference Shares purchased entirely by HM Treasury. As a result of this capital raising, HM Treasury acquired approximately 57.9 per cent. of the issued ordinary share capital of the Company. The intention of the Board was that HM Treasury's holding of Preference Shares would be redeemed as soon as practicable.

In the last few weeks of 2008 the continuing dislocation in financial markets and significant uncertainties in credit conditions, together with the sharp deterioration in economic conditions, negatively impacted the trading performance of many financial institutions globally, including RBS. As a result, RBS incurred significant credit impairment losses and credit market write downs.

In view of the above, the Board, in conjunction with HM Treasury, decided to take steps to improve the quality of the Group's capital base by carrying out the Second Placing and Open Offer, and using the proceeds to redeem the Preference Shares held by HM Treasury. Shareholders were able to apply to subscribe for £5.37 billion of new ordinary shares pro rata to their existing shareholdings at a fixed price of 31.75 pence per share by way of the open offer.

The capital restructuring resulting from the Second Placing and Open Offer removed the £0.6 billion annual cost of the preference share dividend and created £5 billion of additional Core Tier 1 capital, which provides a higher quality level of capital support against the impact on the Group's business of any further deterioration in economic and financial market conditions. Following the Second Placing and Open Offer, HM Treasury currently own approximately 70.3 per cent. of the issued ordinary share capital of the company.

Various initiatives, such as the Asset Protection Scheme ("APS") and the Credit Guarantee Scheme, are being progressed by the UK Government to stabilise the UK banking system further and enhance support for the economy. The stated aims of the APS and the Credit Guarantee Scheme are to reinforce the stability of the financial system, to increase confidence and capacity to lend, and in turn to support the recovery of the UK economy. The other initiatives are expected to focus on asset and funding risks which are central to freeing up additional lending capacity whilst augmenting the impact of the capital measures described above.

By participating in the APS, the Group will be able to free up its lending capacity. Consequently, the Group announced on 26 February 2009 that it would increase its lending to UK homeowners and businesses subject to the Group's ordinary course credit and pricing criteria on the Group's normal contractual terms by £25 billion over the next 12 months. The increased lending will be split £9 billion to mortgage lending and the remaining £16 billion to business lending. Similar levels of lending have been committed to in 2010. This latest commitment supersedes the lending commitments the Group announced in October 2008 and in January 2009 and builds on NatWest's and RBS plc's recently announced pledge to continue to provide committed overdrafts and no increased pricing for small business customers until at least the end of 2009. These lending commitments will cease if RBS does not participate in the APS and Credit Guarantee Scheme by 1 June 2009 or will reduce if it participates in only one of the APS or Credit Guarantee Scheme prior to 1 June 2009.

While redemption of the Preference Shares allows the resumption of a sustainable and progressive dividend policy for the Ordinary Shares (it was a term of the Preference Shares that no such dividends may be paid while the Preference Shares were in issue), it is not the Board's intention to pay a dividend on the Ordinary Shares in 2009. If the B Shares are issued as announced on 26 February 2009, no cash dividend may be paid on the Ordinary Shares unless the cash dividend payable in respect of the same period on the B Shares is paid in full, and no scrip dividend may be paid on the Ordinary Shares unless the cash or scrip dividend payable in respect of the same period on the B Shares is paid in full.

Impact of the Second Placing and Open Offer and the Preference Share Redemption on RBS

The effect of the Second Placing and Open Offer and the Preference Share Redemption was to improve the quality of RBS's regulatory capital by increasing RBS's Core Tier 1 ratio; the Tier 1 ratio was not affected. The Second Placing and Open Offer and the Preference Share Redemption had no other impact on RBS's balance sheet. The Preference Shares carried a coupon of 12 per cent. at the discretion of the Board while the new shares issued in connection with the Second Placing and Open Offer rank pari passu with the existing shares of the company for any dividend payments. Accordingly, other than the elimination of the annual distribution at the discretion of the Board in respect of the preference share coupon, and the inclusion of the new shares in the payment of any future dividends on RBS's ordinary shares, the Placing and Open Offer and Preference Share Redemption had no impact on the Group's income statement.

Sale of Bank of China Investment

On 14 January 2009, the Group (through RBS China Investment Sarl.) sold its entire 4.26 per cent stake in Bank of China for HKD18.4 billion.

Debt Tender and Exchange Offer

On 26 March 2009, RBS Financing Limited ("RBSF"), a subsidiary of the Group, launched a cash tender offer in the United States (the "RBSF US Tender Offer") for any and all of the outstanding securities of ten different series previously issued by the Group and certain of its affiliates. Concurrently therewith, RBSF also launched a cash tender offer outside of the United States (the "RBSF Non-US Tender Offer") for five different series of securities previously issued by The Royal Bank and certain of its affiliates and an offer outside of the United States to exchange (the "RBSF Exchange Offer") any or all of the outstanding securities of fourteen different series previously issued by The Royal Bank and certain of its affiliates for new senior unsecured notes of The Royal Bank.

The RBSF Tender Offers and the RBSF Exchange Offer expired on 22 April 2009. In the RBSF US Tender Offer, an aggregate of approximately US $4.1 billion principal amount of securities were validly tendered, resulting in an aggregate purchase consideration paid for the tendered securities of approximately US $1.7 billion.

In the RBSF Non-US Tender Offer, an aggregate of approximately €2.3 billion principal amount of Euro-denominated securities and approximately US $264 million principal amount of Dollar-denominated securities were validly tendered, resulting in aggregate purchase consideration paid for the tendered securities of approximately €1.1 billion and US $100 million, respectively.

In the RBSF Exchange Offer, an aggregate of approximately £3.5 billion principal amount of securities were validly offered for exchange and exchanged for new senior unsecured notes of The Royal Bank in an aggregate principal amount of approximately £1.8 billion.

Litigation Update

Note 32 of the Notes on the Accounts provides disclosure regarding, among other things, litigation claims in the United Kingdom. With respect to the claims regarding unarranged overdraft charges, the Group and other banks appealed against the orders of the High Court. On 26 February 2009, the Court of Appeal delivered its judgment and rejected the appeals. The House of Lords has granted the Group and other banks leave to appeal the Court of Appeal's decision. That further appeal is scheduled to take place on 23 June 2009. With respect to class action complaints filed in the United States District Court for the Southern District of New York, complaints relating to public filings in connection with the broad class of RBS publicly traded securities between 26 June 2007 and 19 January 2009 are included in the description of class action complaints in Note 32.

Strategic review

RBS has embarked on a sweeping restructuring of the Group that will fit its activities to the goals outlined above. While the details of the strategic plan will be refined over the coming weeks to take account of the final agreements reached with HM Treasury in respect of RBS's participation in the APS, the plan is expected to include the following:

- RBS will create a "Non-Core" division of RBS during the second quarter of 2009, separately managed, but within the existing legal structures of the Group and matrix managed to donating divisions where necessary. RBS currently intends that this division will have approximately £240 billion of third party assets, £145 billion of derivative balances and £155 billion of risk-weighted assets, comprising individual assets, portfolios and businesses of the Group that RBS intends to run off or dispose of during the next three to five years. The specific timetable will vary in each case but will be as fast as RBS judges consistent with optimising shareholder value and risk. Approximately 90 per cent. of the Non-Core division will consist of GBM assets, primarily linked to proprietary portfolios, excess risk concentrations and illiquid 'originate and hold' asset portfolios. The rest of the Non-Core division will be risk concentrations, 'out of footprint' assets and smaller, less advantaged businesses within our Regional Markets activities across the world. As part of this effort it is intended that RBS's representation in approximately 36 of the 54 countries it operates in around the world will be significantly reduced or sold. RBS will remain strong in all its major existing global hubs, however. Given the commercial and human sensitivity of these issues, detail on this will not be given until the interim results. The income, expenses, impairments and credit market and other trading asset write downs associated with the Non-Core Division in 2008 were approximately £3.9 billion, £1.1 billion, £3.2 billion and £9.2 billion respectively.

- In addition to eliminating expenses associated with the Non-Core division, RBS has launched a restructuring plan to make efficiency savings across the Group, aimed at achieving run-rate reductions by 2011 of greater than £2.5 billion (16 per cent. of 2008 cost base) at constant exchange rates. This will involve a wide range of re-engineering and other measures and, regrettably, reductions in employment. This target excludes any impact of inflation, incentive pay movements or cost reductions arising from business exits or the impact of new projects (if any). It includes the £0.5 billion of ABN AMRO integration benefits previously announced but not reflected in 2008 expenses. We will book one-off charges against these actions over the next three years, with run-rate cost savings expected to provide ‘payback’ in 1.5 to 1.75 years.

- RBS plans to retain each of its major business divisions since it believes, with intensive restructuring, they can meet the attractive business characteristics outlined as targets above. In many cases the restructuring of these businesses to achieve RBS’s goals will be far-reaching, nevertheless. The greatest element of restructuring will be in GBM as signalled above. A substantial shrinkage of size, product and geographic scope will take place. This should leave GBM positioned profitably around those of its existing core strengths that rest on profitable customer franchise business with significantly less illiquid risk overall.

- At all times RBS will responsibly compare the value to RBS of each of its businesses with realistic alternatives and take different action if they prove compelling. However, the distressed and pessimistic state of markets for financial assets and businesses offers little immediate encouragement in that regard.

- Alongside our business restructuring activities will be substantive changes to management and internal processes. There will continue to be changes of personnel as RBS promotes and reassigns internal talent and add to its ranks externally. The Manufacturing division will re-align with the customer facing businesses. Businesses will have clear bottom-line returns, allocated equity and balance sheet and funding goals. While RBS drives for profit, there will be a concentration on earnings quality and sustainability, driven by strategic plans, to ensure alignment of our businesses to their markets and their risk targets. People evaluation and incentivisation will meet best practice levels to support the revised mission of the Company. This will be underpinned by a full suite of risk and funding constraints, including concentration limits.

RBS has already begun this major change programme. To carry it through in parallel with running its continuing business in difficult markets will test management capacity. RBS expects to be successful overall, though it will inevitably have setbacks and make mistakes along the way. But there is no alternative. RBS must change in a far-reaching way. If it does that, the strength, quality and power that are already present in RBS business across the world will have the chance to shine through once again.

## Relationship with major shareholder

The UK Government currently owns 70.3 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. No formal relationship agreement has been concluded between RBS and the UK Government, although the relationship falls within the scope of the framework document between HM Treasury and UKFI published on 2 March 2009. This document states that UKFI will manage the UK financial institutions in which HM Treasury holds an interest "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)", which is designed to ensure that control of the relationship is not abused. This document also makes it clear that such UK financial institutions will continue to be separate economic units with independent powers of decision and "will continue to have their own independent boards and management teams, determining their own strategies and commercial policies (including business plans and budgets)."

These goals are consistent with the stated public policy aims of the UK Government, as articulated in a variety of public announcements.

In the framework document between UKFI and HM Treasury, UKFI stated that its goal was 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 was also stated that UKFI intended to "engage robustly with banks' boards and management, holding both strategy and financial performance to account, and taking a strong interest in getting the incentives structures right on the board and beyond—accounting properly for risk and avoiding inefficient rewards for failure."

In this connection, RBS announced on 17 February 2009 that it had reached an agreement with UKFI in respect of certain changes to its remuneration policy. RBS has also undertaken to conduct a review of its strategy and UKFI has been actively engaged in reviewing the output of this review.

In connection with its proposed access 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 will be subject to a monthly reporting process to the UK Government. The lending commitment does not require RBS to lend in excess of its single name or sectoral risk concentration limits or otherwise to engage in uncommercial practices.

RBS, in common with other financial institutions, also works closely with a number of UK Government departments and agencies on various industry-wide initiatives that are intended to support the UK Government's objective of supporting stability in the wider financial system.

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.

Following consultation with UKFI and other major institutional shareholders the Nominations Committee recommended the appointment of Philip Hampton to the Board of Directors, which approved the appointment.

As a result of the UK Government's holding, the UK Government and UK Government controlled bodies became related parties of the Group. 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 does not believe it is 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.

Trading and outlook
On 26 February 2009, RBS announced its results for the year ended 31 December 2008. In that announcement, RBS made the following statement about current trading and outlook for 2009.

''To make any forecast is hazardous beyond the expectation that 2009 will be a very tough year for the world economy. RBS, in common with all banks, will see some erosion of underlying income levels as a result of weaker business activity and low interest rates squeezing savings margins whilst credit costs rise, probably sharply. We hope that markets will be less disrupted than in 2008, with lower associated write-downs, but time will tell. 2009 has, in fact, started positively for our businesses. At the time of writing, RBS is in discussions with the UK Government concerning participation in the proposed Asset Protection Scheme (''APS''). This would be subject to shareholder vote in due course. The result of the APS discussions will have a material impact on RBS's outlook, positive or negative depending on outcome. More information will be made available as soon as practicable.

Notwithstanding the challenging outlook, our businesses all around the world are inherently good and fully engaged in sustaining as robust a performance as the environment permits. And the strategic restructuring we have embarked on will see high levels of activity designed to reposition RBS successfully.''

Annual General Meeting held on 3 April 2009
On 3 April 2009, the Group held its Annual General Meeting. At the meeting, shareholders voted to (i) elect Philip Hampton, Stephen Hester, John McFarlane and Arthur 'Art' Ryan as directors of the Group, (ii) re-appoint Deloitte LLP as the company's auditor and (iii) authorise the Audit Committee to fix the remuneration of the auditors. All other resolutions presented to shareholders at the Annual General Meeting were also approved by shareholders.

General Meeting held on 3 April 2009
On 3 April 2009, the Group held a General Meeting in connection with the Second Placing and Open Offer. At the meeting, all resolutions presented to shareholders were approved by shareholders.

## Competition

The Group faces strong competition in all the markets it serves. However, the global banking crisis has reduced the capacity 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 reflecting the difficulties in the wholesale money markets.

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 Europe, Asia and the Middle East, the enlarged Group now competes in retail banking with local and international banks. In a number of these markets there are regulatory barriers to entry or expansion, and the state ownership of banks. Competition is generally intensifying as more players enter markets that are perceived to be de-regulating and offer significant growth potential.

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 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 Spain, Italy and Germany.

In Ireland, Ulster Bank and First Active compete 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 may face the risk of full nationalisation and under such circumstances shareholders may lose the full value of their shares.

Under the provisions of the Banking Act, substantial powers have been granted to HM Treasury, the Bank of England and the Financial Services Authority (FSA) as part of the Special Resolution Regime to stabilise banks that are in financial difficulties. The Special Resolution Regime gives the authorities three stabilisation options: private sector transfer, of all or part of the business of a UK-incorporated institution with permission to accept deposits (a "relevant entity"); transfer of all or part of the business of the relevant entity to a "bridge bank" established by the Bank of England; and temporary public ownership (nationalisation) of the relevant entity or its UK-incorporated holding company.

The purpose of the stabilising options is to address the situation where all or part of the business of the 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 a relevant entity such as the Group's banking subsidiaries, including the Royal Bank and NatWest, (i) is failing, or is likely to fail, to satisfy the threshold conditions set out in Schedule 6 to the Financial Services and Markets Act 2000 (the "FSMA") and (ii) having regard to timing and other relevant circumstances it is not reasonably likely that 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 exercise one of the stabilisation options before a relevant entity is in severe difficulties and before an application for insolvency or an 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.

If HM Treasury makes the decision to take the holding company of a relevant entity into temporary public ownership, it may take various actions in relation to securities issued by the holding company, including:

- to transfer securities free from any contractual or legislative restrictions on transfer;
- to transfer securities free from any trust, liability, or encumbrance;
- to extinguish rights to acquire securities;
- to delist securities; or
- to convert securities into another form or class.

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.

Shareholders may have a claim for compensation under one of the compensation schemes provided for in the Banking Act. 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 Shareholders would thereby recover compensation promptly and/or equal to any loss actually incurred.

If the Group were made subject to the Special Resolution Regime and a partial transfer of the Group's business was effected, the nature and mix of the assets and liabilities not transferred may adversely affect its financial condition and increase the risk that the Group may eventually become subject to administration or insolvency proceedings.

Over the last six months, the UK Government has taken action under the Banking (Special Provisions) Act 2008 in respect of a number of UK financial institutions, including in extreme circumstances, full and part nationalisation. There have been concerns in the market in recent months regarding the risks of such nationalisation in relation to RBS and other UK banks. If economic conditions in the UK or globally continue 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 UK Government may decide to take similar action in relation to RBS. Given the extent of HM Treasury's and the Bank of England's powers under the Banking Act, it is difficult to predict what effect such actions might have on RBS and any securities issued by it. However, potential impacts may include full nationalisation of RBS and the total loss of value in RBS shares.

If RBS is unable to participate in the APS, or the operation of the APS fails to have the desired effect on RBS's financial and capital position, the Company may face the increased risk of full nationalisation. If the costs of participation outweigh the benefits, this could have a negative impact on RBS's business, earnings and financial prospects and its Share price may suffer.

On 26 February 2009, RBS announced its intention to participate in the APS. However, its ability to participate in the APS is subject to the satisfaction of a number of conditions which may not be satisfied, including, among others, the completion of due diligence by (and to the satisfaction of) HM Treasury, the receipt of certain regulatory approvals (including European Commission State Aid clearance), the approval of a majority of RBS's Independent Shareholders, finalisation of the terms of the APS and RBS's participation therein and the satisfaction by RBS of certain specified application criteria. The failure to satisfy these conditions could result in RBS being unable to participate in the APS and therefore failing to obtain protection against stressed losses through the economic cycle as well as failing to improve its capital ratios at the RBS consolidated Group level. The result of this may mean intervention by the UK Government, which could include full nationalisation, under which circumstances any compensation payable to Shareholders would be subject to the provisions of the Banking Act, and Shareholders may lose the full value of their Shares.

Furthermore, even if RBS is able to participate in the APS, there can be no assurance that such participation will enable RBS to achieve all of the stated goals of the APS. While the APS is expected to limit losses associated with assets to be covered by the APS, RBS would remain fully exposed in respect of a specified "first loss" amount and exposed to 10 per cent. of losses exceeding that "first loss" amount. In addition, RBS would continue to be exposed to the risk of losses, impairments and write-downs with respect to assets not covered by the APS. Although RBS would have the option to obtain an additional £6 billion in capital from HM Treasury (in the form of a subscription for further B Shares) there can be no assurance that such additional capital, together with RBS's strengthened capital position as a result of the Placing and Open Offer, and the capital resulting from the proposed issue of the £6.5 billion and £13 billion of B Shares, will be sufficient to maintain the Group's capital ratios in the event of further losses, which could cause RBS's business, results of operation and financial condition to suffer, its credit rating to drop, its ability to lend and access funding to be further limited, its cost of funding to increase and its Share price to decline, any of which would increase the risk of the full nationalisation of RBS.

In addition, there can be no assurance that the costs to RBS of its participation in the APS will not outweigh any benefits received. For example, RBS has agreed in principle that if it accedes to the APS, it will give up the right to certain tax losses and allowances which may affect the after-tax returns of the Group in future years. As a result of RBS's agreement to give up such UK tax losses and allowances it is likely that RBS will pay UK corporation tax in earlier accounting periods than it would otherwise have done.

The Group's businesses, earnings and financial condition have been and will continue to be affected by the continued deterioration in the global economy, as well as ongoing 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 and Asia. Recessionary conditions are present in many of these countries, including the United Kingdom and the United States, and such conditions are expected to continue or worsen over the near to medium term. In addition, the global financial system is continuing to experience the difficulties which first manifested themselves in August 2007, and the financial markets have deteriorated significantly since the bankruptcy filing by Lehman Brothers in September 2008. These conditions have led to severe and continuing dislocation of financial markets around the world and unprecedented levels of illiquidity, 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 UK Government, the governments of the other EU member states and the US 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 at unprecedented levels, and global recessionary conditions are expected to continue. These conditions have produced and will continue to produce downward pressure on stock prices and on availability and cost of credit for financial institutions, including the Group, and will continue to impact on 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 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 or to incur losses.

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's performance may also be affected by future recovery rates on assets and the historical assumptions underlying asset recovery rates, which 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 Group's control.

Any conversion of the B Shares would significantly increase HM Treasury's ownership interest in RBS, have a corresponding dilutive effect on other RBS Shareholders and could result in the delisting of RBS's securities.
At the same time as RBS announced its proposed participation in the APS, RBS announced that, if it participated in the APS, it would issue £6.5 billion of B Shares to HM Treasury. RBS also announced that it would issue a further £13 billion of B Shares to HM Treasury on or after implementation of the APS, and HM Treasury would grant RBS the option to require HM Treasury to purchase a further £6 billion of B Shares from it. The B Shares, if issued, will rank pari passu with the Ordinary Shares on a winding-up. The B Shares would be convertible, at the option of the holder at any time, into Ordinary Shares at an initial conversion price of £0.50 per Ordinary Share. HM Treasury would agree not to convert any B Shares it holds if, as a result of such conversion, it would hold 75 per cent. or more of the Ordinary Shares, unless the price of the Ordinary Shares is equal to or exceeds £0.65 for a specified period in which case conversion is mandatory in any event. If all £25.5 billion of B Shares are issued, such conversion of the B Shares would significantly increase HM Treasury's ownership interest in RBS up to approximately 84.4 per cent. of the Company's issued share capital, and have a corresponding dilutive effect on other RBS Shareholders (as would the issue of the B Shares themselves in the event of a winding-up) although any such conversion would have no impact on the Group's Tier 1 capital position. Furthermore, a mandatory conversion of the B Shares by HM Treasury would put RBS in breach of the Listing Rules requirement that 25 per cent. of its issued share capital must be in public hands. Although RBS may apply to the UKLA 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 RBS 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 Ordinary Shares acquired by it as a result of the conversion of B Shares into Ordinary Shares to the extent, but only to the extent, that votes cast on such Ordinary Shares, 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.

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. Credit markets worldwide have experienced and continue to experience a severe reduction in liquidity and term-funding in the aftermath of events in the US sub-prime residential mortgage market and the current severe market dislocation. Perception of counterparty risk between banks has also increased significantly following the bankruptcy filing by Lehman Brothers. This increase in perceived counterparty risk has led to further reductions in inter-bank lending, and hence, in common with many other banks, 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 operations, 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.

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.

Furthermore, like many banks, the Group relies on customer deposits to meet a considerable portion of its funding requirements and such deposits are subject to fluctuation due to certain factors outside the Group's control, such as a loss of confidence, 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. 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 liquidity unless corresponding actions were taken to improve the liquidity profile of other deposits or to reduce assets.

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 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 RBS shares.

Governmental support schemes are subject to cancellation, change or withdrawal (on a general or individual basis), which may have a negative impact on the availability of funding in the markets in which the Group operates.
Governmental support schemes are subject to cancellation, change or withdrawal (on a general or individual basis), based on changing economic and political conditions in the jurisdiction of the relevant scheme. Furthermore, certain schemes which have been recently announced have in fact not been fully implemented, or their terms have not yet been finalised. 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 banks, 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 and result in a loss of value in RBS shares.

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. The outlook for the global economy over the near to medium term has continued to deteriorate, particularly in the UK, the United States and other European economies. For example, there is an expectation of further reductions in residential and commercial property prices, higher unemployment rates and reduced profitability of corporate borrowers. As a result, the Group has seen and expects to continue to see adverse changes in the credit quality of its

borrowers and counterparties, with increasing delinquencies, defaults and insolvencies across a range of sectors. This trend has led and may lead to further impairment charges, higher costs, additional write downs and losses for the Group or result in a loss of value in RBS shares.

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 and could lead to 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. 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 currently 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 RBS shares.

The Group's earnings and financial condition have been, and its future earnings and financial condition are likely to continue to be, affected by depressed asset valuations resulting from poor market conditions.

Financial markets are currently 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 (CDOs), the US sub-prime residential mortgage market 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 and 2008. The Group expects that the deterioration in economic and financial market conditions will lead to further impairment charges and write-downs during the current financial year. Moreover, recent market volatility and illiquidity has made 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 RBS shares.

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. As a result, their actual and perceived credit worthiness deteriorated significantly in 2008 and may continue to be so impacted in 2009. If the financial condition of these counterparties or their actual and perceived credit worthiness deteriorates further, the Group may record further credit valuation adjustments on the CDSs bought from these counterparties in addition to those already recorded.

Changes in interest rates, foreign exchange rates, 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, 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 recent months. 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 Group's non-UK subsidiaries (principally ABN AMRO, Citizens and RBS Greenwich Capital) 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 or result in a loss of value in RBS shares.

The Group's borrowing costs and its access to the debt capital markets depend significantly on its credit ratings.
On 19 January 2009, S&P affirmed the long-term and short-term counterparty credit ratings for the Royal Bank at A+ and A-1 respectively. The outlook for all entities of the Group was confirmed as stable, reflecting S&P's view that the Group is of systemic importance to the UK banking system and that S&P now explicitly factor four notches of uplift into their long-term counterparty credit rating on the Group. At the same time S&P lowered its ratings on the Group's hybrid capital issues to BB from BBB, additionally the BB rating was placed under CreditWatch with negative implications. On the same date, Fitch affirmed the Group and the Royal Bank's Long-term and Short-term Issuer Default Ratings at AA- and F1+ respectively and downgraded the Group and the Royal Bank's individual ratings to E from B/C. The outlook for the Issuer Default Ratings remains stable reflecting Fitch's expectation of continued strong government support for the Group. The Group's support rating was upgraded from 1 to 5 and its support floor revised to AA- from No Floor. Fitch also downgraded the Group and the Royal Bank's Tier 1 preference shares to BB- from A+, and upper tier 2 hybrid capital instruments issued by Group companies to BB from A+ and placed all of these securities on Rating Watch Negative. Moody's on 20 January 2009 downgraded the senior unsecured rating of the Royal Bank to Aa3 from Aa1 with a negative outlook. The Group's senior debt rating was downgraded to A1 from Aa2 again with a negative outlook. The Bank Financial Strength Rating was lowered to C- from B and remains under review for further possible downgrade. The short term P-1 ratings of both the Group and the Royal Bank were affirmed. The outlook for all Group entities incorporates Moody's view on the long-term credit profile of the Group beyond the current government support-phase as well as their view of the very high probability of on-going support from the Aaa-rated UK Government. Any future reductions in the long-term credit ratings of the Group or one of its principal subsidiaries (particularly the Royal Bank) could further increase its borrowing costs. Any further reductions may also limit the Group's access to the capital markets and trigger additional collateral requirements in derivative contracts and other secured funding arrangements. Credit ratings of the Group and the Royal Bank 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 Group's or the Royal Bank's credit ratings could adversely affect its 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 RBS shares.

The Group's business performance could be adversely affected if its capital is not managed effectively.

Effective management of the Group's capital is critical to its ability to operate its businesses, to grow organically and to pursue its strategy. The Group is required by regulators in the United Kingdom, the United States, the Netherlands and in other jurisdictions in which it undertakes regulated activities, to maintain adequate capital. The maintenance of adequate capital is also necessary to enhance the Group's financial flexibility in the face of continuing turbulence and uncertainty in the global economy. Accordingly, the purpose of the First Placing and Open Offer and the issue of the Preference Shares was to allow the company to strengthen its capital position. As at 31 December 2008 the Group's Tier 1 and Core Tier 1 capital ratios were 10.0 per cent. and 6.8 per cent. respectively, using the Basel II methodology. Although the net proceeds of the First Placing and Open Offer and the Preference Share Issue strengthened the Group's capital base significantly, and the net proceeds of the Second Placing and Open Offer were used to redeem the existing £5 billion of Preference Shares and which thereby improved the quality of the Group's capital by increasing the Group's Core Tier 1 capital ratio, any change that limits the Group's ability effectively to manage 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 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 RBS shares.

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, each as further described in ‘Accounting Policies’ on page 166 of the financial statements. 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 current 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 has challenged the factual bases of certain underlying assumptions and has 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 RBS shares.

The Group’s future earnings and financial condition in part depend on the success of the Group’s strategic refocus on core strengths and its disposal programme.
In light of the recently changed global economic outlook, the Group has embarked on a restructuring which focused on achieving appropriate risk-adjusted returns under these changed circumstances, reducing reliance on wholesale funding and lowering exposure to capital intensive businesses. The Group will also continue with its disposal programme and continue to review its portfolio to identify further disposals of certain non-core assets. For further details of these re-structuring plans, please read “Business Review – Strategic Review” on page 9 of this document. Although the proceeds of the Second Placing and Open Offer improved the quality of the Group's capital by replacing the existing £5 billion of Preference Shares with £5 billion of Core Tier 1 capital, the global credit markets remain challenging and the Group’s execution of its current and future strategic plans may not be successful. In connection with the implementation of these plans, the Group may incur restructuring charges, which may be material. Furthermore, if the Group’s plans, including any planned disposals, are not successful or fail to achieve the results expected, the Group’s business, capital position financial condition, results of operations and future prospects may be negatively impacted or this could result in a loss of value in RBS shares.

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. This consolidation, in combination with

the introduction of new entrants into the US and UK markets from other European and Asian countries, could increase competitive pressures on the Group. Moreover, if financial markets continue to be volatile, more banks may be forced to consolidate.

In addition to the effects of consolidation, 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 it 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. 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 RBS shares.

The Group has agreed to certain undertakings in relation to the operation of its business in the First Placing and Open Offer Agreement, the Second Placing and Open Offer Agreement and in connection with the proposed APS, which may serve to limit the Group's operations.
Under the terms of the First Placing and Open Offer Agreement, the Group provided certain undertakings aimed at ensuring that the subscription by HM Treasury for the relevant Ordinary Shares and the Preference Shares and the Group's potential participation in the guarantee scheme promoted by HM Treasury as part of its support for the UK 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 Group's balance sheet. Under the terms of the Second Placing and Open Offer Agreement, the Group's undertakings in relation to mortgage lending and lending to SMEs were extended to larger commercial and industrial companies in the United Kingdom. These undertakings may serve to limit the Group's operations. In addition, pursuant to the Lending Commitments Letter, the Group is subject to further undertakings, which supersede the lending commitments made to HM Treasury in October 2008 and January 2009 by agreeing to lend £16 billion above the amount the Group had budgeted to lend to UK businesses and £9 billion above the amount the Group had budgeted to lend to UK homeowners in the year commencing 1 March 2009, with a commitment to lend at similar levels in the year commencing 1 March 2010. For a description of these undertakings, please read "Material Contracts" on page 267 of this document.

The Group could fail to attract or retain senior management or other key employees.
The Group's ability to implement its strategy depends on the ability and experience of its senior management 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 Group). The Group recently announced changes to its compensation structure which included significant reductions in bonuses to be paid in respect of 2008, and limitations on pay rises in 2009. Details of these changes are outlined in the letter from the Chairman of the Remuneration Committee on page 140. 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 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 RBS shares.

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, 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 Kingdom, the United States 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 any government or regulator-led initiatives), the Group expects to face greater regulation in the United Kingdom, the United States, the Netherlands 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 its business, the products and services it offers and the value of its assets or result in a loss of value in RBS shares.

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 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 or may increase the costs of doing business in those markets;
- changes to financial reporting standards;
- other general changes in the regulatory requirements, such as prudential rules relating to the capital adequacy framework and the imposition of onerous compliance obligations, restrictions on business growth or pricing and requirements to operate in a way that prioritises objectives other than shareholder value creation;
- changes in competition and pricing environments;
- further developments in the financial reporting environment;
- differentiation amongst 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 2008, the Group recorded a £32.6 billion accounting write-down of goodwill and other intangibles relating to prior year acquisitions.

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 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 prospects for them to continue over the near and medium term, the Group may be required or elect to make further contributions to the pension schemes and such 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 RBS shares.

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 United States and other jurisdictions, including class-action litigation. 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 judgements 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 RBS shares. 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 or 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 identifying and rectifying weaknesses in existing procedures and to training 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, results of operations and share price. Notwithstanding anything contained in this risk factor, it should not be taken as implying that either the company or the Group will be unable to comply with its obligations as a company with securities admitted to the Official List or as a supervised firm 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 would reduce the Group’s profitability. Revisions to tax legislation or to its interpretation might also affect the Group’s results in the future.

The acquisition of a majority shareholding in the Group by HM Treasury in December 2008 could lead to certain adverse tax consequences for the Group.
The acquisition by HM Treasury of a majority shareholding in the Group in consequence of the First Placing and Open Offer could, in certain circumstances, have adverse tax consequences which could affect the post-tax profitability of the Group. However, if the Group enters into the APS it has agreed, in principle, to give up the right to certain UK tax losses and allowances and this may limit the adverse tax consequences of the acquisition by HM Treasury of a majority shareholding in the Group.

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 mortality 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 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 “Scheme”) was established under the FSMA and is the UK’s statutory fund of last resort for customers of authorised financial services firms. The Scheme can pay compensation to customers if a firm is unable, or likely to be unable, to pay claims against it and, if the Banking Bill is enacted in its current form, 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 that Bill. The Scheme is funded by levies on firms authorised by the FSA, including the Group. In the event that the 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 2008, the Group made a provision of £150 million related to a levy by the Scheme.

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 RBS shares.

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 into and among the businesses and operations of the consortium members is complex, involving substantial reorganisation of ABN AMRO's operations and legal structure. In addition, the plan contemplates activities taking place simultaneously in a number of businesses and jurisdictions. Although integration efforts are well underway and are being advanced on a number of fronts, the implementation of the reorganisation and the realisation of the forecast benefits within the planned timescales, particularly given current market and economic conditions, remains challenging, although the Group remains confident that such goals will be achieved. Execution of the restructuring requires management resources previously devoted to the Group businesses and the retention of appropriately skilled ABN AMRO staff. 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, may have a negative impact on the Group's financial condition and results of operations. It is not expected that the Dutch State's acquisition of Fortis Bank Nederland's shares in RFS Holdings, which was effected in December 2008, will materially affect the integration benefits envisaged by the Group.

The recoverability of certain deferred tax assets recognised by the Group depend on the Group's ability to generate sufficient future taxable profits and there being no adverse changes to tax legislation.
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 losses are quantified on the basis of current tax legislation and are subject to change in respect of the rate of tax or the rules for computing taxable profits and allowable losses. Failure to generate sufficient future taxable profits or changes in tax legislation may reduce the recoverable amount of the recognised deferred tax assets.

RBS's ability to pay dividends on or make other distributions in respect of the Ordinary Shares will depend on the availability of distributable reserves and may be limited by the terms of the B Shares.
RBS's ability to pay dividends is limited under UK company law, which limits a company to only paying cash dividends to the extent that it has distributable reserves and cash available for this purpose. As a holding company, RBS's ability to pay dividends in the future is affected by a number of factors, principally its ability to receive sufficient dividends from subsidiaries. The payment of dividends to RBS by its subsidiaries is, in turn, subject to restrictions, including certain regulatory requirements and the existence of sufficient distributable reserves and cash in RBS's subsidiaries. The ability of these subsidiaries to pay dividends and RBS's ability to receive distributions from its investments in other entities are subject to applicable local laws and regulatory requirements and other restrictions, including, but not limited to, applicable tax laws and covenants in some of RBS's debt facilities. These laws and restrictions could limit the payment of future dividends and distributions to RBS by its subsidiaries, which could restrict RBS's ability to fund other operations or to pay, in due course, a dividend to holders of the Existing Shares or the New Shares.

In addition, if the B Shares are issued, no cash dividend may be paid on the Ordinary Shares unless the cash dividend payable in respect of the same period on the B Shares is paid in full, and no scrip dividend may be paid on the Ordinary Shares unless the cash or scrip dividend payable in respect of the same period on the B Shares is paid in full.

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Key financials

| for the year ended 31 December | 2008 £m | 2007 £m | 2006 £m |
|---|---|---|---|
| Total income | 25,868 | 30,366 | 28,002 |
| Operating (loss)/profit before tax | (40,667) | 9,832 | 9,186 |
| (Loss)/profit attributable to ordinary shareholders | (24,137) | 7,303 | 6,202 |
| Cost: income ratio | 208.9% | 45.9% | 44.6% |
| Basic (loss)/earnings per share (pence) (1) | (145.7p) | 64.0p | 54.4p |

| at 31 December | 2008 £m | 2007 £m | 2006 £m |
|---|---|---|---|
| Total assets | 2,401,652 | 1,840,829 | 856,832 |
| Loans and advances to customers | 874,722 | 828,538 | 466,893 |
| Deposits | 897,556 | 994,657 | 516,365 |
| Owners' equity | 58,879 | 53,038 | 40,227 |
| Risk asset ratio – Tier 1 (2) | 10.0% | 7.3% | 7.5% |
| – total | 14.1% | 11.2% | 11.7% |

Notes:

(1) Prior year per share data have been restated to reflect the rights issue in June 2008 and the capitalisation issue in September 2008.

(2) 2008 data are on a Basel II basis; data for 2007 and 2006 are on a Basel I basis.

Overview of results

As discussed on page 2, the results of ABN AMRO are fully consolidated in the Group's financial statements. Consequently, the statutory results of RBS for the year ended 31 December 2007 and 2008 include the results of ABN AMRO for 76 days and the full year respectively. The interests of the State of the Netherlands and Santander in RFS Holdings are included in minority interests.

Summary consolidated income statement for the year ended 31 December 2008

| | 2008 £m | 2007 £m | 2006 £m |
|---|---|---|---|
| Net interest income | 18,675 | 12,069 | 10,596 |
| Fees and commissions receivable | 9,831 | 8,278 | 7,116 |
| Fees and commissions payable | (2,386) | (2,193) | (1,922) |
| Other non-interest income | (6,578) | 6,125 | 6,239 |
| Insurance net premium income | 6,326 | 6,087 | 5,973 |
| Non-interest income | 7,193 | 18,297 | 17,406 |
| Total income | 25,868 | 30,366 | 28,002 |
| Operating expenses | 54,033 | 13,942 | 12,480 |
| (Loss)/profit before other operating charges and impairment | (28,165) | 16,424 | 15,522 |
| Insurance net claims | 4,430 | 4,624 | 4,458 |

| | | | |
|---|---|---|---|
| Impairment losses | 8,072 | 1,968 | 1,878 |
| Operating (loss)/profit before tax | (40,667) | 9,832 | 9,186 |
| Tax | (2,323) | 2,044 | 2,689 |
| (Loss)/profit after tax from continuing operations | (38,344) | 7,788 | 6,497 |
| Profit/(loss) from discontinued operations, net of tax | 3,971 | (76) | - |
| (Loss)/profit for the year | (34,373) | 7,712 | 6,497 |
| Minority interests | (10,832) | 163 | 104 |
| Other owners | 596 | 246 | 191 |
| (Loss)/profit attributable to ordinary shareholders | (24,137) | 7,303 | 6,202 |
| Basic earnings per ordinary share (1) | (145.7p) | 64.0p | 54.4p |
| Diluted earnings per ordinary share | (145.7p) | 63.4p | 53.9p |

Note:

(1) Prior year data have been restated to reflect the rights issue in June 2008 and the capitalisation issue in September 2008.

2008 compared with 2007

Operating loss

Operating loss before tax was £40,667 million compared with an operating profit of £9,832 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 £32,581 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 £24,137 million, compared with an attributable profit of £7,303 million in 2007.

Total income

Total income declined by 15% to £25,868 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. While income increased in 2008 in Global Transaction Services and Regional Markets, and held steady in Insurance, a significant reduction occurred in Global Banking & Markets, 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 55% to £18,675 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 Regional Markets 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 £7,193 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's credit markets and equities businesses, with reduced business volumes and mounting mark-to-market trading losses, Regional Markets 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 £54,033 million, with cost growth in the Group's core retail and commercial banking franchises offset by efficiency programmes and a significant reduction in Global Banking & Markets staff costs. Integration and restructuring costs were £1,357 million compared with £108 million in 2007. Write-down of goodwill and other assets was £32,581 million.

Net insurance claims

Bancassurance and general insurance claims, after reinsurance, decreased by 4% to £4,430 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 £8,072 million in 2008, compared with £1,968 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, where fourth quarter impairments totalled £2,938 million, including a loss of approximately £900 million on the Group's exposure to LyondellBasell. However, the Regional Markets 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 2.52% of gross loans and advances to customers, excluding reverse repos, compared with 1.64% 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. 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 has recorded an impairment charge of £32,581 million. Of this charge, £23,348 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 £2,323 million in 2008, compared with a tax charge of £2,044 million in 2007. The effective tax rate for 2008 was 5.7% compared with 20.8% in 2007.

Earnings

Basic earnings per ordinary share decreased from 64.0p to (145.7p).

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.

2007 compared with 2006
Profit
Profit before tax was up 7%, from £9,186 million to £9,832 million. The results of ABN AMRO are included from the date of acquisition, 17 October 2007.

Total income
The Group achieved strong growth in income during 2007. Total income was up 8% or £2,364 million to £30,366 million, notwithstanding the significant impact of the developments in global credit markets in the second half of 2007.

Net interest income increased by 14% to £12,069 million and represents 40% of total income (2006 – 38%). Average loans and advances to customers grew by 23% and average customer deposits grew by 25%.

Non-interest income increased by £891 million to £18,297 million and represents 60% of total income (2006 – 62%).

Net interest margin
The Group’s net interest margin at 2.32% was down from 2.53% in 2006.

Operating expenses
Operating expenses increased by 12% to £13,942 million. Integration costs were £108 million compared with £134 million in 2006.

Cost:income ratio
The Group’s cost:income ratio was 45.9% compared with 44.6% in 2006.

Net insurance claims
Bancassurance and general insurance claims, after reinsurance, increased by 4% to £4,624 million reflecting adverse weather conditions in the summer of 2007.

Impairment losses
Impairment losses rose 5% to £1,968 million, compared with £1,878 million in 2006.

Risk elements in lending and potential problem loans represented 1.64% of gross loans and advances to customers excluding reverse repos at 31 December 2007 (2006 – 1.57%).

Provision coverage of risk elements in lending and potential problem loans was 57% (2006 – 62%).

Taxation
The effective tax rate for 2007 was 20.8% (2006 – 29.3%). The headline rate is lower than the standard rate of UK corporation tax of 30% principally due to certain non-taxable capital gains and changes to deferred tax balances following the change in rate of corporation tax.

Earnings and dividends
Basic earnings per ordinary share increased by 18%, from 54.4p to 64.0p.

A final dividend of 19.3p per ordinary share was recommended and paid, giving a total dividend for the year of 27.8p, an increase of 10%.

Balance sheet

Total assets were £1,840.8 billion at 31 December 2007. The acquisition of ABN AMRO in October 2007 increased assets by £774.5 billion, with the balance accounted for largely by growth in our lending to customers and in trading assets.

Lending to customers, excluding repurchase agreements and stock borrowing (“reverse repos”), increased in 2007 by 70% or £282.2 billion to £686.2 billion. Customer deposits, excluding repurchase agreements and stock lending (“repos”), grew by 71% or £227.2 billion to £547.5 billion.

Capital ratios at 31 December 2007 were 7.3% (Tier 1) and 11.2% (Total).

Bonus issue

In May 2007, the Group capitalised £1,576 million of its share premium account by way of a bonus issue of two new ordinary shares of 25p each for every one held.

Profitability

The after-tax return on ordinary shareholders’ equity, which is based on profit attributable to ordinary shareholders and average ordinary shareholders’ equity, was 18.8% compared with 18.5% in 2006.

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Analysis of results
Net interest income

| | 2008 | 2007 | 2006 |
|---|---|---|---|
| | £m | £m | £m |
| Interest receivable | 49,522 | 32,252 | 24,688 |
| Interest payable | (30,847) | (20,183) | (14,092) |
| Net interest income | 18,675 | 12,069 | 10,596 |
| | % | % | % |
| Gross yield on interest-earning assets of the banking business | 5.61 | 6.19 | 5.90 |
| Cost of interest-bearing liabilities of the banking business | (3.79) | (4.36) | (3.85) |
| Interest spread of the banking business | 1.82 | 1.83 | 2.05 |
| Benefit from interest-free funds | 0.30 | 0.49 | 0.48 |
| Net interest margin of the banking business | 2.12 | 2.32 | 2.53 |

| Yields, spreads and margins of the banking business | % | % | % |
|---|---|---|---|
| Gross yield (1) | | | |
| Group | 5.61 | 6.19 | 5.90 |
| UK | 5.72 | 6.69 | 6.13 |
| Overseas | 5.54 | 5.52 | 5.50 |
| Interest spread (2) | | | |
| Group | 1.82 | 1.83 | 2.05 |
| UK | 1.92 | 2.30 | 2.37 |
| Overseas | 1.76 | 1.20 | 1.47 |
| Net interest margin (3) | | | |
| Group | 2.12 | 2.32 | 2.53 |
| UK | 2.39 | 2.55 | 2.68 |
| Overseas | 1.91 | 1.99 | 2.26 |
| The Royal Bank of Scotland plc base rate (average) | 4.67 | 5.51 | 4.64 |
| London inter-bank three month offered rates (average): | | | |
| Sterling | 5.51 | 6.00 | 4.85 |
| Eurodollar | 2.92 | 5.29 | 5.20 |
| Euro | 4.63 | 4.28 | 3.08 |

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.

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Average balance sheet and related interest

| | 2008 | | | 2007 - Restated | | |
|---|---|---|---|---|---|---|
| | Average balance £m | Interest £m | Rate % | Average balance £m | Interest £m | Rate % |
| Assets | | | | | | |
| Loans and advances to banks | | | | | | |
| – UK | 19,039 | 939 | 4.93 | 21,133 | 1,024 | 4.85 |
| – Overseas | 31,388 | 1,417 | 4.51 | 12,654 | 546 | 4.31 |
| Loans and advances to customers | | | | | | |
| – UK | 319,696 | 19,046 | 5.96 | 268,911 | 18,506 | 6.88 |
| – Overseas | 393,405 | 22,766 | 5.79 | 175,301 | 10,062 | 5.74 |
| Debt securities | | | | | | |
| – UK | 33,206 | 1,276 | 3.84 | 10,883 | 600 | 5.51 |
| – Overseas | 85,625 | 4,078 | 4.76 | 31,792 | 1,514 | 4.76 |
| Total interest-earning assets | | | | | | |
| – banking business (2, 3) | 882,359 | 49,522 | 5.61 | 520,674 | 32,252 | 6.19 |
| – trading business (4) | 425,454 | | | 313,110 | | |
| Total interest-earning assets | 1,307,813 | | | 833,784 | | |
| Non-interest-earning assets (2, 3) | 732,872 | | | 289,188 | | |
| Total assets | 2,040,685 | | | 1,122,972 | | |
| Percentage of assets applicable to overseas operations | 48.6% | | | 38.0% | | |
| Liabilities and owners' equity | | | | | | |
| Deposits by banks | | | | | | |
| – UK | 46,217 | 1,804 | 3.90 | 52,951 | 2,234 | 4.22 |
| – Overseas | 113,592 | 4,772 | 4.20 | 31,073 | 1,172 | 3.77 |
| Customer accounts: demand deposits | | | | | | |
| – UK | 99,852 | 2,829 | 2.83 | 93,764 | 3,296 | 3.52 |
| – Overseas | 70,399 | 1,512 | 2.15 | 30,739 | 1,031 | 3.35 |
| Customer accounts: savings deposits | | | | | | |
| – UK | 42,870 | 1,708 | 3.98 | 36,334 | 1,658 | 4.56 |
| – Overseas | 72,473 | 2,203 | 3.04 | 27,645 | 902 | 3.26 |
| Customer accounts: other time deposits | | | | | | |
| – UK | 94,365 | 4,011 | 4.25 | 88,089 | 4,201 | 4.77 |
| – Overseas | 105,660 | 4,097 | 3.88 | 43,141 | 2,100 | 4.87 |
| Debt securities in issue | | | | | | |
| – UK | 101,520 | 4,095 | 4.03 | 57,140 | 3,060 | 5.36 |
| – Overseas | 132,699 | 5,846 | 4.41 | 49,848 | 2,627 | 5.27 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Subordinated liabilities | | | | | | |
| – UK | 26,300 | 1,356 | 5.16 | 23,502 | 1,300 | 5.53 |
| – Overseas | 12,385 | 788 | 6.36 | 4,509 | 230 | 5.10 |
| Internal funding of trading business | | | | | | |
| – UK | (85,664) | (3,445) | 4.02 | (68,395) | (3,307) | 4.84 |
| – Overseas | (18,090) | (729) | 4.03 | (7,454) | (321) | 4.31 |
| Total interest-bearing liabilities | | | | | | |
| – banking business (2, 3) | 814,578 | 30,847 | 3.79 | 462,886 | 20,183 | 4.36 |
| – trading business (4) | 466,610 | | | 316,453 | | |
| Total interest-bearing liabilities | 1,281,188 | | | 779,339 | | |
| Non-interest-bearing liabilities: | | | | | | |
| Demand deposits | | | | | | |
| – UK | 45,472 | | | 18,416 | | |
| – Overseas | 9,721 | | | 14,455 | | |
| Other liabilities (3, 4) | 645,760 | | | 267,403 | | |
| Owners' equity | 58,544 | | | 43,359 | | |
| Total liabilities and owners' equity | 2,040,685 | | | 1,122,972 | | |
| Percentage of liabilities applicable to overseas operations | 46.8% | | | 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.

The 2007 comparative amounts have been restated for the netting of certain derivative asset and derivative liability balances with the London Clearing House, the finalisation of the ABN AMRO acquisition accounting and for the classification of Banco Real as a discontinued operation.

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Average balance sheet and related interest

| | 2006 - Restated | | |
|---|---|---|---|
| | Average balance £m | Interest £m | Rate % |
| Assets | | | |
| Loans and advances to banks | | | |
| – UK | 15,934 | 681 | 4.27 |
| – Overseas | 7,237 | 237 | 3.27 |
| Loans and advances to customers | | | |
| – UK | 239,086 | 15,141 | 6.33 |
| – Overseas | 121,092 | 6,977 | 5.76 |
| Debt securities | | | |
| – UK | 12,816 | 598 | 4.67 |
| – Overseas | 22,032 | 1,054 | 4.78 |
| Total interest-earning assets | | | |
| – banking business (2, 3) | 418,197 | 24,688 | 5.90 |
| – trading business (4) | 202,408 | | |
| Total interest-earning assets | 620,605 | | |
| Non-interest-earning assets (2, 3) | 199,898 | | |
| Total assets | 820,503 | | |
| Percentage of assets applicable to overseas operations | 35.2% | | |
| Liabilities and owners' equity | | | |
| Deposits by banks | | | |
| – UK | 35,985 | 1,393 | 3.87 |
| – Overseas | 28,772 | 1,228 | 4.27 |
| Customer accounts: demand deposits | | | |
| – UK | 86,207 | 2,428 | 2.82 |
| – Overseas | 13,113 | 441 | 3.36 |
| Customer accounts: savings deposits | | | |
| – UK | 30,933 | 1,058 | 3.42 |
| – Overseas | 19,766 | 529 | 2.68 |
| Customer accounts: other time deposits | | | |
| – UK | 67,126 | 2,807 | 4.18 |
| – Overseas | 36,177 | 1,636 | 4.52 |
| Debt securities in issue | | | |
| – UK | 45,829 | 2,210 | 4.82 |
| – Overseas | 25,249 | 1,076 | 4.26 |
| Subordinated liabilities | | | |
| – UK | 23,873 | 1,226 | 5.14 |
| – Overseas | 2,639 | 160 | 6.06 |
| Internal funding of trading business | | | |
| – UK | (44,475) | (1,893) | 4.26 |
| – Overseas | (4,930) | (207) | 4.20 |
| Total interest-bearing liabilities | | | |
| – banking business (2, 3) | 366,264 | 14,092 | 3.85 |

| | |
|---|---|
| – trading business (4) | 204,810 |
| Total interest-bearing liabilities | 571,074 |
| Non-interest-bearing liabilities: | |
| Demand deposits | |
| – UK | 17,909 |
| – Overseas | 11,668 |
| Other liabilities (3, 4) | 182,976 |
| Owners' equity | 36,876 |
| Total liabilities and owners' equity | 820,503 |
| Percentage of liabilities applicable to overseas operations | 32.3% |

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.

The 2006 comparative amounts have been restated for the netting of certain derivative asset and derivative liability balances with the London Clearing House.

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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.

| | 2008 over 2007 (restated) Increase/(decrease) due to changes in: | | | 2007 (restated) over 2006 (restated) 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 | (103) | 18 | (85) | 243 | 100 | 343 |
| Overseas | 845 | 26 | 871 | 217 | 92 | 309 |
| Loans and advances to customers | | | | | | |
| UK | 3,221 | (2,681) | 540 | 1,985 | 1,380 | 3,365 |
| Overseas | 12,621 | 83 | 12,704 | 3,112 | (27) | 3,085 |
| Debt securities | | | | | | |
| UK | 906 | (230) | 676 | (98) | 100 | 2 |
| Overseas | 2,564 | - | 2,564 | 465 | (5) | 460 |
| Total interest receivable of the banking business | | | | | | |
| UK | 4,024 | (2,893) | 1,131 | 2,130 | 1,580 | 3,710 |
| Overseas | 16,030 | 109 | 16,139 | 3,794 | 60 | 3,854 |
| | 20,054 | (2,784) | 17,270 | 5,924 | 1,640 | 7,564 |
| Interest-bearing liabilities | | | | | | |
| Deposits by banks | | | | | | |
| UK | 271 | 159 | 430 | (706) | (135) | (841) |
| Overseas | (3,452) | (148) | (3,600) | (94) | 150 | 56 |
| Customer accounts: demand deposits | | | | | | |
| UK | (204) | 671 | 467 | (227) | (641) | (868) |
| Overseas | (956) | 475 | (481) | (591) | 1 | (590) |
| Customer accounts: savings deposits | | | | | | |
| UK | (276) | 226 | (50) | (206) | (394) | (600) |
| Overseas | (1,367) | 66 | (1,301) | (241) | (132) | (373) |
| Customer accounts: other time deposits | | | | | | |
| UK | (286) | 476 | 190 | (962) | (432) | (1,394) |
| Overseas | (2,500) | 503 | (1,997) | (332) | (132) | (464) |
| Debt securities in issue | | | | | | |
| UK | (1,932) | 897 | (1,035) | (587) | (263) | (850) |
| Overseas | (3,714) | 495 | (3,219) | (1,248) | (303) | (1,551) |
| Subordinated liabilities | | | | | | |
| UK | (148) | 92 | (56) | 19 | (93) | (74) |
| Overseas | (489) | (69) | (558) | (99) | 29 | (70) |
| Internal funding of trading business | | | | | | |

| | | | | | | |
|---|---|---|---|---|---|---|
| UK | 751 | (613) | 138 | 1,129 | 285 | 1,414 |
| Overseas | 430 | (22) | 408 | 109 | 5 | 114 |
| Total interest payable of the banking business | | | | | | |
| UK | (1,824) | 1,908 | 84 | (1,540) | (1,673) | (3,213) |
| Overseas | (12,048) | 1,300 | (10,748) | (2,496) | (382) | (2,878) |
| | (13,872) | 3,208 | (10,664) | (4,036) | (2,055) | (6,091) |
| Movement in net interest income | | | | | | |
| UK | 2,200 | (985) | 1,215 | 590 | (93) | 497 |
| Overseas | 3,982 | 1,409 | 5,391 | 1,298 | (322) | 976 |
| | 6,182 | 424 | 6,606 | 1,888 | (415) | 1,473 |

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Non-interest income

| | 2008 | 2007 | 2006 |
|---|---|---|---|
| | £m | £m | £m |
| Fees and commissions receivable | 9,831 | 8,278 | 7,116 |
| Fees and commissions payable | (2,386) | (2,193) | (1,922) |
| (Loss)/income from trading activities | (8,477) | 1,292 | 2,675 |
| Other operating income (excluding insurance net premium income) | 1,899 | 4,833 | 3,564 |
| | 867 | 12,210 | 11,433 |
| Insurance premium income | 6,626 | 6,376 | 6,243 |
| Reinsurers' share | (300) | (289) | (270) |
| | 6,326 | 6,087 | 5,973 |
| | 7,193 | 18,297 | 17,406 |

2008 compared with 2007
Non-interest income, decreased by 61%, £11,104 million to £7,193 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 & Market's credit markets and equities businesses, with reduced business volumes and mounting mark-to-market trading losses, Regional Markets 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 £11,343 million to £867 million.

Within non-interest income, fees and commissions receivable increased by 19% or £1,553 million, to £9,831 million, while fees and commissions payable increased by 9%, £193 million to £2,386 million.

Income from trading activities was down from £1,292 million to a loss of £8,477 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 61%, £2,934 million to £1,899 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, increased by 4% to £6,326 million primarily reflecting a full year of ABN AMRO businesses in comparison with 76 days in 2007. This was partly offset by the discontinuation of less profitable partnership contracts.

2007 compared with 2006
Non-interest income increased by 5%, £891 million to £18,297 million, including £810 million from the acquisition of ABN AMRO. Good organic growth was offset by write-downs in Global Banking & Markets in respect of US mortgage-related and leveraged finance exposures. Non-interest income represents 60% of total income (2006 – 62%). Excluding general insurance premium income, non-interest income rose by 7%, £777 million to £12,210 million.

Within non-interest income, fees and commissions receivable increased by 16% or £1,162 million, to £8,278 million, while fees and commissions payable increased by 14%, £271 million to £2,193 million.

Income from trading activities was down from £2,675 million to £1,292 million. Interest rate and currency trading activities benefited from increased volatility and there was good growth from a broadening product range. These improvements were, however, more than offset by credit markets write downs.

Other operating income increased by 36%, £1,269 million to £4,833 million. This was principally due to growth in income from rental and asset-backed activities and principal investments in Global Markets.

General insurance premium income, after reinsurance, increased by 2% to £6,087 million with good growth in policies in the core businesses, particularly in Continental Europe.

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Credit market exposures

| | 2008 | | | 2007 | |
|---|---|---|---|---|---|
| | Net exposure (1) £m | Write-downs before tax £m | Average price % | Net exposure(1) £m | Average price % |
| Asset-backed CDOs | | | | | |
| High grade | 1,231 | 1,836 | 29 | 2,581 | 84 |
| Mezzanine | 144 | 1,140 | 6 | 1,253 | 70 |
| | 1,375 | 2,976 | | 3,834 | 79 |
| Monolines | 4,804 | 3,557 | n/a | 2,547 | n/a |
| US residential mortgages (2) | | | | | |
| Sub-prime | — | 353 | n/a | 1,292 | 72 |
| Alt-A | — | 1,071 | n/a | 2,233 | 83 |
| Other non-agency | — | 43 | n/a | 794 | 94 |
| | — | 1,467 | | 4,319 | 81 |
| US commercial mortgages (2) | 437 | 95 | 87 | 1,809 | 97 |
| Leveraged finance (2) | | | | | |
| Held-for-trading | 103 | 1,088 | 64 | 11,992 | 96 |
| Loans and receivables | 5,920 | — | n/a | 2,514 | n/a |
| | 6,023 | 1,088 | | 14,506 | |
| CLOs | 520 | 240 | 81 | 1,386 | 93 |
| | | 9,423 | | | |
| CDS hedging | | (1,642) | | | |
| Total net of CDS hedging | | 7,781 | | | |

Note:

(1) Net of hedges and write-downs.

(2) Figures represent the Group’s remaining net exposure to its previously reported credit market exposures.

(3) Includes commitments to lend.

Additional disclosures on these and other related exposures can be found in the rest of this document as follows:

| Disclosure | Section | Sub-section | Page |
|---|---|---|---|
| Further analysis (1) | Risk management | Credit market and related disclosures | 101 – 123 |
| Valuation aspects (1) | Financial statements | Note 11 Financial instruments | 186 – 191 |
| Valuation of financial instruments (1) | Financial statements | Critical accounting policies | 170 – 171 |
| (general and level 3) | | Note 11 Financial instruments | 184 – 191 |

Note:

(1) In preparing these disclosures, the Group took into consideration the leading practice recommendations of the Financial Stability Forum issued in April 2008 and the report of the IASB Advisory Panel ‘measuring and disclosing fair value of financial instruments in markets that are no longer active’ issued in October 2008.

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Operating expenses

| | 2008 £m | 2007 £m | 2006 £m |
|---|---|---|---|
| Administrative expenses: | | | |
| Staff costs | 10,241 | 7,338 | 6,723 |
| Premises and equipment | 2,593 | 1,703 | 1,421 |
| Other administrative expenses | 5,464 | 2,969 | 2,658 |
| Total administrative expenses | 18,298 | 12,010 | 10,802 |
| Depreciation and amortisation | 3,154 | 1,932 | 1,678 |
| Write-down of goodwill and other assets | 32,581 | — | — |
| | 54,033 | 13,942 | 12,480 |

2008 compared with 2007

Operating expenses increased by £40,091 million to £54,033 million, primarily reflecting the write-down of goodwill and other assets of £32,581 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 and a significant reduction in Global Banking & Markets staff costs. The 2008 costs reflect a full year of the retained ABN AMRO businesses in comparison with 76 days in 2007.

The Group’s ratio of operating expenses to total income was 208.9% compared with 45.9% in 2007, largely reflecting the impact on income of the year’s difficult market conditions and the write-down of goodwill and other assets.

2007 compared with 2006

Operating expenses increased by 12%, £1,462 million to £13,942 million including £1,387 million relating to ABN AMRO. Adjusting for this, operating expenses increased by just £75 million, 1%, reflecting tight cost management and the benefits of the Group’s manufacturing platform. Further improvements in productivity have supported growth in business volumes, and allowed the Group to maintain high levels of customer satisfaction.

The Group’s ratio of operating expenses to total income was 45.9% compared with 44.6% in 2006.

Integration costs

| | 2008 £m | 2007 £m | 2006 £m |
|---|---|---|---|
| Staff costs | 503 | 18 | 76 |
| Premises and equipment | 25 | 4 | 10 |
| Other administrative expenses | 486 | 26 | 32 |
| Depreciation and amortisation | 36 | 60 | 16 |
| | 1,050 | 108 | 134 |

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 £m | Currency translation adjustments £m | Charge to income statement £m | Utilised during the year £m | At 31 December 2008 £m |
|---|---|---|---|---|---|
| Staff costs | 4 | — | 503 | (502) | 5 |
| Premises and equipment | 2 | — | 25 | (26) | 1 |
| Other | 1 | 1 | 522 | (521) | 3 |
| | 7 | 1 | 1,050 | (1,049) | 9 |

2007 compared with 2006
Integration costs in 2007 were £108 million compared with £134 million in 2006 comprising amortisation of internally developed software and other expenditure. Software costs were previously written-off as incurred under UK GAAP but under IFRS are now amortised over the expected useful lives of up to five years. Software amortisation included in integration costs principally relates to the integration of Churchill, First Active and Citizens’ acquisitions, including Charter One which was acquired in August 2004.

Restructuring costs

| | 2008 £m | 2007 £m | 2006 £m |
|---|---|---|---|
| Staff costs | 251 | — | — |
| Premises and equipment | 15 | — | — |
| Other administrative expenses | 41 | — | — |
| | 307 | — | — |

Accruals in relation to restructuring costs are set out below.

| | At 31 December 2007 £m | Currency translation adjustments £m | Charge to income statement £m | Utilised during the year £m | At 31 December 2008 £m |
|---|---|---|---|---|---|
| Staff costs | — | 33 | 251 | — | 284 |

| | | | | | |
|---|---|---|---|---|---|
| Premises and equipment | — | — | 15 | — | 15 |
| Other | — | 10 | 41 | — | 51 |
| | — | 43 | 307 | — | 350 |

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Impairment

| | 2008 £m | 2007 £m | 2006 £m |
|---|---|---|---|
| New impairment | 8,391 | 2,310 | 2,093 |
| less: recoveries of amounts previously written-off | (319) | (342) | (215) |
| Charge to income statement | 8,072 | 1,968 | 1,878 |
| Comprising: | | | |
| Loan impairment | 7,091 | 1,946 | 1,877 |
| Impairment of available-for-sale securities | 981 | 22 | 1 |
| Charge to income statement | 8,072 | 1,968 | 1,878 |

2008 compared with 2007
Credit impairment losses increased to £8,072 million in 2008, compared with £1,968 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 Global Banking & Markets. However, the Regional Markets 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.

2007 compared with 2006
Impairment losses were £1,968 million compared with £1,878 million. Impairment losses in ABN AMRO in the period since acquisition were £103 million. Adjusting for this, impairment losses fell by £13 million, 1%. This reflected improvement in Global Markets and UK Retail & Commercial Banking partially offset by higher impairment in US Retail & Commercial Banking. New impairment losses were up 10%, £217 million to £2,310 million. Recoveries of amounts previously written-off were up £127 million, 59% to £342 million. Consequently the net charge to the income statement was up £90 million, 5% to £1,968 million.

Total balance sheet provisions for impairment, including ABN AMRO, amounted to £6,452 million compared with £3,935 million in 2006.

Total provision coverage (the ratio of total balance sheet provisions for impairment to total risk elements in lending) decreased from 62% to 60%. The ratio of total balance sheet provisions for impairment to total risk elements in lending and potential problem loans decreased to 57% compared with 62% in 2006. This reflects amounts written-off and the slightly lower risk profile of the portfolio.

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Taxation

| | 2008 | 2007 | 2006 |
|---|---|---|---|
| | £m | £m | £m |
| Tax | (2,323) | 2,044 | 2,689 |
| | % | % | % |
| UK corporation tax rate | 28.5 | 30.0 | 30.0 |
| Effective tax rate | 5.7 | 20.8 | 29.3 |

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

| | 2008 | 2007 | 2006 |
|---|---|---|---|
| | £m | £m | £m |
| Expected tax (credit)/charge | (11,590) | 2,950 | 2,756 |
| Non-deductible goodwill impairment | 8,292 | 12 | — |
| Unrecognised timing differences | 274 | 29 | — |
| Other non-deductible items | 330 | 222 | 288 |
| Non-taxable items | (491) | (595) | (251) |
| Taxable foreign exchange movements | 80 | 16 | 5 |
| Reduction in deferred tax liability following change in the rate of UK corporation tax | — | (189) | — |
| Foreign profits taxed at other rates | 203 | (25) | 63 |
| Losses in year not recognised | 942 | 2 | — |
| Losses brought forward and utilised | (11) | (11) | 14 |
| Adjustments in respect of prior periods | (352) | (367) | (186) |
| Actual tax (credit)/charge | (2,323) | 2,044 | 2,689 |

The effective tax rate for the year was 5.7% (2007 – 20.8%; 2006 – 29.3%). The tax credit is lower than that arising from applying the standard rate of UK corporation tax of 28.5% to the loss for the period, principally due to non-deductible goodwill impairment and certain carried forward losses on which no tax relief has been recognised.

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## Divisional performance

The divisional results are stated before amortisation of purchased intangible assets, write-down of goodwill and other intangible assets and integration and restructuring costs ('Contribution'). The Group manages costs where they arise. Customer-facing divisions control their direct expenses whilst Manufacturing is responsible for shared costs. In 2008, the Group did not allocate these shared costs between divisions in the day-to-day management of its businesses, and the way in which divisional results are presented reflects this.

| | 2008 £m | 2007 £m | 2006 £m |
|---|---|---|---|
| Global Markets | | | |
| Global Banking & Markets | (10,515) | 3,653 | 3,811 |
| Global Transaction Services | 1,818 | 1,315 | 1,186 |
| Total Global Markets | (8,697) | 4,968 | 4,997 |
| Regional Markets | | | |
| UK Retail & Commercial Banking | 5,679 | 6,225 | 5,718 |
| US Retail & Commercial Banking | 883 | 1,479 | 1,744 |
| Europe & Middle East Retail & Commercial Banking | 429 | 769 | 675 |
| Asia Retail & Commercial Banking | 127 | 91 | 67 |
| Total Regional Markets | 7,118 | 8,564 | 8,204 |
| RBS Insurance | 1,020 | 905 | 967 |
| Group Manufacturing | (4,793) | (3,773) | (3,523) |
| Central items | (675) | (552) | (1,231) |
| Share of shared assets | (300) | (73) | — |
| RFS Holdings minority interest | 41 | 163 | — |
| Contribution | (6,286) | 10,202 | 9,414 |
| Amortisation of purchased intangibles | (443) | (262) | (94) |
| Integration and restructuring costs | (1,357) | (108) | (134) |
| Write-down of goodwill and other intangible assets | (32,581) | — | — |
| Operating (loss)/profit before tax | (40,667) | 9,832 | 9,186 |

The performance of each of the divisions is reviewed on pages 35 to 52.

Risk-weighted assets of each division were as follows:

| | Basel II 31 December 2008 £bn | Basel II 1 January 2008 £bn | Basel I 31 December 2007 £bn |
|---|---|---|---|
| Global Markets | | | |
| Global Banking & Markets | 278.5 | 211.9 | 188.7 |
| Global Transaction Services | 19.6 | 16.8 | 15.4 |
| Total Global Markets | 298.1 | 228.7 | 204.1 |
| Regional Markets | | | |
| UK Retail & Commercial Banking | 152.5 | 153.1 | 179.0 |
| US Retail & Commercial Banking | 78.0 | 53.8 | 57.1 |
| Europe & Middle East Retail & Commercial Banking | 30.9 | 30.3 | 36.7 |

| | | | |
|---|---|---|---|
| Asia Retail & Commercial Banking | 6.4 | 4.9 | 3.3 |
| Total Regional Markets | 267.8 | 242.1 | 276.1 |
| RFS Holdings minority interest | 118.0 | 147.4 | 119.0 |
| Other | 11.9 | 15.3 | 9.8 |
| | 695.8 | 633.5 | 609.0 |

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Global Markets – Global Banking & Markets

| | 2008 | 2007 | 2006 |
|---|---|---|---|
| | £m | £m | £m |
| Net interest income from banking activities | 3,894 | 1,303 | 1,547 |
| Funding costs of rental assets | (404) | (495) | (519) |
| Net interest income | 3,490 | 808 | 1,028 |
| Net fees and commissions receivable | 1,288 | 1,198 | 859 |
| Income from trading activities | (8,098) | 1,789 | 2,341 |
| Other operating income | 800 | 3,024 | 2,476 |
| Non-interest income | (6,010) | 6,011 | 5,676 |
| Total income | (2,520) | 6,819 | 6,704 |
| Direct expenses | | | |
| – staff costs | 2,687 | 2,134 | 2,000 |
| – other | 1,441 | 561 | 402 |
| – operating lease depreciation | 224 | 404 | 406 |
| | 4,352 | 3,099 | 2,808 |
| Impairment | 3,643 | 67 | 85 |
| Contribution | (10,515) | 3,653 | 3,811 |

| | | | |
|---|---|---|---|
| | £bn | £bn | £bn |
| Loans and advances | 354.3 | 254.1 | 125.7 |
| Reverse repos | 96.1 | 308.9 | 114.5 |
| Securities | 163.2 | 239.5 | 109.1 |
| Cash and eligible bills | 26.1 | 26.9 | 7.5 |
| Other assets | 52.2 | 44.5 | 24.8 |
| Total third party assets (excluding derivatives mark to market) | 691.9 | 873.9 | 381.6 |
| Net derivative assets (after netting) | 146.0 | 64.1 | 17.9 |
| Customer deposits (excluding repos) | 105.0 | 106.7 | 44.6 |
| Non-performing loans | 6.2 | 1.0 | 0.5 |

2008 compared with 2007

Global Banking & Markets (GBM) contribution fell from £3,653 million in 2007 to a loss of £10,515 million. This sharp decline reflected the effect of the market turmoil on the enlarged business which severely affected the division's results in 2008, with a particularly adverse impact in the fourth quarter. GBM incurred £5,776 million of losses, write-downs or reserves largely on credit trading, counterparty risk (including CDPCs), counterparty failure (notably Lehman and Madoff) and sovereign events as the effects of the down-turn widened. In addition, losses on previously identified credit market exposures totalled £7,781 million, including impairments of £466 million on reclassified assets. These were only partly offset by gains on the fair value of own debt.

After credit market write-downs and one-off items and trading asset write-down, GBM recorded negative income of £2,520 million. Total income before credit market write-downs and one-off items (£6,958 million) and trading asset write-downs (£5,776 millions) was £10,214 million, up 19% from 2007. The increase reflects good performances in a number of businesses, most notably in rates and currencies and the inclusion of the ABN AMRO businesses for a full twelve months. Direct costs were up by 40%, 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, £67 million, to £3,643 million, resulting in a 2008 operating loss of £10,515 million.

Net interest income grew by £2,682 million to £3,490 million, with the rates business benefiting from the declining interest rate environment. Non-interest income reduced by £12,021 million to negative income of £6,010 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 £1,789 million to negative income of £8,098 million primarily as a result of trading asset write-downs and credit market exposures. Other operating income fell sharply from £3,024 million to £800 million, reflecting losses incurred on European loan sales and much reduced gains on other portfolio assets, partially offset by the gain on sale of Angel Trains of £570 million.

By business line, the rates and currencies business achieved a particularly strong performance in 2008, with high volumes of customer activity and flow trading resulting in an increase in income from rates trading to £3,543 million and growth in currencies income to £1,697 million. The Sempra Commodities joint venture performed ahead of expectations in the nine months since its formation, with GBM’s commodities income reaching £778 million for the year.

Equities improved slightly primarily as a result of the inclusion of a full year of ABN AMRO related businesses. However, reduced customer flow and also experienced losses on illiquid trading positions as markets deteriorated rapidly partially offset this increase.

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.

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

Credit impairments increased sharply to £3,643 million, including £466 million on assets reclassified out of the held for trading category following the amendments to IAS 39 issued in October. Of the total impairment charge, £2,938 million was incurred in the fourth quarter of 2008, including £918 million relating to the Group’s exposure to Lyondell Basell.

GBM’s total third party assets were reduced by £182 billion to £692 billion at 31 December 2008, a reduction of 21% from a year earlier, or 31% at constant exchange rates. Within this total, loans and advances to customers were £354 billion, an increase of 14% at constant exchange rates. 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 £146 billion, compared with £64 billion at the end of 2007.

Although GBM took steps to reduce underlying risk-weighted assets, these measures were masked by the impact of foreign exchange movements and of Basel II pro-cyclicality, with the result that RWAs at 31 December 2008 totalled £279 billion, up 31% from a year earlier, or 14% at constant exchange rates.

2007 compared with 2006

GBM achieved strong performances in many of its businesses in 2007, with particularly strong growth in interest rate and currency trading activities, but financial results were held back by challenging credit market conditions in the second half of the year. Contribution was £3,653 million, 4% lower than 2006's record result.

Total income of £6,819 million was 2% higher than in 2006, with £394 million as a result of the inclusion of 76 days of GBM related ABN AMRO businesses. Whilst many parts of GBM grew strongly, there were write-downs of our subprime related and leveraged finance positions and additional provisions in response to the weakening credit profile of certain financial guarantors. These losses were partially offset by a reduction in the carrying value of our own debt and by a gain of £712 million realised on the sale of Southern Water.

The strength of GBM and the successful diversification of its product capabilities resulted in a continuation of the strong growth we have achieved in Asia and continental Europe in recent years. In Asia we have now established a solid platform, with good product capabilities and client relationships. In 2007 this resulted in strong Asian income growth, with outstanding growth in our activities in China and Japan. In Europe, income grew considerably, with particularly good results in the Nordic region and in the Iberian Peninsula, where GBM further expanded its strong position in the provision of financing and risk management services to corporates and financial institutions. Income in the UK grew strongly, while results in North America declined as a result of credit market conditions affecting GBM's asset-backed and structured credit businesses.

Net interest income fell by 21% to £808 million. Loans and advances to customers, excluding reverse repos, increased by £128.4 billion as a result of the continued expansion of our customer base outside the UK and the inclusion of GBM related ABN AMRO businesses (£102.7 billion). Customer deposits increased by £62.1 billion, with £48.3 billion from GBM related ABN AMRO businesses.

Net fee income rose by 39% to £1,198 million, reflecting our top tier position in arranging, structuring and distributing large scale financings and the inclusion of GBM related ABN AMRO businesses (£151 million). We achieved particularly strong growth in non-US loan markets.

Income from trading activities declined by £552 million, 24% to £1,789 million, with GBM related ABN AMRO businesses contributing income of £285 million. Strong performances in interest rate and currency trading activities were supplemented by good growth in our broadening product range, including equity derivatives and retail investor products. However, in credit markets, write-downs reflecting the weakening of the US housing market led to a sharp fall in income.

Other operating income increased by £548 million, 22% to £3,024 million, including the successful sale of Southern Water which concluded during the second half. The majority of our remaining private equity portfolio has been sold into a fund, managed by RBS, thereby improving capital efficiency while offering more predictable and stable returns.

Direct expenses increased by 10% to £3,099 million. We continued to invest in expanding our geographical footprint, our infrastructure and our product range.

Portfolio credit risk remained stable and impairment losses declined to £67 million in 2007, with no deterioration in overall corporate credit quality. The liquidity and profitability of our corporate customers remains generally strong.

Total assets increased to £873.9 billion, reflecting the inclusion of GBM related ABN AMRO businesses (£400.9 billion) and growth in derivative assets (mostly rates and currencies) accompanied by a corresponding increase in derivative liabilities. The derivatives increase was a result of the strong growth in client-driven interest rate and currency trading activities in a more volatile market environment. Risk-weighted assets increased by 39%, driven by the inclusion of £39.0 billion of risk-weighted assets from GBM related ABN AMRO businesses and careful risk and capital management.

Global Markets – Global Transaction Services

| | 2008 | 2007 | 2006 |
|---|---|---|---|
| | £m | £m | £m |
| Net interest income | 909 | 595 | 449 |
| Non-interest income | 1,563 | 1,183 | 1,081 |
| Total income | 2,472 | 1,778 | 1,530 |
| Direct expenses | | | |
| – staff costs | 392 | 271 | 231 |
| – other | 202 | 178 | 109 |
| | 594 | 449 | 340 |
| Impairment | 60 | 14 | 4 |
| Contribution | 1,818 | 1,315 | 1,186 |

| | | | |
|---|---|---|---|
| | £bn | £bn | £bn |
| Total third party assets | 24.0 | 22.5 | 7.4 |
| Loans and advances | 18.6 | 18.7 | 6.6 |
| Customer deposits | 60.9 | 56.8 | 34.2 |

2008 compared with 2007

Global Transaction Services (GTS) grew income by 39% to £2,472 million and contribution by 38% to £1,818 million for the full year 2008, reflecting the strength and enhanced international capability of its 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. The key driver of this growth has been the acquisition of the ABN AMRO business with the historic RBS business contributing year on year income growth of 5%.

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 particularly in the small and middle markets.

Direct expenses rose by 32% to £594 million, reflecting the full year costs of the ABN AMRO business, historic RBS business costs increased by 10%. The full year cost growth reflected investment in staffing and infrastructure to support GTS's development.

Impairment losses were £60 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.

2007 compared with 2006
Global Transaction Services grew income by 16% to £1,778 million and contribution by 11% to £1,315 million, driven by growth in the Merchant Services business, combined with the enhanced international cash management and trade platforms introduced through the ABN AMRO acquisition.

Revenue growth was evident across all product lines. Cash management growth was the result of increased deposit balances combined with payment fee growth initiatives. Merchant services and commercial cards delivered a 6% increase in income with particularly good growth in the international businesses. This growth has been driven by increased volumes across both debit and credit card transactions.

The Trade finance business benefits materially from the product suite introduced through the ABN AMRO acquisition through improved international capabilities and a global reach. Margins in this business have also begun to see the benefit of improved pricing reflecting country risk premiums.

Direct expenses rose by 32% to £449 million in comparison with 2006, primarily reflecting investment to expand the business. This includes the acquisition of ABN AMRO which incorporates costs directly related to the GTS business.

Impairment losses were £14 million compared with £4 million in 2006.

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Regional Markets – UK Retail & Commercial Banking

| | 2008 £m | 2007 £m | 2006 £m |
|---|---|---|---|
| Net interest income | 6,999 | 6,602 | 6,350 |
| Net fees and commissions – banking | 2,919 | 3,054 | 2,896 |
| Other non-interest income | 1,080 | 1,450 | 1,327 |
| Non-interest income | 3,999 | 4,504 | 4,223 |
| Total income | 10,998 | 11,106 | 10,573 |
| Direct expenses | | | |
| – staff costs | 1,978 | 1,919 | 1,788 |
| – other | 1,193 | 1,076 | 1,082 |
| | 3,171 | 2,995 | 2,870 |
| Insurance net claims | 184 | 518 | 488 |
| Impairment | 1,964 | 1,368 | 1,497 |
| Contribution | 5,679 | 6,225 | 5,718 |

| | £bn | £bn | £bn |
|---|---|---|---|
| Total banking assets | 249.4 | 232.8 | 202.4 |
| Loans and advances to customers – gross | | | |
| – UK Retail Banking | 117.5 | 111.0 | 107.4 |
| – UK Corporate & Commercial Banking | 110.4 | 99.3 | 86.1 |
| – UK Wealth | 10.1 | 8.4 | 7.2 |
| Customer deposits* | 186.1 | 189.4 | 179.7 |
| Investment management assets – excluding deposits | 22.5 | 25.8 | 34.5 |
| Non-performing loans | 7.9 | 5.5 | 5.1 |

* excluding bancassurance

UK Retail and Commercial Banking retains an extremely strong franchise and represents the core of the RBS Group. However, the external environment over the next few years will present significant challenges with pressure on income as a result of very low interest rates, lower fee income, and impairment costs likely to increase further.

The business plans to respond to this environment through reducing costs and increasing productivity by investing in online service channels, automation of activities and re-design of end-to-end processes. The business will tailor the cost of service for different client segments more closely to their value generation.

Wealth management remains a strong growth opportunity and the business plans to pursue a more consolidated approach to the market through more co-ordination across the multiple brands with which it currently faces the market, whilst investing in additional Relationship Managers and platform functionality.

The division will pursue above market growth in customer deposits to improve its funding contribution to the Group, and will diversify its customer lending, reducing its exposure to commercial property.

Regional Markets – UK Retail & Commercial Banking
UK Retail Banking

| | 2008 £m | 2007 £m | 2006 £m |
|---|---|---|---|
| Net interest income | 4,390 | 4,172 | 4,099 |
| Net fees and commissions – banking | 2,219 | 2,375 | 2,297 |
| Other non-interest income | 369 | 765 | 731 |
| Non-interest income | 2,588 | 3,140 | 3,028 |
| Total income | 6,978 | 7,312 | 7,127 |
| Direct expenses | | | |
| – staff costs | 1,258 | 1,266 | 1,203 |
| – other | 574 | 545 | 552 |
| | 1,832 | 1,811 | 1,755 |
| Insurance net claims | 184 | 518 | 488 |
| Impairment | 1,281 | 1,184 | 1,307 |
| Contribution | 3,681 | 3,799 | 3,577 |

| | £bn | £bn | £bn |
|---|---|---|---|
| Loans and advances to customers – gross | | | |
| – mortgages | 74.9 | 67.4 | 65.3 |
| – personal | 16.2 | 17.1 | 17.1 |
| – cards | 6.4 | 7.8 | 8.1 |
| – business | 20.0 | 18.7 | 16.9 |
| Customer deposits* | 95.9 | 96.1 | 86.8 |
| Investment management assets – excluding deposits | 5.7 | 7.0 | 6.7 |
| Non-performing loans | 4.8 | 4.3 | 4.4 |

* customer deposits exclude bancassurance

2008 compared with 2007
Despite an economic environment which became markedly weaker in the second half of the year, UK Retail Banking, which includes both personal and small business banking, held direct costs in line with 2007 while total income decreased 5% to £6,978 million. However the deterioration in the macroeconomic environment resulted in an 8% increase in impairment losses. Consequently, contribution decreased 3%, £118 million, to £3,681 million. In the personal segment, RBS retained top position and NatWest was again joint second for customer satisfaction amongst main high street banks. The business segment has continued to grow, maintaining market leadership with a share of 26%, alongside 23% of the start-up market. 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 increased 5% to £4,390 million as a result of strong balance sheet growth. Net interest income performance in the personal segment was strong, up 7%, as a result of good volume growth coupled with improving new lending margins. The small business sector has seen more pressure on asset margins, from increased funding costs, which has restricted net interest income growth to 4%. Average loans and advances to customers increased 7%

and average deposits were up 6% with personal savings growing 9% and small business deposits growing 3%. At year end deposit balances were in line with 2007 levels, reflecting increasing competitive pressure in a slowing market. Net interest margin reduced from 3.92% to 3.85%, reflecting increased funding and liquidity costs.

UK Retail mortgage balances grew 11% despite more muted demand in the second half, and net mortgage lending market share increased to 19% (2007 – 2%). Small business lending grew 7% despite a significant contraction in demand. Personal unsecured lending slowed, however, particularly in the second half of the year. Further, the sale of Tesco Personal Finance (TPF) reduced personal unsecured balances at 31 December 2008 by £1.9 billion, though income of £285 million from TPF was included up to the date of the sale completion on 19 December.

Non-interest income declined 18% to £2,588 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 this, underlying non-interest income declined 6% reflecting reduced demand for unsecured lending and lower sales of payment protection insurance.

Direct expenses increased 1% to £1,832 million. Direct staff costs reduced 1% reflecting increased efficiency. Other direct costs rose by 5% 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 8% to £1,281 million, with an increase in small business delinquencies and personal impairments reflecting the changed economic environment, particularly in the second half. In the small business segment impairments increased to £158 million (2007 – £80 million). In the personal segment the increase in impairments has been more modest, with mortgage impairment charges at £33 million (2007 – £21 million) on a total book of £74.9 billion, while unsecured personal lending impairments remained level with 2007 at £1,091 million (2007 – £1,084 million). Higher Loan-to-Value ratio mortgages have been restricted and affordability criteria tightened. The average LTV for new business was 67% (2007 – 62%). 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 £63.8 billion at year end, a fall of 3% from 1 January 2008. The upward pressure from procyclicality, especially on the mortgage book, and book growth was offset by the disposal of TPF and improvements in Basel II methodologies.

2007 compared with 2006

UK Retail achieved strong results in 2007, increasing contribution by 6% to £3,799 million as a result of good income growth in both consumer and business banking combined with tight cost control and a reduction in impairment losses. Total income grew by 3% to £7,312 million, while income net of insurance claims grew by 2% to £6,794 million.

We have accelerated the expansion of our consumer banking franchise, opening more than 975,000 new personal current accounts in 2007 and maintaining the Group's joint number one position in the current account market. RBS and NatWest continue to lead the other major high street banks in Great Britain for customer satisfaction. We continue to focus on sales through the branch channel, and by adding more customer advisers in our branches have achieved a significant uplift in volumes.

Bancassurance continued its excellent progress with sales growth of 28% to £342 million annual premium equivalent, representing a doubling of 2005 sales. We invested further in our sales force, ending the year with more than 1,000 financial planning managers.

In business banking we strengthened our management team and improved operational processes, producing good results. During 2007 we placed an additional 500 business managers back in branches, launched additional products to support the start-up market, and added new roles supporting ethnic minorities, women in business and community banking.

In our cards and direct finance business, we have maintained our focus on credit card sales through the branch channel, where new business sales were up 47% on 2006, while continuing to take a cautious view on direct sales.

Savings balance growth was helped by good sales of new accounts to branch customers, with NatWest opening more than 1 million new savings accounts.

Mortgage activity focused on branch channels, where net lending was 14% higher than in the previous year. We also took advantage of improved margins in the intermediary segment in the latter part of the year to improve volumes. Direct loan balances declined over the year as we maintained our strategy of focussing unsecured personal lending on profitability rather than volume, although we continued to grow lending through the branch channel. After a decline in credit card balances in the first half of the year we improved recruitment and retention in the second half.

Net interest income increased by 2% to £4,172 million, with strong growth in deposits helping to mitigate the impact of lower unsecured lending volumes and lower average card balances. Net interest margin declined modestly, in line with previous guidance, with savings margins consistent with 2006, despite increased competition for deposits.

Non-interest income was £3,140 million, 4% ahead of 2006, with strong growth in investment income offset by lower levels of direct lending and reduced instances of current account fees.

Direct expenses rose by 3% to £1,811 million, driven by increased investment in customer-facing staff in branches and in our bancassurance and investment businesses. Other costs reduced by 1% to £545 million.

Impairment losses decreased by 9% to £1,184 million, reflecting the improvement in arrears trends on both credit cards and unsecured personal loans. Mortgage arrears remained very low, and we have maintained conservative lending criteria – the average loan-to-value ratio of UK Retail’s mortgages was 46% overall and 63% on new mortgages written in 2007, and this improved as the year progressed. Small business credit quality remained good.

Regional Markets – UK Retail & Commercial Banking
UK Corporate & Commercial Banking

| | 2008<br>£m | 2007<br>£m | 2006<br>£m |
|---|---|---|---|
| Net interest income | 2,039 | 1,924 | 1,807 |
| Net fees and commissions | 450 | 425 | 385 |
| Other non-interest income | 672 | 658 | 569 |
| Non-interest income | 1,122 | 1,083 | 954 |
| Total income | 3,161 | 3,007 | 2,761 |
| Direct expenses | | | |
| – staff costs | 486 | 431 | 381 |
| – other | 529 | 467 | 457 |
| | 1,015 | 898 | 838 |
| Impairment | 671 | 180 | 188 |
| Contribution | 1,475 | 1,929 | 1,735 |

| | £bn | £bn | £bn |
|---|---|---|---|
| Loans and advances to customers – gross | 110.4 | 99.3 | 86.1 |
| Customer deposits | 64.3 | 66.2 | 71.0 |
| Non-performing loans | 3.0 | 1.2 | 0.7 |

2008 compared with 2007
UK Corporate & Commercial Banking 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 5% to £3,161 million. However, growth in impairments, especially in the second half of the year, resulted in a 24% fall in contribution to £1,475 million.

Net interest income increased 6% to £2,039 million. Average loans and advances were 18% 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 suppressed growth in net interest income.

Non interest income increased 4% to £1,122 million. 2007 benefited from the profit on disposal of the Securities Services Group business. This strong performance reflects increased sales of interest rate and currency risk management products.

Direct expenses increased 13% to £1,015 million, reflecting a 26% rise in operating lease depreciation to £401 million, due to higher volumes as well as additional provisions of £54 million for lower residual values in the Lombard vehicle leasing business. Direct expenses, excluding operating lease depreciation, increased by 6% to £614 million with cost growth reflecting the recruitment of additional relationship managers in 2007.

Impairment losses totalled £671 million, a sharp increase from the historically low levels seen in 2007. 48% of the charge related to house builder and property development companies. 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. The commercial businesses charge was £368 million (2007 – £100 million) and the corporate business charge was £303 million (2007 – £80 million).

The performance of our commercial property book remains under close watch. Average LTVs in the UK portfolio is 68% and less than 5% of the portfolio has LTVs greater than 85%.

RWA growth has been constrained by improvements in Basel II methodologies and active risk management, which have offset growth in the underlying balance sheet and the impacts of procyclicality.

2007 compared with 2006

UK Corporate & Commercial Banking had another successful year of profitable growth, building further on our market-leading position and achieving significant improvements in customer satisfaction. Total income rose by 9% to £3,007 million and contribution by 11% to £1,929 million.

There has been good growth in customer volumes, with average loans and advances up 15% and average deposits up 12%. Net interest income increased by 6% to £1,924 million as net interest margin narrowed slightly from the prior year. In recent months we have seen firmer margins in some areas.

Non-interest income rose by 14% to £1,083 million, as a result of growth in fees and continued progress in the distribution of trade and invoice finance products as well as of interest rate and foreign exchange products.

Direct expenses increased by 7% at £898 million due to investment targeted towards improving customer service. Around 600 new front line roles were created and major new functionality was added to the Bankline electronic banking platform. These initiatives have contributed to strongly favourable customer satisfaction scores in 2007.

Impairment losses totalled £180 million, 4% lower than in 2006, reflecting the strong quality of the portfolio. Corporate credit metrics remained stable.

Regional Markets – UK Retail & Commercial Banking
UK Wealth

| | 2008 | 2007 | 2006 |
|---|---|---|---|
| | £m | £m | £m |
| Net interest income | 570 | 506 | 444 |
| Net fees and commissions | 250 | 254 | 214 |
| Other non-interest income | 39 | 27 | 27 |
| Non-interest income | 289 | 281 | 241 |
| Total income | 859 | 787 | 685 |
| Direct expenses | | | |
| – staff costs | 234 | 222 | 204 |
| – other | 90 | 64 | 73 |
| | 324 | 286 | 277 |
| Impairment | 12 | 4 | 2 |
| Contribution | 523 | 497 | 406 |

| | £bn | £bn | £bn |
|---|---|---|---|
| Loans and advances to customers – gross | | | |
| – mortgages | 5.2 | 4.2 | 3.8 |
| – personal | 3.7 | 3.0 | 2.5 |
| – other | 1.2 | 1.2 | 0.9 |
| Customer deposits | 25.9 | 27.1 | 21.9 |
| Investment management assets – excluding deposits | 16.8 | 18.8 | 15.3 |
| Non-performing loans | 0.1 | — | — |

2008 compared with 2007
UK Wealth delivered robust growth, with total income increasing by 9% to £859 million and contribution increasing by 5% to £523 million.

UK Wealth generates earnings from both private banking and investment services, and this has enabled the division to maintain strong organic growth, despite the deterioration in global market conditions. Coutts & Co. performed particularly well, with contribution up by 15%.

Average loans and advances to customers rose by 17% and average customer deposits by 11%, underpinning a 13% rise in net interest income to £570 million.

Non interest income grew by 3% to £289 million as higher fee income was offset by lower investment income. Although average assets under management were 4% higher than in 2007, lower stock market levels in the latter part of the year reduced assets under management by 11% to £16.8 billion.

Direct expenses rose by 13% to £324 million partly due to increased headcount and higher deposit protection scheme contributions.

Impairments rose from £4 million in 2007 to £12 million and represented approximately 0.1% of the total UK lending book.

2007 compared with 2006

Wealth Management's offering of private banking and investment services continued to deliver very strong growth in income, up 15% in 2007 to £787 million. Contribution grew by 22% to £497 million.

We have continued Coutts & Co's UK regional expansion programme, and this has helped us to grow customer numbers by 7% and income by 22%.

Growth in banking volumes contributed to a 14% rise in net interest income to £506 million. Average loans and advances to customers rose by 16% and average deposits by 22%.

Non-interest income grew by 17% to £281 million, reflecting higher investment management fees and new product sales, including new investment vehicles specialising in private equity and natural resources, as well as continued growth in underlying new business volumes. Assets under management rose to £18.8 billion at 31 December 2007, up 23% from a year earlier.

Direct expenses increased by 3% to £286 million, reflecting continued investment in the UK.

Regional Markets – US Retail & Commercial Banking

| | 2008 | 2007 | 2006 | 2008 | 2007 | 2006 |
|---|---|---|---|---|---|---|
| | £m | £m | £m | $m | $m | $m |
| Net interest income | 2,106 | 1,935 | 2,041 | 3,902 | 3,872 | 3,764 |
| Non-interest income | 904 | 846 | 949 | 1,676 | 1,692 | 1,747 |
| Total income | 3,010 | 2,781 | 2,990 | 5,578 | 5,564 | 5,511 |
| Direct expenses | | | | | | |
| – staff costs | 675 | 598 | 664 | 1,250 | 1,197 | 1,225 |
| – other | 411 | 364 | 402 | 762 | 728 | 743 |
| | 1,086 | 962 | 1,066 | 2,012 | 1,925 | 1,968 |
| Impairment – core | 722 | 177 | 180 | 1,337 | 351 | 332 |
| Impairment – SBO | 319 | 163 | - | 592 | 329 | - |
| Contribution | 883 | 1,479 | 1,744 | 1,637 | 2,959 | 3,211 |

| | £bn | £bn | £bn | US$bn | US$bn | US$bn |
|---|---|---|---|---|---|---|
| Total assets | 103.9 | 79.6 | 82.1 | 151.8 | 159.2 | 161.3 |
| Loans and advances to customers – gross | | | | | | |
| – mortgages | 10.7 | 9.5 | 9.5 | 15.7 | 19.1 | 18.6 |
| – home equity | 23.8 | 17.9 | 17.6 | 34.8 | 35.9 | 34.5 |
| – other consumer | 14.6 | 10.8 | 11.7 | 21.3 | 21.6 | 23.1 |
| – corporate and commercial | 28.2 | 18.8 | 16.7 | 41.2 | 37.6 | 32.7 |
| Customer deposits | 64.6 | 52.8 | 51.5 | 94.3 | 105.8 | 101.1 |
| Non-performing loans | 0.8 | 0.3 | 0.2 | 1.1 | 0.6 | 0.3 |
| Average exchange rate – US$/£ | | | | 1.853 | 2.001 | 1.844 |
| Spot exchange rate – US$/£ | | | | 1.460 | 2.004 | 1.965 |

2008 compared with 2007

US Retail & Commercial Banking increased income by 8% to £3,010 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, contribution declined to £883 million, down 40%. In dollar terms, total income was held steady at $5,578 million while contribution declined by 45% to $1,637 million.

Total income of £3,010 million increased by 8%, with 20% growth in commercial banking to £664 million and a 5% growth in retail banking income to £2,346 million. In dollar terms, total income of $5,578 million was essentially unchanged, with 11% growth in commercial banking to $1,231 million offsetting a 2% decline in retail banking income to $4,347 million. Both segments were affected by the deterioration in credit conditions, with retail contribution down 54% to £499 million and commercial contribution flat at £384 million. In dollar terms, retail contribution was was down 58% to $926 million and commercial contribution was down 7% to $711 million.

Overall, net interest income grew modestly, offset by a small decline in non-interest income. 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 2.73%, reflecting widening asset margins and management of savings rates in a competitive deposit market.

Direct expenses increased by 13% to £1,086 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 5% to $2,012 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 £1,041 million, up from £340 million in 2007 reflecting the deterioration in economic conditions. In dollar terms, impairment losses totalled $1,929 million, up 184% from 2007.

In the core US Retail & Commercial portfolio, 2008 impairment losses totalled £722 million ($1,337 million), with a marked increase in the second half. Consumer non-performing loans represented 0.37% of core home equity balances and 1.20% of residential mortgage balances. While there has been a decline in some customers' credit scores in line with weakening economic conditions, refreshed weighted average FICO scores for consumer real estate-secured lending at 31 December 2008 was approximately 740 with a weighted average LTV of 63%. Stress has emerged in all consumer segments during the second half of the year, with increased delinquency in core home equity (up 10bps to 0.86%), and auto (up 94bps to 2.78%). US Retail & Commercial does not originate negative amortization mortgages or option adjustable rate mortgages. Closing provision balances for the core portfolio were £892 million ($1,303 million) compared with £388 million ($777 million) at the end of 2007.

Credit quality has continued to deteriorate sharply in the externally sourced home equity portfolio (the Serviced By Others (SBO) portfolio). On a constant currency basis this portfolio, now managed by a separate work-out group and in run-off, has been reduced by £1.0 billion over the last year to £4.9 billion and $1.5 billion in dollar terms to $7.1 billion at 31 December 2008. Non-performing SBO loans represent 2.66% of SBO balances. Impairment losses in relation to the SBO portfolio totalled £319 million ($592 million) for 2008, with £155 million ($268 million) incurred in the second half of 2008 compared with £164 million ($324 million) in the first half. Closing SBO provision balances amounted to £325 million ($474 million) at 31 December 2008, up from £208 million ($413 million) at 30 June 2008, providing a coverage ratio of 2.5 times non-performing loans.

The overall commercial loan portfolio has begun to show signs of stress, with a marked deterioration in the commercial real estate book. Impairments in the commercial and industrial portfolio, including lease financing, totalled $212 million, or 0.74% of balances. Total impairments within the commercial real estate portfolio were $177 million, or 1.63% of balances.

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.

2007 compared with 2006

Against the background of weaker housing and credit market conditions, the US Retail & Commercial Banking division demonstrated resilience in 2007, with a particularly good performance in corporate and commercial banking. Despite modest growth in net interest margins and strong fee growth in several products, total income fell by 7% to £2,781 million due mainly to the weak dollar exchange rate but, in dollar terms, total income was flat at $5,564 million. Tight cost control helped limit the fall in contribution. However, impairment losses increased from 0.31% of loans and advances to 0.60%, resulting in a decrease in contribution of 15% to £1,479 million, or 8% to $2,959 million in dollar terms.

Net interest income fell by 5% to £1,935 million due mainly to the unfavourable dollar exchange rate. In dollar terms, net interest income rose by 3% to $3,872 million. Average loans and advances to customers increased by 4%, with strong growth in corporate and commercial lending, up 13%, with close attention being paid to our risk appetite in light of prevailing market conditions. Average customer deposits were flat and deposit margins narrowed as a result of deposit pricing competition and continued migration from low-cost checking accounts and liquid savings to higher-cost products. Notwithstanding this migration, US Retail & Commercial Banking net interest margin increased slightly to 2.74% in 2007, compared with 2.66% in 2006, thanks in part to improved lending spreads in the latter part of the year.

Non-interest income fell by 11% to £846 million. In dollar terms, non-interest income fell by 3% to $1,692 million. Business and corporate fees rose strongly, with good results especially in foreign exchange and interest rate derivatives, driven by increasing cooperation with RBS Global Markets. Good progress was also made in credit card issuing, where we increased our customer base by 20%.

In response to more difficult market conditions the division intensified cost discipline, with a reduction in headcount helping to reduce direct expenses by 10%. In dollar terms, the fall in direct expenses was just 2%, despite enhancements to infrastructure and processes as well as continued investment in growth opportunities including mid-corporate banking, and contactless debit cards.

Rising losses and increased provisions lifted impairment costs from £180 million in 2006 to £340 million in 2007. In dollar terms, impairment losses rose from $332 million in 2006 to $680 million in 2007. Against a background of weaker economic activity the US Retail & Commercial Banking division portfolio is performing well, although we have experienced a reversion from the very low levels of impairment seen in recent years, reflecting both the planned expansion of our commercial loan book and the impact of a softer housing market. There has also been an increase in reserving. The average FICO scores on our consumer portfolios, including home equity lines of credit, remain in excess of 700, with 97% of lending secured. Average loan-to-value ratios at the end of 2007 were 58% on our residential mortgage book and 74% on our home equity book.

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Regional Markets – Europe & Middle East Retail & Commercial Banking

| | 2008 | 2007 | 2006 |
|---|---|---|---|
| | £m | £m | £m |
| Net interest income | 1,087 | 958 | 824 |
| Net fees and commissions | 320 | 219 | 201 |
| Other non-interest income | 111 | 169 | 119 |
| Non-interest income | 431 | 388 | 320 |
| Total income | 1,518 | 1,346 | 1,144 |
| Direct expenses | | | |
| – staff costs | 404 | 307 | 251 |
| – other | 159 | 152 | 114 |
| | 563 | 459 | 365 |
| Impairment | 526 | 118 | 104 |
| Contribution | 429 | 769 | 675 |
| | £bn | £bn | £bn |
| Total assets | 66.4 | 56.1 | 44.5 |
| Loans and advances to customers – gross | | | |
| – mortgages | 24.6 | 18.3 | 14.9 |
| – corporate | 33.4 | 25.3 | 19.6 |
| – other | 3.7 | 4.2 | 3.6 |
| Customer deposits | 25.0 | 22.3 | 18.1 |
| Non-performing loans | 3.3 | 0.7 | 0.5 |

2008 compared with 2007

The significant deterioration in global and local market conditions has impacted the main Europe & Middle East markets, with contribution falling to £429 million, 44% lower than in 2007. The main driver of this reduction has been an increase of £408 million in impairments, albeit from a low base, reflecting deterioration in credit quality particularly in the property and construction sectors, as economic conditions have slowed.

Total income was up £172 million, 13% at £1,518 million benefitting from the full year of the ABN AMRO businesses and movements in exchange rates. Direct expenses were up 23% to £563 million. Impairment losses rose sharply to £526 million from £118 million reflecting the economic environment.

In sterling terms the results have been materially affected by the movement in the euro exchange rate and references to percentage movement in the following analysis are in constant currency terms.

Within the core business of the region, Ulster Bank, contribution fell to £117 million. Total income decreased by 2% to £1,269 million; net interest income increased by 1%, with average loans and advances to customers up 12% 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. Other income was 12% lower than in 2007, reflecting a slowdown in particular in the bancassurance and wealth businesses.

Average mortgage balances in Ulster Bank were 11% 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.

Average deposit balances in Ulster Bank were largely flat year-on-year reflecting the highly competitive market for resources in Ireland in 2008. 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 8% to £432 million, reflecting 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 in Ulster Bank rose to £394 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.

Outside Ireland, Europe & Middle East Retail & Commercial Banking continued to trade satisfactorily, although our markets in the United Arab Emirates, Romania and Kazakhstan have also experienced a marked slowdown in the past year. In UAE, we are a market leader in credit cards with over 430,000 cards in issue.

The sale of the European Consumer Finance business to Santander was completed on 1 July 2008, while the Imagine business in Spain was sold to Bank of America in the second half of 2008. The former ABN AMRO retail business in Russia was also closed during the year.

2007 compared with 2006

Europe and Middle East Retail & Commercial Banking maintained its success in building its personal and corporate banking business, particularly in the island of Ireland, with total income rising by 18% to £1,346 million and contribution by 14% to £769 million. These results reflect solid sales growth across all activities, driven by an enhanced range of innovative products and an expanded distribution network.

Net interest income increased by 16% to £958 million, reflecting good growth in both loans and deposits. Average loans and advances to customers increased by 24%, with particular strength in business lending, with a 29% increase spread across a variety of industrial sectors. Our mortgage book also saw very good growth in 2007, in spite of the slowdown in the housing market, with average balances up 17%. We achieved particular success in attracting remortgagers with our Switcher package. We were also successful in the current account switching market, winning 100,000 new current account customers during the year. This, together with new product launches such as the eSavings Account and Reward Reserve savings accounts, contributed to a 18% increase in average customer deposits. Net interest margin tightened, reflecting more competitive market conditions and increased funding costs.

Non-interest income rose by 21% to £388 million, driven by strong performances in Global Markets and credit cards. We successfully launched our new wealth business in the course of the year.

Direct expenses increased by 26% to £459 million, as we continued our investment programme to support the future growth of the business. We continued to expand our branch and business centre footprint and recruited additional customer-facing staff, particularly in our Global Markets business.

Impairment losses have risen to £118 million, reflecting growth in lending as well as a slowdown in economic conditions which has affected commercial credit metrics.

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Regional Markets – Asia Retail & Commercial Banking

| | 2008 | 2007 | 2006 |
|---|---|---|---|
| | £m | £m | £m |
| Net interest income | 379 | 123 | 52 |
| Net fees and commissions | 309 | 161 | 136 |
| Other non-interest income | 93 | 71 | 23 |
| Non-interest income | 402 | 232 | 159 |
| Total income | 781 | 355 | 211 |
| Direct expenses | | | |
| – staff costs | 284 | 150 | 95 |
| – other | 199 | 90 | 50 |
| | 483 | 240 | 145 |
| Impairment | 171 | 24 | (1) |
| Contribution | 127 | 91 | 67 |
| | £bn | £bn | £bn |
| Total assets | 8.3 | 7.6 | 3.1 |
| Loans and advances to customers – gross | 5.8 | 4.5 | 1.6 |
| Investment management assets – excluding deposits | 21.2 | 19.9 | 0.3 |
| Customer deposits | 15.1 | 10.8 | 6.5 |
| Non-performing loans | 0.3 | 0.5 | — |

2008 compared with 2007
Total income rose by £426 million to £781 million largely reflecting the full year contribution from the acquired ABN AMRO businesses. Retail & Commercial Banking income was up £380 million reflecting the full year contribution of the ABN AMRO business with the Affluent banking income slowing markedly in the second half due to reduced structured product and equity fund sales, as investors stayed out of volatile markets. Income was particularly strong from RBS Coutts, increasing £46 million or 19%. Comparisons with the previous year are affected by the marked weakening of sterling over the course of the year.

Credit cards and consumer finance credit metrics have continually been reviewed over the period resulting in further tightening of consumer lending policies. This has led to lower levels of card and loan acquisition. There has also been a slowdown in the number of card transactions. Despite this, the cards and consumer finance business reported income growth together with an increase in consumer net receivables.

Business banking has seen strong growth across most regions, having performed particularly well in the Indian, Pakistani and Chinese markets.

RBS Coutts' offering of private banking and investment services continued to deliver good income growth of 19% and strong levels of client acquisition, up 5% in the year. Net interest income grew 56% on the back of strong banking volumes, though this was offset in part by weaker sales of equity-related investment products and lower assets under management. Despite adverse financial markets and significant levels of client deleveraging, assets under management in the international wealth business grew by 8%.

Direct expenses rose by £243 million to £483 million, reflecting the full year impact of the acquired ABN AMRO businesses, legal costs and continued investment in the Group's infrastructure in the region, including the recruitment of additional experienced private bankers in RBS Coutts Asia.

Impairments increased from £24 million to £171 million, relecting the full year impact of the acquired ABN AMRO businesses which are predominately consumer focused, and an increase in provisioning levels across a number of consumer finance markets in the region.

Total assets under management for the division at 31 December 2008 were 7% higher than a year earlier at £21.2 billion, while customer deposits were 40% higher at £15.1 billion, partly reflecting exchange rate movements.

2007 compared with 2006

2007 results reflect the introduction of ABN AMRO businesses in the Asia region. Asia Retail & Commercial's 2007 results include the accounting for 76 days of the Asia Retail arm of ABN AMRO (total income £101 million, total direct expenses £57 million, total contribution £21 million including £23 million of impairment losses). Asia Retail & Commercial Banking reported strong growth, with total income rising 68% to £355 million. Contribution grew by 36% to £91 million.

The division operates in 8 countries in Asia: China, Hong Kong, India, Indonesia, Malaysia, Pakistan, Singapore and Taiwan, across 4 core business segments: affluent banking, cards & consumer finance, business banking and private banking.

RBS Coutts, which excludes the ABN AMRO businesses, offering of private banking and investment services delivered good organic income growth in 2007. The division has seen healthy levels of client acquisition with growth in banking volumes leading to a rise of 21% in net interest income. Non-interest income grew by 18%, largely driven by a rise in transactional, market-driven income and volumes as a result of consistent global equity market growth and positive client sentiment.

Direct expenses rose by 66% to £240 million, reflecting the part-year inclusion of ABN AMRO's Asia Retail division and underlying investment in the existing wealth management businesses in the region. Despite the highly competitive market, RBS Coutts successfully recruited additional, experienced private bankers.

Impairment losses, at £24 million, have increased from negligible levels in 2006 reflecting the introduction of the ABN AMRO businesses in the Asia region.

RBS Insurance

| | 2008 £m | 2007 £m | 2006 £m |
|---|---|---|---|
| Earned premiums | 5,520 | 5,607 | 5,713 |
| Reinsurers' share | (227) | (220) | (212) |
| Insurance premium income | 5,293 | 5,387 | 5,501 |
| Net fees and commissions | (401) | (465) | (486) |
| Other income | 674 | 734 | 664 |
| Total income | 5,566 | 5,656 | 5,679 |
| Direct expenses | | | |
| – staff costs | 309 | 297 | 319 |
| – other | 462 | 444 | 423 |
| | 771 | 741 | 742 |
| Gross claims | 3,857 | 4,091 | 4,030 |
| Reinsurers' share | (124) | (81) | (60) |
| Net claims | 3,733 | 4,010 | 3,970 |
| Impairment | 42 | — | — |
| Contribution | 1,020 | 905 | 967 |

| | 2008 | 2007 | 2006 |
|---|---|---|---|
| In-force policies (000's) | | | |
| – Own-brand motor | 6,964 | 6,713 | 6,790 |
| – Own-brand non-motor (home, rescue, pet, HR24) | 5,642 | 3,752 | 3,759 |
| – Partnerships and broker (motor, home, rescue, SMEs, pet, HR24) | 8,450 | 9,302 | 11,242 |
| General insurance reserves – total (£m) | 8,159 | 8,192 | 8,068 |

2008 compared with 2007

RBS Insurance made good progress in 2008, with contribution rising by £115 million to a record £1,020 million, an increase of 13%. Total income was £90 million lower at £5,566 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 on investment income.

Own-brand businesses increased income by 4% and contribution before impairments by 13%. 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 Spain, Italy and Germany performed well, with income up 24% and contribution up 37%. Over the last year own-brand motor policy numbers have again begun to increase, and rose by 4% to 7.0 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 50% 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 9% over the last year with a corresponding 9% reduction in income, yet contribution grew by 27%.

For RBS Insurance as a whole, insurance premium income, net of fees and commissions, was broadly maintained at £4,892 million, reflecting 7% growth in the Group's own brands offset by a 10% decline in the partnerships and broker segment. Other income declined by 8% to £674 million, reflecting the effect of depressed financial markets on investment income.

Direct expenses grew by 4% to £771 million, in part as a result of accelerated marketing development in own brands, including the launch of Direct Line for Business.

Net claims fell by 7% to £3,733 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.

2007 compared with 2006
RBS Insurance has made good progress in 2007 in competitive markets. Total income was maintained at £5,656 million, in line with 2006 levels, with growth in our own-brand businesses offset by a decline in partnerships.

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Contribution fell by 6% to £905 million, reflecting the impact of the severe flooding experienced in June and July. Excluding the £274 million impact of the floods, contribution grew by 22%, supported by strong claims management and the benefits of improved risk selection in this and prior years. We have continued to focus on selective underwriting of more profitable business.

Our own-brand businesses have performed well, with income rising by 1% and contribution growing by 4%. Excluding the impact of the floods, own-brand contribution grew by 24%. In the UK motor market we have pursued a strategy of targeting lower risk drivers and have increased premium rates to offset claims inflation, improving profitability by implementing heavier price increases in higher risk categories. Our international businesses performed well, with Spain delivering strong profit growth while, in line with plan, our German and Italian businesses also achieved profitability in 2007. Home insurance grew across all of our own brands in the second half, and we achieved particular success in the distribution of home policies through our bank branches, with sales up 40%.

In our partnerships and broker business, providing underwriting and processing services to third parties, we have concentrated on more profitable opportunities and have consequently not renewed a number of large rescue contracts. We also pulled back from some less profitable segments of the broker market. This resulted in a 17% reduction in in-force policies, but income fell by only 2%. Contribution from partnerships and brokers fell by 22% as a result of flood-related claims. Excluding the impact of the floods, contribution from partnerships and brokers increased by 18%.

For RBS Insurance as a whole, insurance premium income, net of fees and commissions, was 2% lower at £4,922 million, reflecting modest growth in our own brands offset by a 5% decline in the partnerships and broker segment. Other income rose by 11% to £734 million, reflecting increased investment income.

Direct expenses were flat at £741 million. Within this, staff costs reduced by 7%, reflecting our continued focus on improving efficiency whilst maintaining service standards. A 5% rise in non-staff costs reflects increased marketing investment in our own brands.

Net claims rose by 1% to £4,010 million. Gross claims relating to the floods in June and July cost more than £330 million, with a net impact, after allowing for profit sharing and reinsurance, of £274 million. Excluding the impact of the floods, net claims costs were reduced by 6%. In the motor book, while average claims costs have continued to rise, this has been mitigated by improvements in risk selection and management and by continuing efficiencies in claims handling.

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Group Manufacturing

| | 2008 | 2007 | 2006 |
|---|---|---|---|
| | £m | £m | £m |
| Staff costs | 1,197 | 998 | 934 |
| Other costs | 3,596 | 2,775 | 2,589 |
| Total manufacturing costs | 4,793 | 3,773 | 3,523 |
| | | | |
| Analysis of manufacturing costs: | | | |
| Technology Services and support functions | 1,757 | 1,336 | 1,222 |
| Group Property | 1,690 | 1,262 | 1,167 |
| Global Operations | 1,346 | 1,175 | 1,134 |
| Total manufacturing costs | 4,793 | 3,773 | 3,523 |

2008 compared with 2007

Group Manufacturing costs increased by 27% to £4,793 million in 2008. This growth reflects movements in exchange rates and the inclusion of a full year of ABN AMRO related costs (£937 million) in 2008 whereas 2007 reflects the costs incurred from the date of acquisition (£193 million).

Increasing business volumes have been absorbed through improvements in productivity. Group Manufacturing has maintained high levels of customer satisfaction while continuing to invest in the further development of the business.

Technology Services and support functions costs increased by 32% to £1,757 million. This growth reflects the inclusion of a full year of ABN AMRO related costs (£453 million) in 2008 whereas 2007 includes only the post acquisition element of costs (£104 million).  In addition, increases in business demand have been balanced by savings delivered across the business.

Group Property costs increased by 34% to £1,690 million. This growth reflects the inclusion of a full year of ABN AMRO related costs (£309 million) in 2008 whereas 2007 includes only the post acquisition element of costs (£61 million) together with further development of the Group’s Corporate Banking branch network and investment in Manufacturing infrastructure.

Global Operations cost increased by 15% to £1,346 million. This growth reflects the inclusion of a full year of ABN AMRO costs (£174 million) in 2008 whereas 2007 includes only the post acquisition element of 2007 costs (£28 million).  Further improvements in productivity enabled us to continue to absorb increases in volumes and global inflationary pressure. Ongoing investment in process re-engineering across our operational centres under the 'Work-Out' banner continues to deliver efficiency gains.

2007 compared with 2006

Manufacturing costs increased by 7% to £3,773 million reflecting the inclusion of £193 million related to the ABN AMRO business which was acquired in October 2007. Excluding ABN AMRO, costs have increased by 2%. Further improvements in productivity have enabled us to support growth in business volumes and to maintain high levels of customer satisfaction while continuing to invest in the further development of our business.

Technology Services and Support Functions costs increased by 9% to £1,336 million. Excluding ABN AMRO (£104 million) costs from 2007, costs grew by only 1% as a result of continued tight cost control and investment in software development being balanced by significant improvements in productivity.

Group Property costs rose by 8% to £1,262 million. Excluding ABN AMRO costs (£61 million) from 2007, costs rose by 3% reflecting refurbishment and expansion of the Ulster Bank network and continuing investment to support the strong growth of our business in Europe and Asia, including the opening of a new Global Markets office in Paris and further development of our office portfolio in India and Singapore.

Global Operations costs rose by 4% to £1,175 million. Excluding ABN AMRO costs (£28 million) from 2007, costs rose by 1% with further significant improvements in productivity enabling us to continue to absorb significant increases in service volumes. At the same time we maintained our focus on service quality, and our UK-based telephony centres continued to record market-leading customer satisfaction scores. Our investment in process re-engineering across our operational centres under the 'Work-Out' banner is expected to deliver further improvements in efficiency.

Central items

| | 2008 £m | 2007 £m | 2006 £m |
|---|---|---|---|
| Funding costs | 1,330 | 623 | 566 |
| Departmental costs | 665 | 438 | 425 |
| Other corporate costs | (1,320) | (509) | 240 |
| Total central Items | 675 | 552 | 1,231 |

2008 compared with 2007
Central costs increased by £123 million to £675 million.

Funding costs rose by £707 million to £1,330 million, reflecting higher funding costs for the full year related to the acquisition of ABN AMRO in October 2007. Funding costs also rose due to higher cost of funds including those relating to the Bank of England Special Liquidity Scheme. The Group seeks to hedge its interest rate risk economically, and it is not always possible to achieve hedge accounting in accordance with IFRS. The movements in interest rates, currencies and inflation indices, particularly in the latter part of 2008, resulted in volatility for accounting purposes, leading to a charge of £204 million in 2008. These costs were largely offset by increased dividends from Bank of China and benefits from the additional capital raised during the year.

Departmental costs rose by £227 million to £665 million, including the full year impact of the acquisition of ABN AMRO. This also reflects an increase in central function headcount as well as higher Basel II costs.

Other corporate costs amounted to a net credit of £1,320 million, compared with a net credit of £509 million in 2007. The increase reflects higher gains in the fair value of own debt and the profit on sale of Tesco Personal Finance in 2008.

2007 compared with 2006

Central Costs reduced by £679 million to £552 million.

Funding costs rose by £57 million reflecting an increase in funding costs of £144 million relating to ABN AMRO partially offset by a reduction in the carrying value of our own debt accounted for at fair value and the receipt of a dividend on our investment in Bank of China.

Departmental and other costs increased by 3% to £438 million. This largely reflects the centralisation of certain functions and increased regulatory requirements.

Other Corporate costs were substantially lower amounting to a net credit of £509 million, reflecting the gains realised on a number of planned disposals that formed part of the Group’s funding arrangements for the acquisition of ABN AMRO.

Share of Shared Assets

| | 2008 | 2007 | 2006 |
|---|---|---|---|
| | £m | £m | £m |
| Net interest income | (175) | 15 | - |
| Non-interest income | (18) | (54) | - |
| Total income | (193) | (39) | - |
| Operating expenses | 62 | 37 | - |
| Depreciation and amortisation | 41 | - | - |
| | 103 | 37 | - |
| Impairment | 4 | (3) | - |
| Contribution | (300) | (73) | - |
| | | | |
| | £bn | £bn | £bn |
| Total assets | 2.0 | 27.2 | - |

Share of shared assets recorded a loss of £300 million in 2008 compared with a loss of £73 million in 2007. This reflected the inclusion of a full year compared with 76 days in 2007.

RFS Holdings minority interest

| | 2008 | 2007 | 2006 |
|---|---|---|---|
| | £m | £m | £m |
| Net interest income | 2,911 | 545 | - |
| Non-interest income | 1,916 | 287 | - |
| Total income | 4,827 | 832 | - |
| Operating expenses | 3,303 | 573 | - |
| Depreciation and amortisation | 843 | 58 | - |
| | 4,146 | 631 | - |
| Impairment | 640 | 38 | - |
| Contribution | 41 | 163 | - |
| | | | |
| | £bn | £bn | £bn |
| Total assets | 183.0 | 245.8 | - |

RFS Holdings minority interest recorded a contribution of £41 million (2007 - £163 million). This reflected the full year contribution in 2008 compared with 76 days in 2007, offset by increased impairment.

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

| | 2008 | 2007 | 2006 |
|---|---|---|---|
| Global Banking & Markets | 20,200 | 24,100 | 8,500 |
| Global Transaction Services | 4,500 | 3,700 | 2,600 |
| UK Retail & Commercial Banking | 46,500 | 46,200 | 42,900 |
| US Retail & Commercial Banking | 17,600 | 17,800 | 18,300 |
| Europe & Middle East Retail & Commercial Banking | 7,900 | 7,900 | 5,600 |
| Asia Retail & Commercial Banking | 11,500 | 8,900 | 4,500 |

| | | | |
|---|---|---|---|
| RBS Insurance | 16,600 | 17,300 | 17,600 |
| Group Manufacturing | 44,900 | 42,500 | 32,200 |
| Centre | 4,300 | 4,200 | 2,800 |
| | 174,000 | 172,600 | 135,000 |
| Integration | 900 | — | — |
| Share of shared assets | 400 | 1,200 | — |
| RFS minority interest | 24,500 | 21,600 | — |
| Group total | 199,800 | 195,400 | 135,000 |

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Consolidated balance sheet at 31 December 2008

| | 2008 £m | 2007 £m |
|---|---|---|
| Assets | | |
| Cash and balances at central banks | 12,400 | 17,866 |
| Loans and advances to banks | 138,197 | 219,460 |
| Loans and advances to customers | 874,722 | 828,538 |
| Debt securities | 267,549 | 294,656 |
| Equity shares | 26,330 | 53,026 |
| Settlement balances | 17,832 | 16,589 |
| Derivatives | 992,559 | 277,402 |
| Intangible assets | 20,049 | 49,916 |
| Property, plant and equipment | 18,949 | 18,745 |
| Deferred tax | 7,082 | 3,119 |
| Prepayments, accrued income and other assets | 24,402 | 15,662 |
| Assets of disposal groups | 1,581 | 45,850 |
| Total assets | 2,401,652 | 1,840,829 |
| Liabilities | | |
| Deposits by banks | 258,044 | 312,294 |
| Customer accounts | 639,512 | 682,363 |
| Debt securities in issue | 300,289 | 274,172 |
| Settlement balances and short positions | 54,277 | 91,021 |
| Derivatives | 971,364 | 272,052 |
| Accruals, deferred income and other liabilities | 31,482 | 34,208 |
| Retirement benefit liabilities | 2,032 | 460 |
| Deferred tax | 4,165 | 5,400 |
| Insurance liabilities | 9,976 | 10,162 |
| Subordinated liabilities | 49,154 | 38,043 |
| Liabilities of disposal groups | 859 | 29,228 |
| Total liabilities | 2,321,154 | 1,749,403 |
| Minority interests | 21,619 | 38,388 |
| Equity owners | 58,879 | 53,038 |
| Total equity | 80,498 | 91,426 |
| Total liabilities and equity | 2,401,652 | 1,840,829 |
| Analysis of repurchase agreements included above | | |
| Reverse repurchase agreements and stock borrowing | | |
| Loans and advances to banks | 58,771 | 175,941 |
| Loans and advances to customers | 39,313 | 142,357 |
| | 98,084 | 318,298 |
| Repurchase agreements and stock lending | | |
| Deposits by banks | 83,666 | 163,038 |
| Customer accounts | 58,143 | 134,916 |
| | 141,809 | 297,954 |

Overview of consolidated balance sheet
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 were partially offset by the attributable loss for the period of £23.5 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.

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Cash flow

| | 2008 £m | 2007 £m | 2006 £m |
|---|---|---|---|
| Net cash flows from operating activities | (75,338) | 25,604 | 17,441 |
| Net cash flows from investing activities | 16,997 | 15,999 | 6,645 |
| Net cash flows from financing activities | 15,102 | 29,691 | (1,516) |
| Effects of exchange rate changes on cash and cash equivalents | 29,209 | 6,010 | (3,468) |
| Net (decrease)/increase in cash and cash equivalents | (14,030) | 77,304 | 19,102 |

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 £36,459 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, £8,603 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 principle 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.

2006

The major factors contributing to the net cash inflow from operating activities of £17,441 million were the profit before tax of £9,186 million adjusted for the elimination of foreign exchange differences of £4,516 million and depreciation and amortisation of £1,678 million, together with an increase of £3,980 million in operating liabilities less operating assets.

Net sales and maturities of securities of £8,000 million was partially offset by net purchases of property, plant and equipment of £1,292 million, resulting in the net cash inflow from investing activities of £6,645 million.

The issue of £671 million of equity preference shares, £3,027 million of subordinated liabilities and proceeds of £1,354 million from minority interests issued were more than offset by dividend payments of £2,727 million, purchase of ordinary shares amounting to £991 million, repayment of £1,318 million of subordinated liabilities and interest on subordinated liabilities of £1,409 million, resulting in a net cash outflow from financing activities of £1,516 million.

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Capital resources

The following table analyses the Group's regulatory capital resources on a fully consolidated basis at 31 December:

| | 2008 £m | 2007 £m | 2006 £m | 2005 £m | 2004 £m |
|---|---|---|---|---|---|
| Capital base | | | | | |
| Tier 1 capital | 69,847 | 44,364 | 30,041 | 28,218 | 22,694 |
| Tier 2 capital | 32,223 | 33,693 | 27,491 | 22,437 | 20,229 |
| Tier 3 capital | 260 | 200 | — | — | — |
| | 102,330 | 78,257 | 57,532 | 50,655 | 42,923 |
| Less: investments in insurance subsidiaries, associated undertakings and other supervisory deductions | (4,155) | (10,283) | (10,583) | (7,282) | (5,165) |
| Total capital | 98,175 | 67,974 | 46,949 | 43,373 | 37,758 |
| | | | | | |
| Risk-weighted assets | | | | | |
| Credit risk | 551,400 | | | | |
| Counterparty risk | 61,100 | | | | |
| Market risk | 46,500 | | | | |
| Operational risk | 36,800 | | | | |
| | 695,800 | | | | |
| Banking book: | | | | | |
| On-balance sheet | | 480,200 | 318,600 | 303,300 | 261,800 |
| Off-balance sheet | | 84,600 | 59,400 | 51,500 | 44,900 |
| Trading book | | 44,200 | 22,300 | 16,200 | 17,100 |
| | | 609,000 | 400,300 | 371,000 | 323,800 |
| | | | | | |
| Risk asset ratios | % | % | % | % | % |
| Tier 1 | 10.0 | 7.3 | 7.5 | 7.6 | 7.0 |
| Total | 14.1 | 11.2 | 11.7 | 11.7 | 11.7 |

Notes:

(1) The data for 2008 are on a Basel II basis; prior periods are on a Basel I basis.

(2) The data for 2004 are based on UK GAAP as previously published and regulated. As from 1 January 2005, the Group is regulated on an IFRS 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 2008, the Group's total RAR was 14.1% (2007 – 11.2%) and the Tier 1 RAR was 10.0% (2007 – 7.3%).

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On pages 57 to 123 of the Business review certain information has been audited and is labelled as such.

## Risk, capital and liquidity management (unaudited)

2008 has been one of the most challenging years for banks. The financial markets turmoil, which started in the second half of 2007 following concerns over the US sub-prime mortgage market, resulted in a global reduction in liquidity and the availability of term-funding. Confidence in financial institutions was eroded through 2008 as a result of an increased perception of counterparty risk following notable banking and insurance failures.

During the recent market turbulence, in common with other banks, the Group saw the availability of long term funding from both the capital markets and money markets decline significantly during the second half of 2008. As a result, reliance on shorter term funding increased with a consequent deterioration in the Group's liquidity profile. In response to the market stress, central banks increased liquidity through a number of facilities and schemes available to support their respective banking systems. In addition, governments around the world have provided capital to financial institutions and moved to offer guarantees and increase deposit insurance to reassure investors and depositors. As a global bank, the Group has access to a number of those facilities and schemes which, in common with many other banks, it has used to support funding.

Whilst the international stabilisation efforts led by various governments since September 2008 have helped, the knock-on economic impacts are now evident in markets globally. 2009 will see further strains for financial institutions. Whilst the liquidity crisis is likely to stabilise, the level of impairments will increase as recession spreads worldwide.

The Board, in the light of the severe and increasing deterioration in market conditions, the worsening economic outlook and difficulties in the credit markets, concluded that it was appropriate for the Group to strengthen its capital position.

The Group has responded to the changing business and economic conditions by reducing leverage, building and improving liquidity, raising additional capital and through augmenting its risk management resources to drive forward a number of strategic initiatives. The overall risk operating model has been strengthened to ensure its adequacy for changing market conditions and additional capital management disciplines are being embedded across the Group. There is an increased emphasis on the independence of the control functions, capital allocation, stress testing and risk return throughout the Group.

## Risk governance (unaudited)

Risk and capital management strategy is 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.

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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. GAC monitors the identification, evaluation and management of all significant risks throughout the Group. | Independent non-executive directors |
| Advances Committee (AC) | Deals with transactions that exceed the Group Credit Committee's delegated authority and large exposures. | Members of GEMC<br>Group Chief Credit Officer |
| Group Executive Management Committee (GEMC) | Ensures implementation of strategy consistent with risk appetite. | Business and function heads, as determined by the Group Chief Executive/Board |
| 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<br>Group Finance Director<br>Group Chief Risk Officer<br>Chairman, Regional Markets<br>Chief Executive, RBS UK<br>Chief Executive, Global Banking & Markets |
| Group Risk Committee (GRC) | Recommends limits and approves processes and policies to ensure the effective management of all material risks across the Group. | Group Chief Risk Officer<br>Group head of each risk type<br>Group Treasurer<br>Chief Executive and Chief Risk Officer from each division<br>Group General Counsel and Group Secretary<br>Group Chief Economist |
| Group Credit Committee (GCC) | Approves credit proposals under the authority delegated to the committee by the Board and/or the Advances Committee. | Members as determined by GEMC |
| Group Asset and Liability Management Committee (GALCO) | Identifies, manages and controls the Group balance sheet risks. | Group Finance Director<br>Chairman/Chief Executive from each division<br>Group Treasurer<br>Group Chief Risk Officer<br>Heads of Group functions |
| Group Chief Executive's | Acts as a forum for the provision of information and advice to the Group Chief | Group Chief Executive<br>Group Finance Director |

| | | |
|---|---|---|
| Advisory Group (GCEAG) | Executive. Forms part of the control process of the Group. | Chairman and Chief Executives from each division<br>Group Chief Risk Officer<br>Group General Counsel and Group Secretary<br>Group Directors, Strategy, Communications and Human Resources |

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Management responsibilities (unaudited)
All staff have a role to play in the day to day management of risk, in line with Group policy, which is set and managed by specialist staff in:

Risk Management: credit, market, operational, regulatory, enterprise and insurance risk, together with risk analytics.

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 toward greater functional independence, the divisional Chief Risk Officers now have a direct reporting line to the Group Chief Risk Officer.

Group Internal Audit (GIA) supports the GAC in providing an independent assessment of the design, adequacy and effectiveness of internal controls.

Risk appetite (unaudited)
Risk and capital management across the Group is based on the risk appetite set by the Board, which is established through setting strategic direction, contributing to, and ultimately approving annual plans for each division and regularly reviewing and monitoring the Group's performance in relation to risk through monthly Board reports.

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

Quantitative: encompassing stress testing, risk concentration, value- at-risk, liquidity and credit related metrics.

Qualitative: focusing on 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 GEMC 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 a policy framework ensuring that all staff within the Group make appropriate risk and reward trade-offs within pre-agreed boundaries.

| How we do business | Policy |
|---|---|
| Customers | Identifying our customers. |
| | Treating our customers fairly. |
| | Delivering customer value. |
| | Respecting customer confidentiality. |
| Risks | Identifying and managing our risks. |
| | Understanding our markets. |
| Security | Protecting our assets, premises, systems and data. |
| | Operating our processes, systems and controls. |
| | Dealing with external suppliers. |
| People | Working in the Group. |
| | Promoting diversity and inclusion. |
| Reputation | Working within laws and regulation. |

| | |
|---|---|
| | Investing in the community. |
| | Conducting sustainable business. |
| | Maintaining key services and processes. |
| Finances | Managing our capital and resources. |
| | Accounting and financial reporting. |

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

Capital (unaudited)

The Group aims to maintain appropriate levels of capital, in excess of regulatory requirements, to ensure its capital position remains appropriate given the economic and competitive environment. Capital adequacy and risk management are closely aligned. The Group undertakes a regular assessment of its internal capital requirement based on a quantification of the material risks to which it is exposed.

Composition of capital

The Group's regulatory capital resources at 31 December 2008 on a fully consolidated basis, and in accordance with Financial Services Authority (FSA) definitions were as follows:

| | Basel II 31 December 2008 £m | Basel II 1 January 2008 £m | Basel I 31 December 2007 £m |
|---|---|---|---|
| Capital base: | | | |
| Core Tier 1 capital: ordinary shareholders' funds and minority interests less intangibles | 47,623 | 27,324 | 27,324 |
| Preference shares and tax deductible securities | 24,038 | 17,040 | 17,040 |
| Less deductions from Tier 1 capital | (1,814) | (1,457) | n/a |
| Tier 1 capital | 69,847 | 42,907 | 44,364 |
| Tier 2 capital | 32,223 | 28,767 | 33,693 |
| Tier 3 capital | 260 | 200 | 200 |
| | 102,330 | 71,874 | 78,257 |
| Less: supervisory deductions | (4,155) | (5,078) | (10,283) |
| Total regulatory capital | 98,175 | 66,796 | 67,974 |
| Risk-weighted assets: | | | |
| Credit risk | 551,400 | 542,100 | |
| Counterparty risk | 61,100 | 37,500 | |
| Market risk | 46,500 | 17,900 | |
| Operational risk | 36,800 | 36,000 | |
| | 695,800 | 633,500 | |
| Banking book | | | 564,800 |
| Trading book | | | 44,200 |
| | | | 609,000 |
| Risk asset ratio: | | | |
| Core Tier 1 | 6.8% | 4.3% | 4.5% |
| Tier 1 | 10.0% | 6.8% | 7.3% |
| Total | 14.1% | 10.5% | 11.2% |

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%. The Group has complied with the FSA's capital requirements throughout the year. A number of subsidiaries and sub-groups within the Group, principally banking and insurance entities are subject to additional individual regulatory capital requirements in the UK and overseas.

Capital allocation
As part of the annual planning and budgeting cycle, each division is allocated capital based upon risk-weighted assets (RWAs) and their 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 the divisions to manage their allocated RWAs.

Group Treasury and GALCO monitor actual utilisation by tracking capital available and the utilisation of capital by divisions. GALCO makes the necessary decisions around re-allocation of budget and changes in RWA allocations.

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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 (AIRB) for calculating RWAs, making the Group one of a small number of banks whose risk systems and approaches have reached the regulatory standards.

For operational risk, the Group uses The Standardised Approach (TSA), which calculates operational risk-weighted assets based on gross income. In line with other banks, the Group is considering adopting the Advanced Measurement Approach (AMA) for all or part of the business.

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

| | Basel II 31 December 2008 £bn | Basel II 1 January 2008 £bn | Basel I 31 December 2007 £bn |
|---|---|---|---|
| Global Markets | | | |
| – Global Banking & Markets | 278.5 | 211.9 | 188.7 |
| – Global Transaction Services | 19.6 | 16.8 | 15.4 |
| Regional Markets | | | |
| – UK Retail & Commercial Banking | 152.5 | 153.1 | 179.0 |
| – US Retail & Commercial Banking | 78.0 | 53.8 | 57.1 |
| – Europe & Middle East Retail & Commercial Banking | 30.9 | 30.3 | 36.7 |
| – Asia Retail & Commercial Banking | 6.4 | 4.9 | 3.3 |
| Other | 11.9 | 15.3 | 9.8 |
| RFS Holdings minority interest | 118.0 | 147.4 | 119.0 |
| Group | 695.8 | 633.5 | 609.0 |

Basel II is cyclical, unlike Basel I where RWAs are stable through the cycle. Changes in RWA totals are driven by external economic factors and their impact on the risk profile of the underlying portfolio of assets, rather than changes in the asset mix. Whilst Basel II tries to reduce this variation by incorporating measures correlated to downturn conditions, it remains sensitive to cyclical variations.

The AIRB approach to Basel II is based on the following metrics.

Probability of default (PD) models estimate the likelihood that a customer will fail to make full and timely repayment of credit obligations over a one year time horizon. Customers are assigned an internal credit grade which corresponds to PD. Every customer credit grade across all grading scales in the Group can be mapped to a Group level credit grade.

Exposure at default (EAD) models estimate the expected level of utilisation of a credit facility at the time of a borrower's default. The EAD may be assumed to be higher than the current utilisation (e.g. in the case where further drawings may be made on a revolving credit facility prior to default) but will not typically exceed the total facility limit.

Loss given default (LGD) models estimate the economic loss that may occur in the event of default and represent the debt that cannot be recovered. The Group's LGD models take into account the type of borrower, facility and any risk mitigation such as security or collateral held.

In addition to minimum capital calculated, 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, 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 will publish its Pillar 3 (Market disclosures) on the external 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 risk weighted assets (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 is central to the Group's risk and capital framework and integral to Basel II. Stress testing is used at divisional and Group level to assess risk concentrations, estimate the impact of earnings on capital, determine the overall capital adequacy under stress conditions and identify mitigating actions. The principal business benefits of the stress testing framework are: understanding the impact of recessionary scenarios; assessing material risk concentrations; and forecasting the impact of market stress 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 two core elements of scenario stress testing:

Recessionary stress testing considers the impact on both earnings and capital of a range of recessionary scenarios. These are multi-year systemic shocks to assess the Group's ability to meet its capital requirements and liabilities as they fall due under a significant but plausible downturn in the business cycle and/or macroeconomic environment. The summary results are included within the monthly risk report to the Board and discussed in separate papers on a half-yearly basis.

Integrated stress testing considers firm wide stress tests to measure the Group's exposure to exceptional but plausible economic and geopolitical events. Stress testing supports the identification and quantification of material risks that may arise under stress scenarios, and provides information to support management decision-making around risk appetite and control.

Cross divisional stress testing, undertaken to support the Group's framework for managing industry and geographical sector concentrations, is performed through the identification of scenarios which are likely to affect groups of inter-related (correlated) sectors. These stress tests are discussed with senior divisional management and are reported to GRC, GEMC, GALCO and GAC. The Group manages to a trigger limit on the stressed impairment charge for an individual scenario.

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.

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 from the failure of customers to meet their financial obligations to the Group. | Loss characteristics vary materially across portfolios.<br>Significant correlation between losses and the macroeconomic environment.<br>Concentration risk. |
| Funding and liquidity risk | The risk of losses through being unable to meet obligations as they fall due. | Potential to disrupt the business model and stop normal functions of the Group.<br>Significantly correlated with credit risk losses. |
| Market risk | The risk that the value of an asset or liability may change as a result of a change in market rates. | Potential for large material losses.<br>Significantly correlated with equity risk and the macroeconomic environment. |
| 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.<br>Infrequent material losses. |
| Operational risk | The risk of financial loss or reputational impact resulting from fraud; human error; | Generally immaterial losses. |

| | | |
|---|---|---|
| | ineffective or inadequately designed processes or systems; improper behaviour; legal events; or from external events. | |
| Regulatory risk | The risks arising from regulatory changes/enforcement. | Risk of regulatory changes.<br>Compliance with regulations.<br>Potential for fines and/or restrictions in business activities. |
| Other risk | The risks arising from reputation and pension fund risk. | Additional regulation can be introduced as a result of other risk losses. |

Credit risk

Principles for credit risk management (audited)

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 granting of credit approval, whether this is individually or collectively as part of a credit committee. 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.

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.

Specialist credit risk teams oversee the credit process independently, making credit decisions within their discretion, or recommending decisions to the appropriate credit committee.

Assessments of corporate borrower and transaction risk are undertaken using fundamental credit analysis and the application of general corporate and certain specialist counterparty credit risk models. Financial markets counterparties are approved by a dedicated credit function which specialises in traded market product risk. Specialist credit grading models exist for certain bank and non-bank financial institutions.

Different approaches are used for the management of wholesale and retail businesses:

Wholesale businesses: exposures are aggregated to determine the appropriate level of credit approval required and to facilitate consolidated credit risk management. Credit applications for corporate customers are prepared by relationship managers (RMs) in the units originating the credit exposures, or by the RM 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 counterparty credit grades and LGD estimates using approved models, which are also independently checked by the credit team.

Retail businesses: the retail business makes a large volume of small value credit decisions. Credit decisions will typically involve an application for a new or additional product or a change in facilities on an existing product. The majority of these decisions are based upon automated strategies utilising industry standard credit and behaviour scoring techniques.

Model validation (audited)
The performance and accuracy of credit models is critical, both in terms of effective risk management and also the calculation of risk parameters (PD, LGD and EAD) used by the Group to calculate RWAs. The models are subject to frequent validation internally and, if used as part of the AIRB Basel II framework (see page 61), have been reviewed and approved for use by the FSA.

Independent model validation is performed by the Group. This includes an evaluation of the model development and validation for the data set used, logic and assumptions, and performance of the model analysis. Where required, the Group has engaged external risk management consultants to undertake independent reviews and report their findings to the Wholesale or Retail Credit Model Committee. This provides a benchmark against industry practices.

The validation results are a key factor in deciding whether a model is recommended for ongoing use. The frequency, depth and extent of the validation are consistent with the materiality and complexity of the risk being managed. The Group's validation processes include:

Developmental evidence: to ensure that the credit risk model adequately discriminates between different levels of risk and delivers accurate risk estimates.

Process verification: whether the methods used in the credit risk models are being used, monitored and updated in the way intended in the design of the model. Initial testing and validation is performed when the model is developed with the performance of models being assessed on an ongoing basis.

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Credit risk mitigation (audited)
The Group takes a number of steps to mitigate credit risk. The key risk mitigants are as follows:

Real estate: the most common form of security held is real estate within the consumer and wholesale businesses.

Financial collateral: is taken to support credit exposures in the non-trading book. Financial collateral is also taken in Global Markets and Regional Markets to support trading book exposures and is incorporated in E* (adjustment to the exposure value) calculations.

Other physical collateral: the Group takes a wide range of other physical collateral including business assets (stock and inventory, plant and machinery, equipment), project assets, intangible assets which provide a future cashflow and real value, commodities, vehicles, rail stock, aircraft, ships and receivables (not purchased).

Guarantees: third party guarantees are taken from banks, government entities, export credit agencies, and corporate entities. The Group's recovery value estimation methodology is sensitive to the variations in the credit quality of guarantors. Standby letters of credit are also given value in LGD models. Conditional guarantees are accepted, in accordance with internal requirements, and are included as appropriate in PD and LGD estimates (e.g. small firms loan guarantee schemes, completion guarantees). Personal guarantees are considered in the normal credit process where there is a charge over specific assets. While personal guarantees may be called for and are always accepted, no value is given to unsupported personal guarantees in any credit models.

Credit derivatives: credit derivative activity is conducted through designated units within GBM to ensure consistency and appropriate control. Group policies are designed to ensure that the credit protection is appropriate to support offset for an underlying trading book asset or improvement to the LGD of a banking book asset. Within the banking book, credit derivatives are used as risk and capital management tools. The principal counterparties are banks, investment firms and other market participants, with the majority subject to collateralisation under a credit support annex. In accordance with internal policy, stress testing is conducted on the counterparty credit risk created by the purchase of credit protection.

Minimum standards (for example loan to value, legal certainty) are ensured through the policy framework.

Credit risk assets (audited)
Credit risk assets consist of loans and advances (including overdraft facilities), instalment credit, finance lease receivables and other traded instruments across all customer types. The Group uses a series of models to measure the size of its exposure to credit risk and to calculate expected EAD in both its trading and banking books. In so doing, the Group recognises the effects of credit risk mitigation that reduces potential loss.

| Credit risk assets (unaudited) | 2008<br>£bn | 2007<br>£bn |
|---|---|---|
| Global Markets | 469.8 | 307.4 |
| Regional Markets | | |
| – UK Retail & Commercial Banking | 223.5 | 202.1 |
| – US Retail & Commercial Banking | 82.9 | 58.1 |
| – Europe & Middle East Retail & Commercial Banking | 64.7 | 47.1 |
| – Asia Retail & Commercial Banking | 7.5 | 6.8 |
| RBS Insurance | 4.6 | 5.1 |

| | | |
|---|---|---|
| Other | 2.0 | — |
| RFS Holdings minority interest | 176.8 | 206.0 |
| Group | 1,031.8 | 832.6 |

Note:

(1) Excluding reverse repurchase agreements and issuer risk.

Credit risk assets as at 31 December 2008 were £1,031.8 billion (2007 – £832.6 billion), an increase of £199.2 billion during the year.

The discussion and disclosures on pages 65 to 72 relate only to the Group before RFS Holdings minority interest.

Facilities included within RFS Holdings minority interests have not been migrated to RBS risk systems, as they will not be part of the Group following separation of the ABN AMRO business.

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Credit concentration risk (including country risk) (audited)
The Group defines three key areas of concentration in credit risk that are monitored, reported and managed at Group and divisional levels. These are single name concentration, industry/sector and country risk. The Group has a series of quantitative and qualitative controls in place to limit the amount of concentration risk in credit portfolios.

A threshold is set on the aggregate LGD to a single customer group above which approval is required from the Group's most senior credit committee, the Advances Committee.

During the year work progressed on an enhancement of the frameworks for managing single name and sector concentrations. These enhancements are planned to be fully implemented in 2009 to improve the identification and management of concentrations in the portfolio through the introduction of additional parameters and increased scrutiny of concentration limit excesses.

A stress testing framework, Correlated Exposure Loss Testing, assesses the impact on the Group's impairment charge of non-systemic events that affect groups of inter-related sectors in order to limit the impact of these scenarios to within defined tolerances.

Country risk arises from sovereign events (e.g. default or restructuring); economic events (e.g. contagion of sovereign default to other parts of the economy, cyclical economic shock); political events (e.g. 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 acquisition of ABN AMRO materially increased the Group's country risk profile, therefore significant enhancements to the Group's country risk framework have been implemented and continue to be developed.

It is the Group's policy to monitor and control country risk exposures and to avoid excessive concentrations. The Group's appetite is expressed by a matrix of limits by country risk grade and is approved by GEMC. The Group's exposure is managed and measured within this appetite by the Group Country Risk Management Committee (GCRMC), that has delegated authority from the GRC to manage country risk and agree related policy. Membership of GCRMC comprises the Group Chief Credit Officer, Heads of Credit and business representatives from those divisions with material country risk exposures. GCRMC sets limits 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 and longer tenor transactions, for example – may be established depending on the country outlook and business strategy. A country watch list framework is in place to proactively monitor emerging issues and facilitates the development of mitigation strategies.

The country risk table below shows credit risk assets exceeding £1 billion by borrower domicile and is stated gross of mitigating action which may have been taken to reduce or eliminate exposure to country risk events.

| Risk countries (unaudited) | Consumer £m | Sovereign £m | Banks and financial institutions £m | Corporate £m | Total £m |
|---|---|---|---|---|---|
| Russia | 51.0 | — | 362.0 | 5,361.0 | 5,774.0 |
| United Arab Emirates | 756.8 | 91.5 | 1,721.9 | 2,988.6 | 5,558.8 |
| India | 1,020.0 | 5.7 | 737.9 | 3,800.6 | 5,564.2 |
| Turkey | 24.8 | 363.6 | 603.2 | 3,035.5 | 4,027.1 |

| | | | | | |
|---|---|---|---|---|---|
| China | 24.6 | 61.1 | 1,146.3 | 2,027.2 | 3,259.2 |
| South Korea | 1.5 | — | 1,743.0 | 1,104.1 | 2,848.6 |
| Taiwan | 1,019.3 | — | 1,393.2 | 825.0 | 3,237.5 |
| Mexico | 4.2 | 57.1 | 210.9 | 1,999.9 | 2,272.1 |
| Czech Republic | 2.1 | 593.5 | 175.5 | 1,057.9 | 1,829.0 |
| Kazakhstan | 69.5 | 17.0 | 900.8 | 858.9 | 1,846.2 |
| Poland | 6.8 | 38.5 | 309.1 | 1,308.6 | 1,663.0 |
| Chile | 0.3 | 26.1 | 383.7 | 1,250.5 | 1,660.6 |
| Brazil | 3.6 | — | 1,012.3 | 641.7 | 1,657.6 |
| Saudi Arabia | 23.2 | — | 534.9 | 679.4 | 1,237.5 |
| Romania | 583.6 | 145.3 | 160.4 | 916.8 | 1,806.1 |
| Greece | 15.1 | 135.3 | 210.3 | 702.7 | 1,063.4 |
| Hungary | 5.1 | 73.9 | 101.3 | 831.4 | 1,011.7 |

Note:

(1) Risk countries are defined as those with an internal rating of A+ and below. In addition, United Arab Emirates is included which has a rating of AA.

(unaudited)
The outlook for developing markets in 2009 is very challenging, as developed economy demand is weak, liquidity conditions are tight and risk appetite is yet to return. Asian growth is slowing sharply as trade contracts, but generally, both sovereign and private sector leverage is lower than during the 1998 crisis, providing scope for recovery. The Middle East is more insulated from the effects of economic disruption but certain high growth countries, such as UAE, will face challenges. Eastern Europe faces a deep correction as large economic imbalances unwind. Falling commodity prices and US weakness will also affect Latin America, but the region is more resilient than during previous downturns due to reform progress and policy orthodoxy in its largest economies.

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Asset quality by industry and geography (unaudited)
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.

Credit risk assets by industry sector (Group before RFS Holdings minority interest)

Note:
(1) Graph data are shown net of provisions, reverse repurchase agreements and issuer risk for 2008 and 2007.

As at 31 December 2008, 26% of credit risk assets (2007 – 27%) related to personal and includes mortgage lending and other smaller loans that are intrinsically well-diversified. Corporate industry exposure comprised 48% of credit risk assets (2007 – 50%), which are well diversified across a range of sectors. Banks and financial services account for 21% of credit risk assets (2007 – 19%) and public sector and quasi government credit risk assets make up the remaining 5% (2007 – 4%).

Credit risk assets by geography (Group before RFS Holdings minority interest)
Note:
(1) Graph data are shown net of provisions, reverse repurchase agreements and issuer risk for 2008 and 2007.

As at 31 December 2008, 38% of credit risk assets (2007 – 46%) related to the United Kingdom. Western Europe comprised 27% of credit risk assets (2007 – 23%). North America comprised 21% of credit risk assets (2007 – 19%).

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Credit risk asset quality (audited)
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 disparate portfolios. Accordingly, measurement of risk is easily aggregated and can be reported at increasing levels of granularity depending on audience and business need.

The Group has adopted, as part of the move to Basel II, a new master grading scale for wholesale exposures which comprises 27 grades. These in turn map to ten asset quality (AQ) bands used for both wholesale and retail exposures. This replaced the less granular AQ1-5 bands used prior to 2008.

The relationship between these measures is shown below. (unaudited)

| | PD Range | | | |
|---|---|---|---|---|
| Master grading scale | Lower | Upper | New AQ1-10 bands | Old AQ1-5 bands |
| 1 | 0% | 0.006% | | |
| 2 | 0.006% | 0.012% | | |
| 3 | 0.012% | 0.017% | AQ1 | |
| 4 | 0.017% | 0.024% | | |
| 5 | 0.024% | 0.034% | | AQ1 |
| 6 | 0.034% | 0.048% | AQ2 | |
| 7 | 0.048% | 0.067% | AQ3 | |
| 8 | 0.067% | 0.095% | | |
| 9 | 0.095% | 0.135% | | |
| 10 | 0.135% | 0.190% | | |
| 11 | 0.190% | 0.269% | AQ4 | |
| 12 | 0.269% | 0.381% | | AQ2 |
| 13 | 0.381% | 0.538% | | |
| 14 | 0.538% | 0.761% | AQ5 | |
| 15 | 0.761% | 1.076% | | AQ3 |
| 16 | 1.076% | 1.522% | AQ6 | |
| 17 | 1.522% | 2.153% | | AQ4 |
| 18 | 2.153% | 3.044% | | |
| 19 | 3.044% | 4.305% | AQ7 | |
| 20 | 4.305% | 6.089% | | |
| 21 | 6.089% | 8.611% | | |
| 22 | 8.611% | 12.177% | AQ8 | |
| 23 | 12.177% | 17.222% | | AQ5 |
| 24 | 17.222% | 24.355% | | |
| 25 | 24.355% | 34.443% | AQ9 | |
| 26 | 34.443% | 100% | | |
| 27 | 100% | 100% | AQ10 | |

Credit risk assets by new AQ1-10 bands (Group before RFS Holdings minority interest) (unaudited)

TCRE (%)

Note:
(1) Graph data are shown net of provisions, reverse repurchase agreements and issuer risk for 2008.

The following table shows the movement between 2007 and 2008 based on the old AQ1-5 bands for the Group before RFS minority interest. (unaudited)

Note:
(1) Graph data are shown net of provisions, reverse repurchase agreements and issuer risk for 2008 and 2007. (unaudited)
As at 31 December 2008, including ABN AMRO net of minority interest, exposure to investment grade counterparties (AQ1) accounted for 47% (2007 – 37%) of credit risk assets and 46% (2007 – 59%) of exposures were to counterparties between AQ2 and AQ4. The exposure to the lowest asset quality (AQ5) is 7% (2007 – 4%).

Expressed as an annual PD, the upper and lower boundaries and the midpoint for each of these Group level asset quality grades are as follows:

| | Annual probability of default | | | |
|---|---|---|---|---|
| | Minimum | Midpoint | Maximum | S&P |
| Asset quality grade | % | % | % | equivalent |
| AQ1 | 0.00 | 0.10 | 0.20 | AAA to BBB- |
| AQ2 | 0.21 | 0.40 | 0.60 | BB+ to BB |
| AQ3 | 0.61 | 1.05 | 1.50 | BB- to B+ |
| AQ4 | 1.51 | 3.25 | 5.00 | B+ to B |
| AQ5 | 5.01 | 52.50 | 100.00 | B and below |

Key credit portfolios (unaudited)
The following discussion relates only to the Group before RFS Holdings minority interest. All exposures are monitored closely, but in the current environment the following are under specific scrutiny:

Property lending (unaudited)
Commercial property
The commercial property portfolio totals £97 billion. The bulk of this is concentrated in GBM (£31 billion) and RBS UK (£42 billion) with the remainder in Ulster Bank (£17 billion) and CFG (£6 billion).

Lending falls into different categories and is spread across Investment (72.6%), Development (24.1%) and Other (3.3%). Speculative lending represents 1.6% of this portfolio. 58% of the lending is in the UK, 30% Western Europe, 8% North America and 4% RoW but with the extent of the current global downturn all markets are coming under considerable pressure.

Whilst the Group expects to see an overall deterioration in LTV ratios, 72% of the portfolio within GBM and UKCB continue to have an LTV less than 75% and an average interest coverage ratio (ICR) for GBM of 164% and 151 % for RBS UK. The Group’s lending approach has always been predominantly cash flow driven and areas of stress in the portfolio will primarily be impacted by the wider corporate and economic environment affecting tenant quality with the retail sector being an area of focus at the present time.

The Group has experienced a number of defaults in its Spanish portfolio with current limits of £2 billion managed via the Global Restructuring Group. Total impaired limits across the portfolio are £3.9 billion. Limits currently subject to a higher level of monitoring (watch) total £18.9 billion and are actively risk managed.

The outlook for commercial property will remain challenging during 2009 with further falls in capital values expected due to a lack of liquidity and weak demand for assets. There is emerging evidence of falling rents and increasing vacancy rates although downward pressure on rents and longer void periods can be expected due to the weakening economic climate. The Group’s strategy throughout 2008 has been to reduce its exposures wherever prudent, continuing the process of tightening lending parameters begun in the second half of 2007.

Residential mortgages

The Group originates residential mortgages through retail channels in all four divisions within Regional Markets however activity is primarily in the UK, the US and Ireland.

UK residential mortgages
The UK mortgage portfolio totalled £74.4 billion (as at 31 December 2008) an increase of 11% during the year due to strong sales growth and lower redemption rates. The main brands are the Royal Bank, NatWest, the One Account, First Active and Direct Line. The assets comprise prime mortgage lending and include 7.0% (£5.2 billion) of exposure to residential buy-to-let. There is a very small legacy self-certification book (0.5% of total assets) which was withdrawn from sale in 2004.

The Group exited the 100% LTV market in the first quarter of 2008, further restricted the proportion of highest LTV loans and reviewed affordability criteria during the year. The average LTV for new business increased from 62% to 67% in 2008 mainly due to a reduction in the proportion of business within the lowest LTV bands.

The arrears rate (three or more payments missed) on the combined Royal Bank and NatWest brands was 1.5% (31 December 2008) up from 1.0% (31 December 2007). The mortgage impairment charge was £33 million for 2008 (2007 – £19 million) and in current economic conditions is expected to increase further. Anticipated losses from impaired mortgages are covered by a combination of impairment provisions and post default suspended interest. The combined provision cover is currently 0.18% of balances.

Repossessions totalled 1,141 in 2008 (compared with 758 in 2007) with similar volumes in each half of the year.

US real estate
Citizens Financial Group's (CFG) residential real estate portfolio totalled $50.1 billion at 31 December 2008 (2007 – $53.1 billion) comprising $13.8 billion of first mortgages and $36.3 billion of Home Equity loans and lines. This reduction includes the sale of $1.4 billion of real estate assets to the Federal National Mortgage Association in December 2008.

CFG has historically adopted conservative risk policies in comparison to the general market. Small exposures to sub-prime (FICO <=620, approximately 0.6%) and Alt-A / other non-conforming (4.5%) from past bank acquisitions are in run-off. The average indexed LTV was 69% as at 31 December 2008 (2007 – 62%). Loan acceptance criteria were further tightened during 2008 to address deteriorating economic conditions.

The Serviced By Others (SBO) portfolio consists of purchased pools of home equity loans and lines whose LTV and geographic profiles have in the current economic conditions resulted in a higher write-off rate of 4.8% in 2008 than core portfolios. SBO was closed to new purchases in the third quarter of 2007 and is in run-off with exposure down from $8.3 billion (31 December 2007) to $7.0 billion (31 December 2008).

Ireland residential mortgages
The residential mortgage portfolio in Ireland across the Ulster Bank and First Active brands totalled £24.6 billion (as at 31 December 2008) with 92.8% in the Republic of Ireland and 7.2% in Northern Ireland. This represents growth of 6% in the Republic of Ireland (ignoring exchange rate movements) and 6% in Northern Ireland. During the course of 2008, Ulster Bank exited the 100% LTV market and tightened LTV and affordability criteria in other segments. The arrears rate (three or more payments missed) increased to 1.6% at 31 December 2008 from 0.8% at end 2007 driven by deteriorating economic conditions. Repossession remained low and totalled 37 for 2008.

Financial institutions
The confidence and liquidity crisis affecting the banking sector saw the near collapse of some major banks in Western countries along with the fall of Lehman Brothers and the Icelandic banking system, which in turn threatened the

stability of national and global banking systems. Government actions to restore stability by providing guarantees, liquidity facilities, capital injections and facilitating the consolidation of weaker banks with stronger ones met with some success. There remains a high level of risk in the banking sector in 2009, particularly due to the deepening recession that many countries face and increasing corporate defaults.

Financial Institutions constitute the largest segment of the Group's wholesale credit portfolio with exposure of £181 billion. Due to difficulties faced by the sector, the portfolio quality has weakened during 2008. 92% of exposure is to counterparties in developed OECD countries while 90% of exposure is to investment grade counterparties.

The Banks portfolio is the biggest sub-sector with exposure of £86 billion. At the time of default, the Group's exposures to Lehman Brothers and the Icelandic banks totalled £802 million and £494 million respectively and represented less than 1% of the total Banks portfolio.

2008 was a difficult year for the hedge funds sector. More hedge funds collapsed during 2008 than in the previous ten years and the values of many declined significantly. The spate of redemptions from investors forced major hedge fund groups to halt withdrawals. The trends are set to continue in 2009 and the contraction of this sector is expected.

The Group's exposure to leveraged funds (including hedge funds) totalled £10.3 billion. The majority of hedge funds are domiciled in the UK and US but the portfolio is diversified by fund strategy. The Group's activities with hedge funds are primarily collateralised derivatives trading. Exposures to funds encountering problems were reduced, collateral margining was reviewed upwards to further mitigate risk and the appropriateness of limits is regularly reviewed.

During 2009, the Group will continue to place emphasis on the pro-active management of financial institutions at counterparty and portfolio levels, recognising that liquidity is likely to remain tight and credit quality is likely to deteriorate further across a range of portfolios.

Corporate sectors (unaudited)
This section discusses the automotive, shipping, oil and gas sectors, given their significance in the current market environment.

Automotive
The automotive sector exposure totals £14.5 billion, the majority falling within GBM (£9.1 billion), RBS UK (£3.3 billion) and CFG (£1.3 billion). The exposure is spread across the following segments and geographies:

| Segment | Credit book £bn | % |
|---|---|---|
| Original equipment manufacturer/commercial vehicles | 3.3 | 23 |
| Captive finance companies | 1.1 | 8 |
| Component suppliers | 2.4 | 16 |
| Retailers/services | 5.1 | 35 |
| Rental | 2.6 | 18 |
| Total | 14.5 | 100 |

| Domicile | Credit book £bn | % |
|---|---|---|
| Americas | 4.0 | 28 |
| Central Eastern Europe Middle East and Africa | 1.1 | 7 |
| UK | 4.2 | 29 |
| Western Europe | 4.3 | 30 |
| Asia | 0.9 | 6 |
| Total | 14.5 | 100 |

The automotive sector faces numerous challenges with a heavy reliance on discretionary consumer spending, high leverage, volatile input prices and an ongoing pressure to reduce fuel emissions resulting in a shift to smaller cars and overseas production. The Group has maintained a cautious approach to this sector and focus on the largest, most diversified and financially strong counterparties with a wide product offering. Notwithstanding this approach, due to the scale of the downturn in this sector the Group can expect further pressure to be seen across the portfolio. Of particular concern are exposures to the captive finance companies where credit impaired limits total £1.4 billion. The Group continues to seek ongoing limit reductions and improved security.

Shipping
The shipping exposure is £16.6 billion and is almost entirely within GBM. The portfolio is divided across the following sectors:

| Sector | Credit book £bn | % |
|---|---|---|
| Dry bulk | 4.8 | 29 |
| Tankers | 6.3 | 38 |
| Container | 1.6 | 10 |

| | | |
|---|---|---|
| Gas/offshore | 2.3 | 14 |
| Other | 1.6 | 9 |
| Total | 16.6 | 100 |

The majority of the exposures are strong relationships with loans structured to capture direct vessel cash flows, secured on the vessels themselves with the benefit of full security over the asset and all related cash flows. The Group's approach to the sector recognises the cyclical nature of shipping with a focus on experienced independent owners with strong liquidity; customer deposits across the portfolio total £5 billion. Assets financed are non-specialist dry bulk, double hulled tankers and containers.

Following an unprecedented rise in ship values over recent years there has been a material correction since mid 2008 with the dry bulk index falling by c.90% which may affect owners' ability to meet collateral calls. Combined with record ship deliveries for 2009-10 the Group has seen a significant decline in asset values. The Group's exposure to new build assets is significant with commitments relating to 236 vessels in the dry bulk and tanker segment.

The Group currently has £0.5 billion of limits to clients on watch list, but the portfolio comprises modern assets (86% of exposures are secured on vessels built since 2000), which exhibit, for the most part, good cash flow and liquidity.

Oil and gas

The Group's exposure to this sector totals £24.0 billion across the following sectors and geographies:

| Sector | Credit book £bn | % |
|---|---|---|
| Vertically integrate/exploration and production | 9.5 | 40 |
| Midstream | 5.0 | 21 |
| Refining and marketing | 4.6 | 19 |
| Oilfield services | 4.9 | 20 |
| Total | 24.0 | 100 |

| Domicile | Credit book £bn | % |
|---|---|---|
| Americas | 10.6 | 44 |
| Western Europe | 7.6 | 32 |
| CEEMEA | 4.6 | 19 |
| Asia Pacific | 1.2 | 5 |
| Total | 24.0 | 100 |

ABN AMRO and RBS have a number of common clients in this sector, and the Group is working to reduce exposures back within Group concentration limits, primarily in relation to investment grade, vertically integrated counterparties and several of the larger, global exploration and production companies. The Group's exposures to exploration and production companies are principally secured borrowing base facilities referenced to conservative forward looking oil price assumptions that are adjusted on a regular basis. Unsecured exposures are primarily to oil majors and state owned entities.

Global Restructuring Group (GRG) (audited)
GRG was formed in 2008, tasked with managing the Group's problem and potential problem exposures to help rejuvenate and restore customers to profitable business. This may include assisting with the restructuring of their businesses and/or renegotiation.

GRG brings together previously disparate functions across the Group. Its primary function is to work closely with the Group's customer facing businesses to support the proactive management of any problem lending. This is based on a clear process (watch listing) which requires the transfer of problem credits to GRG. GRG reports to the Group Chief Risk Officer.

Given the current economic outlook, it is particularly important that potential problems are identified early and referred to GRG as the Group's past experience has shown that the sooner specialists in restructuring are engaged, the greater the likelihood of a successful outcome. Early identification of potential problems therefore has a benefit to the borrower as well as to the Group.

GRG is structured with specialist teams focused on: large corporate cases (higher value, multiple lenders); small/mid size business cases (lower value, bilateral relationships); and recovery/litigations. Given the negative trends in the portfolio in 2008, the size of GRG has grown substantially and further investment in staffing is expected in 2009.

Originating business units liaise with GRG upon the emergence of a potentially negative event or trend that may impact a borrowers' ability to service its debt. This may be a significant deterioration in some aspect of the borrowers' 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.

Ensure key lessons learned are fed back into origination policies and procedures.

At the start of 2008, the volume and value of cases managed by GRG was low relative to historic levels. During the year, the rate of transfer of cases to GRG accelerated sharply. Cases originated from all divisions and across most sectors although the rate of value growth was sharply higher due to the transfer of a number of high value cases from GBM. Commercial property cases made up a significant proportion of transfers from all divisions.

Retail collections and recoveries (audited)
There are collections and recoveries functions in each of the four regional markets. Their role is to provide support and assistance to customers who are currently experiencing difficulties meeting their financial obligations.

Where possible, the aim of collections and recoveries teams is to return the customer to a satisfactory position, by working with them to restructure their finances and/or business. If this is not possible, the team has the objective of reducing the loss to the Group.

There have been material increases in staffing levels in all collections functions to manage the increase in the number of customers in financial difficulty. In the UK and Ireland, there is a common collection and recovery operational model managed by Group Manufacturing. During 2008, there was significant investment in systems development and staff training to make collections activity more efficient and effective.

In the UK there have been several initiatives to ensure fair and appropriate treatment of customers experiencing difficulties. For mortgage customers the Group will not initiate repossession proceedings for at least six months after arrears are evident.

Preventative measures have also been a key focus throughout 2008, and as a result, the Group has announced the introduction of over 1,000 dedicated Money Sense advisers in its branch network who will provide free financial counselling to both customers and non-customers. The Group has also implemented a programme to proactively contact customers who exhibit early signs of financial stress but are not yet in Collections to offer them assistance in managing their finances more effectively.

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Balance sheet analysis (audited)
The following table provides an analysis of the credit quality of financial assets by the Group's internal credit quality steps.

| 2008 | AQ1 £m | AQ2 £m | AQ3 £m | AQ4 £m | AQ5 £m | Accruing past due £m | Non-accrual £m | Impairment provision £m | Total £m |
|---|---|---|---|---|---|---|---|---|---|
| Cash and balance at central banks | 12,400 | — | — | — | — | — | — | — | 12,400 |
| Loans and advances to banks (2) | 131,963 | 872 | 1,247 | 282 | 943 | — | 129 | (127) | 135,309 |
| Loans and advances to customers | 310,950 | 141,849 | 187,899 | 150,705 | 59,191 | 15,667 | 19,350 | (10,889) | 874,722 |
| Debt securities | 259,207 | 1,461 | 1,485 | 3,755 | 1,626 | — | 52 | (37) | 267,549 |
| Settlement balances | 12,612 | 516 | 290 | 129 | 256 | 4,029 | — | — | 17,832 |
| Derivatives | 912,728 | 36,528 | 30,079 | 5,181 | 8,032 | 11 | — | — | 992,559 |
| Other financial instruments | 691 | — | 161 | — | — | — | — | — | 852 |
| | 1,640,551 | 181,226 | 221,161 | 160,052 | 70,048 | 19,707 | 19,531 | (11,053) | 2,301,223 |
| | | | | | | | | | |
| Commitments | 209,359 | 55,109 | 48,554 | 23,458 | 25,244 | — | — | — | 361,724 |
| Contingent liabilities | 19,693 | 18,461 | 19,502 | 10,977 | 2,904 | — | — | — | 71,537 |
| Total off-balance sheet | 229,052 | 73,570 | 68,056 | 34,435 | 28,148 | — | — | — | 433,261 |
| | | | | | | | | | |
| 2007 | | | | | | | | | |
| Cash and balance at central banks | 17,866 | — | — | — | — | — | — | — | 17,866 |
| Loans and advances to banks (2) | 204,083 | 5,797 | 4,937 | 407 | 1,119 | — | 25 | (3) | 216,365 |
| Loans and advances to customers | 275,715 | 174,074 | 221,561 | 84,791 | 55,273 | 13,236 | 10,337 | (6,449) | 828,538 |
| Debt securities | 258,895 | 15,688 | 2,339 | 1,372 | 16,361 | — | 5 | (4) | 294,656 |
| Settlement balances | 14,491 | 98 | 344 | 21 | 68 | 1,567 | — | — | 16,589 |
| Derivatives | 240,114 | 23,333 | 11,299 | 2,352 | 304 | — | — | — | 277,402 |
| | 669 | — | — | — | 143 | 65 | — | — | 877 |

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| Other financial instruments | 1,011,833 | 218,990 | 240,480 | 88,943 | 73,268 | 14,868 | 10,367 | (6,456) | 1,652,293 |
| Commitments | 131,750 | 89,682 | 74,126 | 25,320 | 17,301 | — | — | — | 338,179 |
| Contingent liabilities | 26,120 | 16,314 | 11,740 | 4,032 | 3,714 | — | — | — | 61,920 |
| Total off-balance sheet | 157,870 | 105,996 | 85,866 | 29,352 | 21,015 | — | — | — | 400,099 |

Notes:

(1) Credit risk assets as reported internally to senior management 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 offset in IFRS. The analysis of credit risk assets on page 68 uses the same risk bands as above and is a sub-set of the full analysis given above.

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

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

| | Past due 1-29 days £m | Past due 30-59 days £m | Past due 60-89 days £m | Past due 90 days or more £m | Total £m |
|---|---|---|---|---|---|
| 2008 | 9,517 | 2,941 | 1,427 | 1,782 | 15,667 |
| 2007 | 8,768 | 2,745 | 1,354 | 369 | 13,236 |

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 (audited)
The following table analyses financial assets by location of office and by industry type.

| | Group | | | | | |
|---|---|---|---|---|---|---|
| 2008 | Loans and advances to banks and customers £m | Debt securities and equity shares £m | Derivatives £m | Other (1) £m | Total £m | Netting and offset (2) £m |
| UK | | | | | | |
| Central and local government | 6,106 | 36,466 | 5,798 | 14 | 48,384 | 1,987 |
| Manufacturing | 26,006 | 1,080 | 11,208 | 180 | 38,474 | 6,279 |
| Construction | 13,426 | 144 | 754 | 26 | 14,350 | 1,485 |
| Finance | 197,659 | 84,696 | 532,857 | 6,257 | 821,469 | 480,762 |
| Service industries and business activities | 88,420 | 10,154 | 13,278 | 1,471 | 113,323 | 7,624 |
| Agriculture, forestry and fishing | 3,118 | 93 | 34 | 15 | 3,260 | 87 |
| Property | 74,050 | 2,008 | 5,094 | 71 | 81,223 | 1,026 |
| Individuals: | | | | | | |
| Home mortgages | 80,967 | — | 14 | — | 80,981 | 52 |
| Other | 27,479 | 250 | 36 | 25 | 27,790 | 5 |
| Finance leases and instalment credit | 17,363 | 3 | 25 | — | 17,391 | 119 |
| Interest accruals | 4,323 | 774 | — | — | 5,097 | — |
| Total UK | 538,917 | 135,668 | 569,098 | 8,059 | 1,251,742 | 499,426 |
| US | | | | | | |
| Central and local government | 482 | 24,996 | 45 | 33 | 25,556 | — |
| Manufacturing | 13,298 | 102 | 1,809 | 128 | 15,337 | 217 |
| Construction | 885 | 63 | 122 | 6 | 1,076 | — |
| Finance | 30,433 | 37,346 | 355,502 | 5,754 | 429,035 | 323,910 |
| Service industries and business activities | 28,232 | 1,498 | 8,535 | 907 | 39,172 | 2,346 |
| Agriculture, forestry and fishing | 30 | — | 3 | 1 | 34 | — |
| Property | 6,579 | 5 | 97 | — | 6,681 | — |
| Individuals: | | | | | | |
| Home mortgages | 34,235 | — | — | — | 34,235 | — |
| Other | 14,368 | — | — | — | 14,368 | — |
| Finance leases and instalment credit | 3,066 | — | — | — | 3,066 | — |
| Interest accruals | 499 | 466 | — | — | 965 | — |
| Total US | 132,107 | 64,476 | 366,113 | 6,829 | 569,525 | 326,473 |
| Europe | | | | | | |
| Central and local government | 2,045 | 24,065 | 228 | 5 | 26,343 | — |
| Manufacturing | 29,348 | 776 | 371 | — | 30,495 | 2 |
| Construction | 5,838 | 1 | 91 | — | 5,930 | — |
| Finance | 35,989 | 34,533 | 8,174 | 3,621 | 82,317 | 61 |
| | 60,179 | 11,754 | 2,823 | 92 | 74,848 | 780 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Service industries and business activities | | | | | | |
| Agriculture, forestry and fishing | 5,750 | 50 | 1 | — | 5,801 | — |
| Property | 23,072 | 19 | 299 | — | 23,390 | — |
| Individuals: | | | | | | |
| Home mortgages | 118,549 | 50 | 4 | — | 118,603 | — |
| Other | 9,024 | 29 | 218 | | 9,271 | — |
| Finance leases and instalment credit | 1,815 | 15 | — | — | 1,830 | — |
| Interest accruals | 1,889 | 1 | — | — | 1,890 | — |
| Total Europe | 293,498 | 71,293 | 12,209 | 3,718 | 380,718 | 843 |
| Rest of the World | | | | | | |
| Central and local government | 7,079 | 16,766 | 311 | 145 | 24,301 | — |
| Manufacturing | 6,837 | 178 | 772 | — | 7,787 | — |
| Construction | 758 | 6 | 17 | — | 781 | 3 |
| Finance | 21,469 | 4,267 | 42,621 | 407 | 68,764 | 31,695 |
| Service industries and business activities | 13,706 | 949 | 1,297 | — | 15,952 | 108 |
| Agriculture, forestry and fishing | 157 | 1 | 7 | — | 165 | — |
| Property | 2,932 | 480 | 96 | — | 3,508 | 41 |
| Individuals: | | | | | | |
| Home mortgages | 847 | — | — | — | 847 | — |
| Other | 5,089 | — | 18 | — | 5,107 | 79 |
| Finance leases and instalment credit | 111 | 5 | — | — | 116 | — |
| Interest accruals | 428 | — | — | — | 428 | — |
| Total Rest of the World | 59,413 | 22,652 | 45,139 | 552 | 127,756 | 31,926 |

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| | Group | | | | | |
|---|---|---|---|---|---|---|
| 2008 | Loans and advances to banks and customers £m | Debt securities and equity shares £m | Derivatives £m | Other (1) £m | Total £m | Netting and offset (2) £m |
| Total | | | | | | |
| 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 leases 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 |

Notes:

(1) Includes settlement balances of £17,832 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 to 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.

| | Group | | | | | |
|---|---|---|---|---|---|---|
| 2007 | Loans and advances to banks and customers £m | Debt securities and equity shares £m | Derivatives £m | Other (1) £m | Total £m | Netting and offset (2) £m |
| UK | | | | | | |
| Central and local government | 4,728 | 30,285 | 3,912 | — | 38,925 | 1,531 |
| Manufacturing | 21,083 | 2,751 | 4,800 | — | 28,634 | 4,032 |
| Construction | 12,363 | 456 | 741 | — | 13,560 | 1,684 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Finance | 294,682 | 106,201 | 239,858 | 12,716 | 653,457 | 186,420 |
| Service industries and business activities | 74,399 | 16,801 | 4,412 | — | 95,612 | 6,687 |
| Agriculture, forestry and fishing | 2,570 | 66 | 58 | — | 2,694 | 104 |
| Property | 63,715 | 640 | 969 | 7 | 65,331 | 2,033 |
| Individuals: | | | | | | |
| Home mortgages | 73,916 | 1,795 | 5 | — | 75,716 | — |
| Other | 28,747 | 1,140 | 15 | 23 | 29,925 | 7 |
| Finance leases and instalment credit | 15,632 | 131 | 27 | — | 15,790 | 5 |
| Interest accruals | 3,512 | 1,607 | — | — | 5,119 | — |
| Total UK | 595,347 | 161,873 | 254,797 | 12,746 | 1,024,763 | 202,503 |
| US | | | | | | |
| Central and local government | 386 | 23,506 | 10 | 212 | 24,114 | — |
| Manufacturing | 7,399 | 608 | 111 | — | 8,118 | 13 |
| Construction | 793 | 96 | — | — | 889 | — |
| Finance | 69,867 | 39,049 | 9,354 | 3,095 | 121,365 | 23,026 |
| Service industries and business activities | 16,474 | 2,190 | 233 | 1 | 18,898 | 18 |
| Agriculture, forestry and fishing | 20 | 4 | — | — | 24 | — |
| Property | 6,456 | 4,089 | — | — | 10,545 | — |
| Individuals: | | | | | | |
| Home mortgages | 27,882 | — | — | — | 27,882 | — |
| Other | 10,879 | — | — | — | 10,879 | — |
| Finance leases and instalment credit | 2,228 | — | — | — | 2,228 | — |
| Interest accruals | 1,421 | 379 | — | — | 1,800 | 2 |
| Total US | 143,805 | 69,921 | 9,708 | 3,308 | 226,742 | 23,059 |

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Industry risk – geographical analysis (continued)

| | Group | | | | | |
|---|---|---|---|---|---|---|
| 2007 | Loans and advances to banks and customers £m | Debt securities and equity shares £m | Derivatives £m | Other( 1) £m | Total £m | Netting and offset (2) £m |
| Europe | | | | | | |
| Central and local government | 2,371 | 30,593 | 132 | — | 33,096 | 9 |
| Manufacturing | 15,159 | 13 | 361 | — | 15,533 | 214 |
| Construction | 4,779 | — | 13 | — | 4,792 | — |
| Finance | 40,481 | 42,418 | 6,285 | 157 | 89,341 | 84,200 |
| Service industries and business activities | 46,500 | 540 | 481 | — | 47,521 | 24,648 |
| Agriculture, forestry and fishing | 4,650 | 2 | 42 | — | 4,694 | — |
| Property | 15,768 | 67 | 8 | — | 15,843 | — |
| Individuals: | | | | | | |
| Home mortgages | 81,557 | 18 | — | — | 81,575 | — |
| Other | 16,292 | 3,292 | — | — | 19,584 | — |
| Finance leases and instalment credit | 1,620 | — | — | — | 1,620 | — |
| Interest accruals | 2,872 | 1,101 | — | — | 3,973 | — |
| Total Europe | 232,049 | 78,044 | 7,322 | 157 | 317,572 | 109,071 |
| Rest of the World | | | | | | |
| Central and local government | 2,592 | 18,821 | 94 | — | 21,507 | — |
| Manufacturing | 8,078 | 46 | 738 | — | 8,862 | — |
| Construction | 825 | 79 | 3 | — | 907 | 1 |
| Finance | 37,502 | 16,919 | 3,797 | 1,210 | 59,428 | 6,059 |
| Service industries and business activities | 14,449 | 1,825 | 661 | — | 16,935 | 103 |
| Agriculture, forestry and fishing | 1,941 | — | — | — | 1,941 | — |
| Property | 2,898 | 217 | 28 | — | 3,143 | — |
| Individuals: | | | | | | |
| Home mortgages | 1,740 | — | — | — | 1,740 | — |
| Other | 12,261 | — | — | — | 12,261 | 3 |
| Finance leases and instalment credit | 18 | — | 254 | 45 | 317 | — |
| Interest accruals | 945 | 11 | — | — | 956 | — |
| Total Rest of the World | 83,249 | 37,918 | 5,575 | 1,255 | 127,997 | 6,166 |
| Total | | | | | | |
| 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 | 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 leases 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) Incudes settlement balances of £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 to 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.

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Impairment (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 of the value of any security held, which could reduce the eventual loss should it occur, and gross of any provision marked. Therefore impaired assets which are highly collateralised, such as mortgages, will have a low coverage ratio of provisions held against reported impaired balance.

The analyses of risk elements and impairment charges 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 (audited)

| | 2008 | | | | | | 2007 | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Division | REIL £m | PPL £m | REIL and PPL £m | Total provision £m | Total provision as % of REIL % | Total provision as % of REIL & PPL % | REIL £m | PPL £m | REIL and PPL £m | Total provision £m | Total provision as % of REIL % | Total provision as % of REIL & PPL % |
| Global Markets | | | | | | | | | | | | |
| – Global Banking & Markets | 6,192 | 18 | 6,210 | 3,491 | 56% | 56% | 952 | 67 | 1,019 | 586 | 62% | 58% |
| – Global Transaction Services | 284 | — | 284 | 245 | 86% | 86% | 336 | — | 336 | 170 | 51% | 51% |
| Total Global Markets | 6,476 | 18 | 6,494 | 3,736 | 58% | 58% | 1,288 | 67 | 1,355 | 756 | 59% | 56% |
| Regional Markets | | | | | | | | | | | | |
| – UK Retail & Commercial Banking | 7,900 | 200 | 8,100 | 3,709 | 47% | 46% | 5,535 | 63 | 5,598 | 3,281 | 59% | 59% |
| – US Retail & Commercial Banking | 770 | — | 770 | 932 | 121% | 121% | 317 | — | 317 | 304 | 96% | 96% |
| – Europe & Middle East Retail & | 3,341 | 8 | 3,349 | 822 | 25% | 25% | 725 | 1 | 726 | 418 | 58% | 58% |

| | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Commercial Banking – Asia Retail & Commercial Banking | 304 | — | 304 | 252 | 83% | 83% | 386 | — | 386 | 183 | 47% | 47% |
| Total Regional Markets | 12,315 | 208 | 12,523 | 5,715 | 46% | 46% | 6,963 | 64 | 7,027 | 4,186 | 60% | 60% |
| Other | — | — | — | — | — | — | — | — | — | 14 | — | — |
| RBS share of shared assets | — | — | — | — | — | — | — | — | — | 16 | — | — |
| RFS Holdings minority interest | 2,470 | — | 2,470 | 1,565 | 63% | 63% | 2,480 | 540 | 3,020 | 1,480 | 60% | 49% |
| Group | 21,261 | 226 | 21,487 | 11,016 | 52% | 51% | 10,731 | 671 | 11,402 | 6,452 | 60% | 57% |

The table below sets out the Group's loans that are classified as REIL and PPL.

| | 2008 Group £m | 2007 Group £m |
|---|---|---|
| Non-accrual loans (1) | 19,479 | 10,362 |
| Accrual loans past due 90 days (2) | 1,782 | 369 |
| Total REIL | 21,261 | 10,731 |
| PPL (3) | 226 | 671 |
| Total REIL and PPL | 21,487 | 11,402 |
| REIL and PPL as % of customer loans and advances – gross (4) | 2.52% | 1.64% |

The sub-categories of REIL and PPL are calculated as described in notes 1 to 4 below.

Notes:

(1) All loans against which an impairment provision is held are reported in the non-accrual category.

(2) Loans where an impairment event has taken place but no impairment recognised. This category is used for fully collateralised non-revolving credit facilities.

(3) 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.

(4) Gross of provisions and excluding reverse repurchase agreements.

REIL as at 31 December 2008 was £21,261 million (2007 – £10,731 million). As a percentage of customer lending, REIL and PPL in aggregate was 2.52% of customer loans and advances at 31 December 2008 (2007 – 1.64%).

Impairment loss provision methodology (audited)
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 guarantor and collateral held after being stressed for downside risk. This incorporates an estimate of the discounted value of any recoveries and realisation of security or collateral. The asset continues to be assessed on an individual basis until it is repaid in full, transferred to the performing portfolio or written-off.

Collectively assessed provisions: provisions on impaired credits below an agreed threshold which are assessed on a portfolio basis, to 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.

Latent loss provisions: provisions held against the estimated impairment in the performing portfolio which have yet to be identified as at the balance sheet date. To assess the latent loss within the portfolios, the Group has developed methodologies to estimate the time that an asset can remain impaired within a performing portfolio before it is identified and reported as such.

Provision analysis (audited)

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 clear provisions governance framework which sets thresholds whereby suitable oversight and challenge is undertaken and significant cases will be presented to a committee chaired by the Group Chief Executive or the Group Finance Director.

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Impairment charge (audited)

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

| | 2008 £m | 2007 £m |
|---|---|---|
| New impairment losses | 8,391 | 2,310 |
| less: recoveries of amounts previously written-off | (319) | (342) |
| Charge to income statement | 8,072 | 1,968 |
| Comprising: | | |
| Loan impairment losses | 7,091 | 1,946 |
| Impairment losses on available-for-sale securities | 981 | 22 |
| Charge to income statement | 8,072 | 1,968 |
| Impairment losses by division: | | |
| Global Markets | | |
| – Global Banking & Markets | 3,643 | 67 |
| – Global Transaction Services | 60 | 14 |
| Regional Markets | | |
| – UK Retail & Commercial Banking | 1,964 | 1,368 |
| – US Retail & Commercial Banking | 1,041 | 340 |
| – Europe & Middle East Retail & Commercial Banking | 526 | 118 |
| – Asia Retail & Commercial Banking | 171 | 24 |
| RBS Insurance | 42 | — |
| Other | (15) | (1) |
| RFS Holdings minority interest | 640 | 38 |
| Group | 8,072 | 1,968 |

Analysis of loan impairment charge (audited)

| | 2008 £m | 2007 £m |
|---|---|---|
| Latent loss impairment charge | 822 | 88 |
| Collectively assessed impairment charge | 2,606 | 1,584 |
| Individually assessed impairment charge (1) | 3,545 | 274 |
| Charge to income statement | 6,973 | 1,946 |
| Charge as a % of customer loans and advances – gross (2) | 0.82% | 0.28% |

Notes:

(1) Excludes loan impairment charge against loans and advances to banks of £118 million (2007 – nil).

(2) Gross of provisions and excluding reverse repurchase agreements.

Analysis of loan impairment provisions (audited)

| | 2008 | 2007 |
|---|---|---|

| | £m | £m |
|---|---|---|
| Latent loss provisions | 1,944 | 1,050 |
| Collectively assessed provisions | 4,102 | 3,845 |
| Individually assessed provisions | 4,843 | 1,554 |
| Total provisions (1) | 10,889 | 6,449 |
| Total provision as a % of customer loans and advances – gross (2) | 1.3% | 0.9% |

Notes:

(1) Excludes provisions against loans and advances to banks of £127 million (2007 – £3 million).

(2) Gross of provisions and excluding reverse repurchase agreements.

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Provisions coverage (audited)
The Group's provision coverage ratios are shown in the table below.

| | 2008 £m | 2007 £m |
|---|---|---|
| Total provision expressed as a: | | |
| % of REIL | 52% | 60% |
| % of REIL and PPL | 51% | 57% |

The coverage ratio of closing provisions to REIL and PPL decreased from 57% to 51% during 2008. The lower coverage ratio reflects amounts written-off and the changing mix from unsecured to secured exposures.

Movement in loan impairment provisions (audited)
The following table shows the movement in the provision for impairment losses for loans and advances.

| | Individually assessed £m | Collectively assessed £m | Latent £m | Total 2008 £m | 2007 £m |
|---|---|---|---|---|---|
| At 1 January | 1,568 | 3,834 | 1,050 | 6,452 | 3,935 |
| Transfer to disposal groups | (222) | (351) | (194) | (767) | — |
| Currency translation and other adjustments | 1,065 | 81 | 295 | 1,441 | 137 |
| Acquisition of subsidiaries | — | — | — | — | 2,221 |
| Disposal of subsidiaries | — | (149) | (29) | (178) | — |
| Net increase in provisions of discontinued operations | — | — | — | — | 46 |
| Amounts written-off | (1,165) | (1,983) | — | (3,148) | (2,011) |
| Recoveries of amounts previously written-off | 113 | 206 | — | 319 | 342 |
| Charged to the income statement | 3,663 | 2,606 | 822 | 7,091 | 1,946 |
| Unwind of discount | (52) | (142) | — | (194) | (164) |
| At 31 December (1) | 4,970 | 4,102 | 1,944 | 11,016 | 6,452 |

Note:

(1) The provison for impairment losses at 31 December 2008 include £127 million relating to loans and advances to banks (2007 – £3 million).

Movement in loan impairment provisions (audited)
The movement in provisions balance by division is shown in the table below.

| | Global Banking & Markets £m | Global Transaction Services £m | UK Retail & Commercial Banking £m | US Retail & Commercial Banking £m | Europe & Middle East Retail & Commercial | Asia Retail & Commercial Banking £m | Central Items £m | RBS Share of Shared Assets £m | RFS Holdings minority interest £m | Total 2008 £m | 2007 £m |
|---|---|---|---|---|---|---|---|---|---|---|---|

| | | | | | Banking £m | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| At 1 January | 586 | 170 | 3,281 | 304 | 418 | 183 | 14 | 16 | 1,480 | 6,452 | 3,935 |
| Transfers to disposal groups | — | — | — | — | — | — | — | — | (767) | (767) | — |
| Currency translation and other adjustments | 496 | 52 | 12 | 219 | 147 | 57 | — | — | 458 | 1,441 | 137 |
| Acquisition of subsidiaries | — | — | — | — | — | — | — | — | — | — | 2,221 |
| Disposal of subsidiaries | — | — | (108) | — | (70) | — | — | — | — | (178) | — |
| Net increase in provisions of discontinued operations | — | — | — | — | — | — | — | — | — | — | 46 |
| Amounts written-off | (307) | (34) | (1,414) | (710) | (174) | (153) | (64) | (16) | (276) | (3,148) | (2,011) |
| Recoveries of amounts previously written-off | 10 | 1 | 113 | 80 | 7 | — | 50 | — | 58 | 319 | 342 |
| Charge to income statement | 2,718 | 59 | 1,965 | 1,039 | 526 | 171 | — | — | 613 | 7,091 | 1,946 |
| Discount unwind | (12) | (3) | (140) | — | (32) | (6) | — | — | (1) | (194) | (164) |
| At 31 December | 3,491 | 245 | 3,709 | 932 | 822 | 252 | — | — | 1,565 | 11,016 | 6,452 |

Liquidity risk (audited)
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.

The management of liquidity risk within the Group is undertaken within a formal governance structure. The Group Board of Directors oversees the liquidity risk appetite and strategy of the Group; the Group Executive Management Committee reviews the key liquidity metrics and trends in the context of the Group's overall risk profile; the Group Asset and Liability Management Committee (GALCO), chaired by the Group Finance Director and including the chief executives of the business divisions as well as the Group Treasurer, Group Chief Risk Officer and heads of other relevant Group functions, sets explicit metrics across a number of asset and liability targets and these are cascaded to the business and monitored by the Group Treasury and risk functions.

Group Treasury has overall responsibility for the daily monitoring and control of the Group's liquidity and funding positions. The Liquidity Managers' Forum is chaired and directed by the Group Treasurer with membership including the Head of Short Term Markets and Financing, GBM. The forum typically meets weekly with more frequent, ad hoc, meetings as necessary. There are Regional and Country ALCOs that oversee Group policy in businesses in Europe, Asia and the Americas. The Group is divided into Liquidity Reporting Units each of which is required to have its own liquidity limits and contingency funding plan. In addition, all subsidiaries and branches outside the UK are required to comply with local regulatory liquidity requirements and are subject to Group Treasury oversight.

Management of term structure
The Group evaluates on a regular basis its structural liquidity risk and applies a variety of balance sheet management and term funding strategies to maintain this risk within its normal 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 may be 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.

Daily management
The primary focus of the daily management activity is to ensure access to sufficient liquidity to meet cash flow obligations within key time horizons, in particular out to one month ahead. The short-term maturity structure of the Group's liabilities and assets is managed daily to ensure that all material or potential cash flow obligations, arising from undrawn commitments and other contingent obligations can be met.

Potential sources include cash inflows from maturing assets, new borrowings or the sale of various debt securities held (after allowing for appropriate haircuts). 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. ABN AMRO, Citizens Financial Group and RBS Insurance manage liquidity locally, given different regulatory regimes, subject to review by Group Treasury. As integration of ABN AMRO's businesses within the Group proceeds, the liquidity risk policies, parameters and metrics used will be progressively aligned within a single framework.

Stress testing

The Group performs stress tests to simulate how events may impact its funding and liquidity capabilities. Such tests inform the overall balance sheet structure and 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. The form and content of stress tests are updated where required as market conditions evolve.

Contingency planning

Contingency funding plans have been developed to anticipate and respond to approaching or actual material deterioration in market conditions. The Group reviews its contingency plans in the light of evolving market conditions. The contingency funding plan covers: 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, including the communication lines for escalation of events which give rise to liquidity stress; assumptions, including the expected change impact of market conditions; and the ability and circumstances within which the Group accesses central bank liquidity.

Global developments (unaudited)

The global financial system has experienced its greatest crisis in the post war period and the dislocation became most acute in the second half of 2008. This loss of confidence in the world's banking system led to massive dislocation in the capital markets and resulted in the effective closure of the term debt and securitisation markets and money markets. Government intervention in, and support for, the international financial system has increased to unprecedented levels taking the form of capital injections, guaranteed funding, asset insurance schemes and expanded facilities from a number of central banks:

In September 2007, the Bank of England announced that to alleviate strains in longer-maturity money markets, it would conduct auctions to provide funds at three month maturity against a wider range of collateral, including mortgage collateral, than in its weekly open market operations.

> In April 2008, the Bank of England launched a special liquidity scheme allowing banks to swap temporarily illiquid mortgage and other assets for Treasury Bills. The scheme closed to new issuances on 30 January 2009. However, it will provide liquidity support for a further three years.

In September 2008, the major central banks announced coordinated action to improve US$ liquidity. As part of this action, the Bank of England and ECB commenced US dollar repo operations. Eligible collateral consists of securities routinely eligible in the Bank of England's and ECB's short-term repo open market operations together with conventional US Treasuries. The Bank of England concluded a reciprocal swap agreement (swap line) with the US Federal Reserve. On 3 February 2009, the Bank of England announced the extension of this facility until 30 October 2009.

In October 2008, the pool of eligible collateral securities for its open market operations was extended to include bank debt guaranteed under the Government's bank debt guarantee scheme.

In October 2008, the Government announced a credit guarantee scheme. It will guarantee new unsecured borrowing in return for a fee. Initially the guarantee period ended on 9 April 2009 but on 19 January 2009 the Government announced an extension to 31 December 2009. It also announced new arrangements, expected to start in April 2009, to guarantee asset-backed securities issued by banks.

In October 2008 the European Central Bank expanded its list of eligible collateral to include marketable debt instruments denominated in non-euro currencies (and issued in the euro area) among others. This is to remain in force until the end of 2009. Enhancements were also made to the provision of longer-term refinancing operations including conducting them through a fixed rate tender procedure with full allotment. This is to stay in place for as long as needed and at least until 31 March 2009.

On 27 October 2008 the Federal Reserve Bank commenced the Commercial Paper Funding Facility to provide a liquidity backstop to issuers of commercial paper. A special purpose vehicle (SPV) funded by the Federal Reserve Bank of New York will purchase eligible three- month unsecured and asset-backed commercial paper from eligible issuers. In February 2009 the FED announced an extension to this facility until 30 October 2009.

In October 2008 the UK Government announced recapitalisation plans for a number of UK banks including RBS.

In January 2009, it was announced that the Bank of England will permit drawings from the discount window facility with a term of 364 days, in addition to the standard option to draw for 30 days.

In January 2009, the Government announced that the Bank of England had been authorised to purchase up to £50 billion of high-quality private sector assets under an asset purchase facility. The following sterling assets are initially eligible for purchase: commercial paper, corporate bonds, paper issued under the Credit Guarantee Scheme (CGS), syndicated loans and asset-backed securities created in viable securitisation structures.

In January 2009, the Government announced an asset protection scheme. The Government will insure, for a commercial fee, certain bank assets against losses. It is anticipated that the scheme will commence in April 2009. The UK banks, including the Group, have been in discussions with the Tripartite Authorities about the scheme's terms.

In January 2009, the FSA has announced that it will ensure that the application of the current International Basel Accord does not create any unnecessary or unintended pro-cyclical effects.

On 3 February 2009 the Federal Reserve Bank announced an extension to a number of its liquidity facilities until 30 October 2009. These included the Term Securities Lending Facility (TSLF), originally announced in March 2008. Under the TSLF, the Federal Reserve Bank of New York auctions 28-day term loans of Treasury securities to primary dealers in exchange for other program eligible collateral.

Liquidity management in 2008 (audited)

The exposure of the Group to wholesale market funding increased markedly in 2008 following the acquisition of the wholesale banking business of ABN AMRO in the latter half of 2007. The amount of unsecured wholesale funding represented by bank funding and debt securities increased from £154 billion in June 2007 to £362 billion in December 2007. The gap between customer loans and customer deposits increased over this period from £86 billion to £121 billion.

The market disruption during 2008 had a marked effect on the Group's liquidity and funding which was at its most acute in the autumn of 2008 following the collapse of Lehman Brothers. During that period, the Group's credit ratings were downgraded constraining both access to and tenor of wholesale funding and there was an outflow of customer deposits. The effective closure of the term funding markets and sharp reduction in the quantity and maturity of short term bank funding had profound consequences for the Group.

Whilst the Group's customer funding sources remain well diversified and its retail franchise proved resilient, the availability of longer term funding diminished. The Group therefore increased its shorter term wholesale funding exposure, increased its access to central bank funding and issued government guaranteed debt to fund the balance sheet. The government schemes have enabled the mitigation of the financial crisis as the Group rebalances its asset and liability structure.

An analysis of the Group's funding is set out below.

| | 2008 | | 2007 | |
|---|---|---|---|---|
| Sources of funding | £m | % | £m | % |
| Customer accounts (excluding repos) | | | | |
| Repayable on demand | 327,547 | 24 | 346,074 | 24 |
| Time deposits | 253,822 | 19 | 201,373 | 14 |
| Total customer accounts (excluding repos) | 581,369 | 43 | 547,447 | 38 |
| Debt securities in issue over one year remaining maturity | 125,782 | 9 | 118,152 | 8 |
| Subordinated liabilities | 49,154 | 4 | 38,043 | 3 |
| Owners' equity | 58,879 | 4 | 53,038 | 4 |
| Total customer accounts and long term funds | 815,184 | 60 | 756,680 | 53 |
| Repo agreements with customers | 58,143 | 5 | 134,916 | 10 |
| Repo agreements with banks | 83,666 | 6 | 163,038 | 11 |
| Total customer accounts, long term funds and collateralised borrowing | 956,993 | 71 | 1,054,634 | 74 |
| Debt securities in issue up to one year remaining maturity | 174,507 | 13 | 156,020 | 11 |
| Deposits by banks (excluding repos) | 174,378 | 13 | 149,256 | 10 |
| Short positions | 42,536 | 3 | 73,501 | 5 |
| Total | 1,348,414 | 100 | 1,433,411 | 100 |

Customer accounts – the principal source of funds for the Group is its core customer deposits gathered by its retail banking, private client, corporate and SME franchises. The underlying strength of the franchise is demonstrated by the performance of the Group in these markets as customer deposits increased from £547 billion in December 2007 to £581 billion at the end of December 2008. There was a fluctuation in balances at the height of the market disruption in October 2008 but this was recovered by the year end. 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.

Repo agreements are borrowings collateralised by a range of debt securities and other assets undertaken with a range of corporate and institutional customers and banks. These reduced significantly in the course of 2008 as the Group took strategic actions and wholesale markets retrenched.

Short positions in various securities are held primarily by GBM including RBS Greenwich Capital in the US.

Debt securities in issue over one year, subordinated liabilities and equity – during 2008, the debt markets saw reduced activity, in both the term and the securitisation markets; as a result the maturity profile of the Group's wholesale funding has become shorter in duration over the course of the year. This was partly offset by issues of government guaranteed debt in the latter part of 2008. The maturity profile of debt securities is predominantly concentrated under one year and this is a source of refinancing risk in the coming twelve months.

The Group raised £27 billion of equity capital during the course of 2008 from a rights issue of £12 billion in June 2008 and a placing and open offer in December 2008 which provided a further £15 billion of equity capital. In December 2008 a further £5 billion was raised from a preference share issue which was repaid from the proceeds of the Second Placing and Open Offer in April 2009.

Short term debt and bank deposits – the Group saw considerable pressure and risk aversion in the short term debt and bank deposit markets. In order to relieve funding shortages in the market, central banks across the world allowed banks to pledge assets to access funding. The Group has used central bank schemes to support its funding and pledged assets into several of these schemes in a number of countries in which it operates. The Group has set up a series of initiatives to improve the liquidity value of its assets to assist in relieving funding pressures.

Undrawn commitments – the Group provides undrawn commitments to both its corporate and personal customers in the form of products such as overdrafts and credit card facilities. The commitments portfolio is well diversified in terms of customers, geography and business type. The total amount of the Group's undrawn commitments at the end of 2008 was £352 billion.

Conduits – the Group's most significant multi-seller conduits have thus far continued to fund the vast majority of their assets solely through ABCP issuance. There were significant disruptions to the liquidity of the financial markets during the year following the bankruptcy filing of Lehman Brothers in September 2008 and this required a small amount of the assets held in certain conduits to be funded by the Group rather than through ABCP issuance. By the end of 2008 there had been an improvement in market conditions, supported by central bank initiatives, which enabled normal ABCP funding to replace this Group funding of the conduits.

The average maturity of ABCP issued by the Group's conduits as at 31 December 2008 was 72.1 days (2007– 60.9 days).

The total assets held by the Group's sponsored conduits are £49.9 billion (2007– £48.1 billion). Since these liquidity facilities are sanctioned on the basis of total conduit purchase commitments, the liquidity facility commitments will exceed the level of assets held, with the difference representing undrawn commitments.

The Group values the funding flexibility and liquidity provided by the ABCP market to fund client and Group-originated assets. Whilst there are plans to decrease the multi-seller conduit business in line with the Group's balance sheet, the Group is reviewing the potential for new own-asset conduit structures to add funding diversity.

Outlook for 2009 (unaudited)
The market outlook for 2009 remains uncertain with the prospect of recession on a global scale. The wholesale funding markets remain difficult with a high degree of risk aversion towards the banking market and no restoration of the unguaranteed debt capital markets for bank issuance yet visible. The continuation of these conditions means that the use of central bank and other government facilities are likely to be required for some time. Other deposit initiatives have commenced to widen wholesale and other retail deposit gathering actions.

Group balance sheet (audited)
The following tables show the contractual undiscounted cash flows receivable and payable up to a period of twenty years including future receipts and payments of interest.

On balance sheet assets by contractual maturity

| | Group | | | | | |
|---|---|---|---|---|---|---|
| 2008 | 0-3 months £m | 3-12 months £m | 1-3 years £m | 3-5 years £m | 5-10 years £m | 10-20 years £m |
| 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 |
| Loans and advances to customers | 195,553 | 81,054 | 138,378 | 125,621 | 160,271 | 152,084 |
| Debt securities | 26,006 | 12,895 | 24,629 | 23,927 | 57,846 | 24,535 |
| Derivatives held for hedging | 266 | 1,796 | 2,281 | 1,359 | 1,517 | 649 |
| Settlement balances | 17,830 | — | — | — | 2 | — |
| Other financial assets | 621 | 193 | 58 | 111 | 343 | — |
| | 314,239 | 115,332 | 168,019 | 151,939 | 220,092 | 177,367 |

On balance sheet liabilities by contractual maturity

| | Group | | | | | |
|---|---|---|---|---|---|---|
| | 0-3 months | 3-12 months | 1-3 years | 3-5 years | 5-10 years | 10-20 years |
| 2008 | £m | £m | £m | £m | £m | £m |
| Deposits by banks | 154,614 | 14,347 | 3,345 | 2,754 | 2,048 | 34 |
| Customer accounts | 523,268 | 33,450 | 6,577 | 6,337 | 7,298 | 5,319 |
| Debt securities in issue | 131,714 | 48,652 | 40,067 | 38,223 | 38,667 | 5,626 |
| Derivatives held for hedging | 394 | 2,216 | 2,543 | 1,334 | 2,682 | 1,373 |
| 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 |
| | 825,094 | 102,941 | 59,368 | 54,447 | 75,208 | 25,388 |

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Other contractual cash obligations

The table below summarises the Group's other contractual cash obligations by payment date.

| | Group | | | | | |
|---|---|---|---|---|---|---|
| | 0-3 months | 3-12 months | 1-3 years | 3-5 years | 5-10 years | 10-20 years |
| 2008 | £m | £m | £m | £m | £m | £m |
| Operating leases | 146 | 433 | 976 | 751 | 1,448 | 1,851 |
| Contractual obligations to purchase goods or services | 237 | 892 | 486 | 208 | 303 | 1 |
| | 383 | 1,325 | 1,462 | 959 | 1,751 | 1,852 |
| 2007 | | | | | | |
| Operating leases | 90 | 268 | 655 | 569 | 1,060 | 1,958 |
| Contractual obligations to purchase goods or services | 441 | 1,007 | 748 | 199 | 5 | 2 |
| | 531 | 1,275 | 1,403 | 768 | 1,065 | 1,960 |

The Group's undrawn formal facilities, credit lines and other commitments to lend were £352,398 million (2007 – £332,811 million). While the Group has given commitments to provide these funds, some facilities may be 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.

The tables above 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 reporting entity; 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 whereas 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 20 years – the principal amounts of financial assets and liabilities that are repayable after 20 years or where the counterparty has no right to repayment of the principal are excluded from the table as are interest payments after 20 years.

Held-for-trading assets and liabilities – held-for-trading assets and liabilities amounting to £1,226.8 billion (assets) and £1,146.7 billion (liabilities) (2007 – £678.6 billion assets, £478.6 billion liabilities) have been excluded from the table in view of their short term nature.

This contractual analysis highlights the maturity transformation of the balance sheet that is fundamental to the structure of banking. In practice, this is not a reflection of the actual behaviour of assets or liabilities. In particular the customer funding of the balance sheet exhibits much greater stability and maturity than the tables indicate. This is because the funding franchise of the Group is diversified across an extensive retail network.

Regulatory environment (audited)
The Group is subject to the FSA's liquidity regime, whilst overseas subsidiaries and branches are subject to local regimes.

Sterling liquidity
The FSA requires the Group, on a consolidated basis, to maintain daily a minimum ratio of 100% between:

a stock of qualifying high quality liquid assets (primarily UK and EU government securities, treasury bills and cash held in branches); and

the sum of: sterling wholesale net outflows contractually due within five working days (offset up to a limit of 50%, by 85% of sterling certificates of deposit held which mature beyond five working days); and 5% of retail deposits with a residual contractual maturity of five working days or less. The FSA also sets an absolute minimum level for the stock of qualifying liquid assets that the Group is required to maintain each day.

Given the developments in 2008 the FSA has published new proposals for liquidity management (CP08/22) to replace the current regulatory framework. The FSA is proposing a major overhaul of liquidity risk regulation that will include:

Improved systems and controls including governance standards, pricing, intra day systems and collateral management.

Individual liquid assessments that will include mandatory scenarios and an analysis of principal liquidity exposure factors.

Reporting standards improved both in scope and frequency by enhanced mismatch reporting.

Market risk (audited)
Market risk arises from changes in interest rates, foreign currency, credit spread, equity prices and risk related factors such as market volatilities. Market risk is actively managed and aligned with the Group's risk appetite. Market conditions were difficult throughout 2008 with significant volatility and write-downs across markets and portfolios.

The Group manages market risk in the trading and non-trading (treasury) portfolios using the market risk management framework. The framework includes value-at-risk (VaR) limits, backtesting, stress testing, scenario analysis, position/sensitivity analysis and model validation.

The focus through 2008 has been on overhauling and reviewing the market risk limits for trading book activities, reflecting market performance and events.

Measurement (audited)
A number of techniques are used to calculate the Group's exposure to market risk, including VaR, sensitivity analysis and stress testing.

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 a confidence level of 95%. The trading book market risk is calculated using VaR at a confidence level of 99% and a time horizon of ten trading days. From 2009, the Group is adopting 99% confidence limits, in line with industry practice.

The Group calculates VaR using historical simulation models but does not make any assumption about the nature or type of underlying loss distribution. The methodology uses the previous 500 trading days of market data and calculates both general market risk (i.e. the risk due to movement in general market benchmarks) and idiosyncratic market risk (i.e. the risk due to movements in the value of securities by reference to specific issuers). All VaR models have limitations, which include:

Historical data may not provide the best estimate of the joint distribution of risk factor changes in the future and may fail to capture the risk of possible extreme adverse market movements which have not occurred in the historical window used in the calculations.

VaR using a one-day time horizon does not fully capture the market risk of positions that cannot be liquidated or hedged within one day.

VaR using a 95% confidence level does not reflect the extent of potential losses beyond that percentile.

Traded portfolios (audited)
The primary focus of the Group's trading activities is client facilitation. The Group also undertakes:

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 margin daily 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.

The Group calculates the VaR of trading portfolios at the close of business and positions may change substantially during the course of a trading day. Further controls are in place to limit the Group's intra-day exposure, such as the calculation of the VaR for selected portfolios. The Group cannot guarantee that losses will not exceed the VaR amounts indicated due to the limitations and nature of VaR measurements.

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 either by the market risk function in the business or at Group level. Group Risk provides an independent evaluation of the model for transactions deemed by the Model Product Review Committee (MPRC) 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 2008 trading portfolios segregated by type of market risk exposure is shown below.

£ million (unaudited)

Note:

(1) The traded market risk VaR excludes super senior tranches of asset backed CDOs.

The average total VaR utilisation increased in 2008 compared with 2007 as a result of increased market volatility. This increase was offset 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 average equity VaR increased in 2008 compared with 2007, due to the integration of ABN AMRO from 17 October 2007.

| | 2008 | | | | 2007 | | | |
|---|---|---|---|---|---|---|---|---|
| | Average £m | Period end £m | Maximum £m | Minimum £m | Average £m | Period end £m | Maximum £m | Minimum £m |
| Interest rate | 20.7 | 26.3 | 36.5 | 12.1 | 12.5 | 15.0 | 21.8 | 7.6 |
| Credit spread | 37.2 | 40.4 | 51.2 | 26.0 | 18.8 | 41.9 | 45.2 | 12.6 |
| Currency | 4.5 | 8.7 | 10.5 | 1.2 | 2.6 | 3.0 | 6.9 | 1.1 |
| Equity | 12.3 | 9.4 | 19.9 | 6.0 | 5.4 | 14.0 | 22.0 | 1.4 |
| Commodity | 6.7 | 6.3 | 18.2 | — | 0.2 | 0.5 | 1.6 | — |
| Diversification | — | (43.3) | — | — | — | (28.7) | — | — |
| Total | 44.6 | 47.8 | 60.9 | 29.9 | 21.6 | 45.7 | 50.1 | 13.2 |

The 2008 data in the table above excludes exposures to super-senior tranches of asset backed CDOs, as VaR no longer produces 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 £1,398 million as at 31 December 2008. For more information, please refer to the discussion of Credit market and related exposures – Super senior CDOs on page 111 and Financial statements: Note 11, Financial instruments – Valuation – level 3 portfolios – collateralised debt obligations on pages 189 and 190.

RBS Sempra Commodities LLP, 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.

Backtesting, stress testing and sensitivity analysis (audited)
The Group undertakes a programme of daily backtesting, which compares the actual profit or loss realised in trading activity to the VaR estimation. The results of the backtesting process are one of the methods by which the Group monitors the ongoing suitability of its VaR model.

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 (e.g. position monitoring, sensitivity limits, triggers or stress limits) are in place.

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. GEMC approves the high-level market stress test limit for the Group. 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, GEMC 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 (audited)
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 MPRC 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 as having material model risk are prioritised for independent quantitative review. Independent quantitative review aims to quantify model risk by comparing model outputs against alternative independently developed models. The results of independent quantitative review are used by Market Risk to inform risk limits and by Finance to inform reserves. Governance over this process is provided by MPRC, a forum which brings together front office quants, 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 (audited)
All divisions that are exposed to market risk in the course of their business are required to comply with the requirements of the Group's Market Risk Policy Standards (MRPS). The main risk management tools are delegated authorities, specifically 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 (for instance, in order to allow orderly unwinding of positions) can be granted.

A permanent increase in the limit can be granted.

Non-traded portfolios (audited)
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.

Various banking regulators review non-trading market risk as part of their regulatory oversight. As home 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, and other debt securities issued, 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:

Repricing risk – arises from differences in the repricing 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 one month LIBOR is used to fund base rate assets.

Yield curve risk – arises as a result of non-parallel changes in the yield curve.

From an economic perspective, 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 repricing behaviour of each asset, liability and off-balance sheet product. For many retail and commercial products, the actual interest rate repricing characteristics differ from the contractual repricing. In most cases, the repricing 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 repricing maturity is determined by the stability of the portfolio. The repricing maturities used are approved by Group Treasury and divisional asset and liability committees at least annually. Key conventions are reviewed annually by GALCO.

A static maturity gap report is produced as at the month-end for each business, in each functional currency based on the behavioural repricing for each product. It is Group policy to include in the gap report, non-financial assets and liabilities, mainly property, plant and equipment and the Group's capital and reserves, spread over medium and longer term maturities. The report includes hedge transactions, principally derivatives.

Any residual 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 199). 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 cashflows 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:

(i) Structural foreign currency exposures that arise from net investment in overseas subsidiaries, associates and branches;

(ii) Transactional/commercial foreign currency exposures that arise from mismatches in the currency balance sheet; and

(iii) 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 restructuring arrangements. From an economic perspective, it is the Group's policy to ensure that equity exposures in the banking book are identified, monitored and controlled, with the aim of maximising their potential strategic or business value.

The commercial decision to invest in equity holdings is taken by GEMC, GCC or an appropriate sub-committee within delegated authority. Investments of a strategic nature are referred to GEMC for approval; those involving the purchase or sale by the Group or subsidiary companies also require Board approval, after consideration by GEMC.

Treasury (audited)

The Group's treasury activities include its money market business and the management of internal funds flow within the Group's businesses. In addition, this includes GBM trading portfolio assets that have been reclassified to available-for-sale. Money market portfolios include cash instruments (principally debt securities, loans and deposits) and related hedging derivatives. VaR for the Group's treasury portfolios, which relates mainly to interest rate risk including credit spreads, was £52.0 million at 31 December 2008 (2007 – £5.5 million). During the year the maximum VaR was £52.0 million (2007 – £6.4 million), the minimum £4.8 million (2007 – £1.3 million) and the average £8.3 million (2007 – £3.7 million).

Non-trading interest rate VaR (audited)
Non-trading interest rate VaR for the Group's treasury and retail and commercial banking activities was £70.6 million at 31 December 2008 (2007 – £42.9 million) with the major exposure being to changes in longer term US dollar interest rates. During 2008, the maximum VaR was £117.6 million (2007 – £53.6 million), the minimum was £53.9 million (2007 – £32.9 million) and the average was £75.1 million (2007 – £43.2 million).

A breakdown of the Group's non-trading VaR on a statutory basis by currency is shown below.

| | 2008 £m | 2007 £m |
|---|---|---|
| EUR | 19.0 | 4.5 |
| GBP | 18.3 | 7.3 |
| USD | 64.8 | 52.8 |
| Other | 4.5 | 2.6 |

Citizens Financial Group (CFG) was the main contributor to overall non- trading interest rate VaR. CFG manages non-trading interest rate risk with the objective of minimising accrual accounted earnings volatility. 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 would. This balance sheet management approach is common for US retail banks. Interest rate risk in the banking book is managed by a professional treasury function which optimises the yield, whilst staying within approved limits on interest rate risk, liquidity and capitalisation.

Mortgages, home equity loans and mortgage-backed securities (MBS) comprise a large portion of CFG's assets. In the US, mortgage and home equity customers may prepay loans without penalty. However, under the requirements of FAS 133, the risk that they may do so cannot be hedged in a cost effective manner and must be born by the lender. Prepayment risk is a primary component of interest rate risk in the banking book at CFG.

| | 2008 | | 2007 | |
|---|---|---|---|---|
| | Principal(1) US$m | Carrying amount US$m | Principal(1) US$m | Carrying amount US$m |
| Total MBS and mortgages | 63,542 | 63,165 | 69,948 | 69,672 |
| MBS – total | | | | |
| – high grade (AA or AAA rated) | 26,268 | 25,893 | 26,848 | 26,572 |
| – rated C to A | 602 | 600 | — | — |
| MBS – commercial | | | | |
| – high grade (AA or AAA rated) | 2,253 | 2,089 | 2,205 | 2,211 |
| MBS – retail | | | | |
| – high grade (AA or AAA rated) | 24,015 | 23,804 | 24,643 | 24,631 |
| – rated C to A | 602 | 600 | — | — |
| Residential Mortgage and Home Equity Loans (non-securitised, fixed rate and ARM, prepayable) | 36,672 | 36,672 | 43,100 | 43,100 |

Note:

(1) The principal on MBS is the redemption amount on maturity or, in the case of an amortising instrument, the sum of future redemption amounts through the residual life of the security.

In addition to VaR, the following measures are reported to CFG ALCO, Group Treasury, GALCO and the Board:

The sensitivity of net accrual earnings to a variety of parallel and non-parallel movements in interest rates.

Economic value of equity (EVE) sensitivity to a series of parallel movements in interest rates. EVE is only used within CFG and to meet the FSA prescribed standard shock test of +/- 200bp parallel shock.

| | Percent increase/ decrease in CFG EVE(1) | |
|---|---|---|
| (unaudited) | 2% parallel upward movement in US interest rates | 2% parallel downward movement in US interest rates (No negative rates allowed) |
| Period end | (0.7) | (19.0) |
| Maximum | (18.2) | (20.8) |
| Minimum | (0.7) | (4.4) |
| Average | (12.2) | (12.6) |

Note:

(1) Economic value of equity is the net present value 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.

Sensitivity of net interest income (unaudited)
There have been no material changes to the Group's measurement and management of the sensitivity of net interest income to movement in interest rates.

The Group 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.

The table below sets out the effect on future net interest income of a sustained +/-100bp parallel rise/fall in all yield curves.

| | Year 1 £m |
|---|---|
| + 100bp shift in yield curves | 138.9 |
| – 100bp shift in yield curves | (234.1) |

The interest rate sensitivities in the table above are illustrative only and are based on simplified scenarios.

The figures represent the effect on pro forma net interest income of movements of the yield curve based on the Group's current non-trading interest rate risk profile. This effect however does not incorporate actions that would be taken by the business units to mitigate the effect of this interest rate risk. In reality the business units proactively seek to change the interest rate risk profile to minimise losses and optimise net revenues.

The projections also assume that interest rates of all maturities move 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 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.

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Currency risk (audited)
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 GALCO. 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 requires that these shares be held on the balance sheet at historic 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:

| 2008 | 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 | 17,480 | (19) | 17,499 | (3,659) | 13,840 |
| Euro | 26,943 | 15,431 | 11,512 | (7,461) | 4,051 |
| Chinese RMB | 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 RMB | 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 |

Retranslation gains and losses on the Group's net investments 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 five percent strengthening in foreign currencies would result in a gain of £1,010 million (2007 – £1,200 million) recognised in equity, while a five per cent weakening in foreign currencies would result in a loss of £960 million (2007 - £1,140 million) recognised in equity. These movements in equity would offset retranslation effects on the Group's foreign currency denominated risk weighted assets, reducing the sensitivity of the Group's Tier 1 capital ratio to movements in foreign currency exchange rates.

Equity risk (audited)

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 balance sheet value of equity exposures at December 2008.

| | Listed | Unlisted | Total |
|---|---|---|---|
| | £m | £m | £m |
| Equity exposures* | 4,267 | 3,018 | 7,285 |

* excludes equity exposures held-for-trading purposes and by insurance/assurance entities

Risk control (unaudited)
The prime risk control mechanism for non-traded market risk exposures is the completion of monthly IRRBB and quarterly FXRBB returns by the Group's business units, collated as part of month-end reporting by Group Treasury to GALCO. In relation to equity risk, risk is mitigated by proper controls in relation to identification of risk prior to investing.

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 returns by the Group's business units, collated as part of month-end 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 minimis limits. Group Treasury monitors adherence to this policy via 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.

Insurance risk (unaudited)
The Group is exposed to insurance risk directly through its general 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 the risk that the technical reserves are assessed incorrectly such that insufficient 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. Claims development data provides information on the historical pattern of reserving risk.

Reinsurance risk management: is used to protect against adverse claims experience on business within normal risk appetite (e.g. catastrophic events, adverse frequency of large claims) and to provide protection on business not within its risk appetite (e.g. quota share reinsurance on certain classes of business).

The aggregate amount of business by product and entity is determined through the business plans.

Overall, insurance risk is predictable over time, given the large volumes of data. Uncertainty does exist, especially around predictions such as the variations in weather. Risk is minimised through the application of documented risk policies, coupled with governance frameworks.

General insurance business
The Group's focus in its general insurance operation is 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.

Other commercial insurance contracts: risk arises from business interruption and loss arising from the negligence of the insured (liability insurance). Business interruption claims arise from the losses of income, revenue and/or profit as a result of property damage claims. Liability insurance includes employer's liability and public/products liability.

Most general insurance contracts are written on an annual basis, which means that the Group's liability extends for a 12 month period, after which the Group is entitled to decline to renew or can impose renewal terms by amending the premium, terms and conditions.

An analysis of gross and net insurance claims can be found in Note 24 on the report and accounts (see page 216).

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Life insurance business

The Group's three regulated life companies, National Westminster Life Assurance Limited, Royal Scottish Assurance plc (RSA) and Direct Line Life Insurance Company Limited, are required to meet minimum capital requirements at all times under the FSA Prudential Sourcebook.

The capital resources covering the regulatory requirement are not transferable to other areas of the Group. To ensure that the capital requirement is satisfied at all times, each company holds a voluntary buffer above the regulatory minimum. Reserving risk is managed for life businesses through detailed analysis of historical and industry claims data and robust control procedures around reserving models. The Group uses exclusively proportional reinsurance, quota share and surplus, for its life insurance entities.

The Group is not exposed to price, currency, credit, or interest risk on unit linked life contracts but it is exposed to variation in management fees. In the UK, the Group also writes insurance contracts with minimum guaranteed death benefits that expose it to the risk that declines in the value of underlying investments may increase the Group's net exposure to mortality risk.

The Group's long-term assurance contracts include whole-life, term assurance, endowment assurance, flexible whole life, pension and annuity contracts that are expected to remain in force for an extended period of time. Contracts under which the Group does not accept significant insurance risk are classified as investment contracts. Long term business provisions 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 actuarial reserves. Key metrics include:

| Assumptions | 2008 | 2007 | 2006 |
|---|---|---|---|
| Valuation interest rate | | | |
| Term assurance | 2.50% | 3.00% | 3.00% |
| Interest | 2.50% | 3.00% | 3.00% |
| Unit growth | 3.70% | 3.50% | 3.50% |
| Expense inflation | 3.00% | 4.00% | 4.00% |

Sample mortality rates, expressed as deaths per million per annum, for term assurance products (age 40).

| Mortality | 2008 per annum | 2007 per annum | 2006 per annum |
|---|---|---|---|
| Male non-smoker | 723 | 810 | 517 |
| Male smoker | 1,590 | 1,830 | 983 |
| Female non-smoker | 568 | 460 | 278 |
| Female smoker | 1,277 | 1,310 | 618 |

Expenses:

| Pre-2000 products – RSA | 2008 per annum | 2007 per annum | 2006 per annum |
|---|---|---|---|
| Lifestyle protection plan | £29.30 | £25.18 | £28.96 |
| Mortgage savings plan | £65.92 | £56.67 | £65.15 |

| | | | |
|---|---|---|---|
| Pre-2000 products – NatWest Life | | | |
| Term assurances | £26.01 | £26.01 | £26.01 |
| Linked life bonds | £26.01 | £26.01 | £26.01 |
| | | | |
| Post-2000 products | | | |
| Term assurances | £23.17 | £23.16 | £23.16 |
| Guaranteed bonds | £25.71 | £25.71 | £25.71 |

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The key factors that increase the frequency of claims include epidemics or widespread changes in lifestyle.

The Group uses base tables of standard mortality appropriate to the type of contract being written and the territory in which the insured person resides. These are adjusted to reflect the Group's experience and expectations for future mortality improvements as appropriate.

| Sensitivity factor | Description of sensitivity factor applied |
|---|---|
| Interest rate and investment return | Change in market interest rates of ±1%<br>The test allows consistently for similar changes to investment returns and movements in the market value of backing fixed interest securities |
| Expenses | Increase in maintenance expenses of 10% |
| Assurance mortality/morbidity | Increase in mortality/morbidity rates for assurance contracts of 5% |
| Annuitant mortality | Reduction in mortality rates for annuity contracts of 5% |

The above UK sensitivity factors are applied through actuarial and statistical models, with the following impact on the financial statements.

| | Impact on profit and equity | | |
|---|---|---|---|
| | | 2008 | 2007 |
| Risk factor | Variability | £m | £m |
| Interest rates | +1% | (11) | (18) |
| Interest rates | –1% | 11 | 15 |
| Expenses | +10% | (7) | (5) |
| Assurance mortality/morbidity | +5% | (9) | (8) |
| Annuitant mortality | –5% | — | — |

Reinsurance

The Group uses various types of reinsurance to transfer risk that is outside the Group's risk appetite, including:

- Per individual risk excess of loss reinsurance.
- Catastrophe excess of loss reinsurance.
- Quota share and surplus reinsurance.

Operational risk (unaudited)
Operational risk is the risk of financial loss or reputational impact resulting from fraud; human error; ineffective or inadequately designed processes or systems; improper behaviour; legal events; or from 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 with the resultant reduction in exposure. Strategies to manage operational risk include avoidance, transfer, and mitigation by controls or risk acceptance.

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<br>Accountable for the ownership and day-to-day management and control of operational risk.<br><br>Responsible for implementing processes in compliance with Group policies.<br>Responsible for testing key controls and monitoring compliance with Group policies. | Operational Risk<br>Responsible for the implementation and maintenance of the operational risk framework, tools and methodologies.<br>Responsible for oversight and challenge on the adequacy of the risk and control processes operating in the business. | Group Internal Audit<br>Responsible for providing independent assurance on the design, adequacy and effectiveness of the Group's system of internal controls. |

The three lines of defence model and the Operational Risk Policy and Principles (ORPP) apply throughout the Group and are implemented taking into account the nature and scale of the underlying business. The ORPP provides the direction for delivering effective operational risk management. It comprises principles, minimum standards and processes that enable the consistent identification, assessment, management, monitoring and reporting of operational risk across the Group. The objectives of the ORPP 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 Group-wide processes defined in the ORPP 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 £10,000. This is used to enhance the adequacy and effectiveness of controls, identify opportunities to prevent or reduce the impact of re-occurrence, 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.

New product approval 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.

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In 2008, the Group introduced a new self-certification process, which requires management to regularly monitor and report on the internal control framework for which they are responsible and regularly review and confirm its adequacy and effectiveness. This includes certifying compliance with the requirements of Group policies.

The ORPP requires each business unit to determine appropriate mitigation techniques to reduce its risk exposure to an acceptable level, and that the adequacy and effectiveness of controls and other risk mitigants (e.g. insurance) are tested regularly and the results documented. 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, as insurance only provides protection against financial loss once a risk has crystallised, it is used as a complement to other controls.

Operational risk metrics
Reporting forms an integral part of operational risk management. The Group's risk management processes are designed to ensure that operational risk issues are identified, escalated and managed on a timely basis. Operational risk exposures for each division are reported through monthly risk and control reports, which provide detail on the risk exposures and action plans for each significant business process.

Operational risk events that have an actual or potential financial impact in excess of £1 million, or which have a material impact on the Group's reputation or customers, are escalated and reported to divisional and Group executive.

The graph below shows the operational risk events by category and value for 2007 and 2008.

Operational risk events by risk category – % of total risk events by count
The chart below shows a similar distribution of loss event numbers across the risk categories in 2008 as those in 2007.

Operational risk events by category – % of total by value

The charts below show that execution, delivery, and process management accounted for over 60% of losses by value during 2008. This differs from 2007 where a single large value event meant that clients, products and business practices was the largest category.

Financial crime

Financial crime remains a big challenge for the Group, especially given the sophistication of the criminal fraternity. However, the Group continues to respond to such threats, by continuing to invest in people and processes for both detective and preventative measures especially relating to card fraud and cyber crime. Key initiatives include changes to authentication of payments, ATM security, software enhancements and improvement in counterfeit detection.

Physical security environment

The number of physical attacks on our retail business was broadly static in 2008 compared with 2007. Business plans and controls have been enhanced to reflect the increase in size of the global business during the year, for example changes to retail and ATM security and sharing best practice with competitors and law enforcement agencies.

Information security

The Group is committed to protecting customer and Group information. Under a Group-wide policy framework, Group Information Security is developing, maintaining and implementing policies and systems to secure such information. 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. The Group Information Security Policies are aligned to international standards and regulatory requirements.

The Group recognises information security, relating to the loss of confidentiality, integrity or availability of our information and systems, as a specific risk, which is managed through a Group Information Security Policy. This is reviewed annually and includes processes for managing and ensuring 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 2008, security reviews on third party suppliers and vendors were significantly increased.

Business continuity

The management of crisis situations and the need to ensure the continuity of business across the Group is a key activity within the risk function. A consistent crisis and incident management framework has been rolled out across the Group, to ensure that any incident is identified, managed and resolved through skilled divisional, country, regional and global teams. A six step methodology is in place within the Group for managing incidents.

Key risks and threats that the Group is consistently monitoring from the crisis and incident management perspective include pandemics, terrorism, environmental impacts and technology disruptions.

Business continuity plans have been implemented to ensure that the Group can continue key services, products and operations.

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## Other risks (unaudited)

### 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 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.

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, on-going supervisory requirements or regulatory investigations.

During the course of 2008, responsibility for policy and oversight of anti-money laundering, sanctions and counter-terrorist financing moved to the Group Head of Regulatory Risk & Compliance.

### 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. 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.

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 potential funding deficit 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.

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 for additional payments over and above the regular contributions. The next funding valuation is scheduled to be carried out as at 31 March 2010.

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Credit market and related exposures

Explanatory note (unaudited)

These disclosures provide information for certain of the Group's business activities affected by the unprecedented market events of 2008, the majority of which arose within Global Banking and Markets (GBM). The disclosures are focused around GBM's credit markets activities, including the conduit business, which have been particularly affected by the widespread market disruptions, as well as similar exposures in US Retail & Commercial ('Citizens') and Group Treasury.

In preparing these disclosures, the Group took into consideration the leading practice disclosure recommendations of the Financial Stability Forum issued in April 2008.

Market background (unaudited)

Overall, 2008 has been characterised by rapid dislocation in financial markets. In many cases, the dramatic liquidity squeeze and rise in funding costs for financial institutions has resulted in reluctance or inability of market participants to transact, and has adversely affected the performance of most financial institutions globally, including the Group. Stock markets have experienced extraordinary falls, and levels of volatility have been at record highs. Commodity prices have reduced sharply in the second half of the year, and credit spreads continued to widen. Market perception of counterparty risk increased and the failure of major credit protection providers caused fair value losses for the Group and other market participants and further increased the costs of mitigating credit exposure. Sustained falls globally in both residential and commercial real estate prices, fund valuations and worsening loan performance combined with a sustained lack of liquidity in the market, resulted in a greater amount of assets being valued at significantly lower prices.

An indication of the continued decline in the price of asset backed securities (ABS), in particular those collateralised with sub-prime assets, is shown in the following graph. While not fully representative of the Group's ABS exposures or pricing basis, the ABX series of indices charted in the graph show, in bond price terms, how differently rated ABS referencing US sub-prime mortgages securitised in 2007 have performed during the year.

The graph below provides an indication of the change in credit worthiness of corporate entities to which the Group has significant exposure through its credit products in the form of credit derivatives and bonds. The MarkiT iTraxx Europe graph demonstrates the impact of the movement of credit spreads in price terms for a basket of European corporate entities (prices rebased to 100 at the beginning of the year).

The first quarter of 2008 saw a further credit and liquidity shortages experienced during 2007, culminating in the collapse of Bear Stearns in March. The centre of the credit issues remained the ABS market with worsening US economic data supporting higher levels of default expectation in the property market. However, these default expectations started to go beyond the sub-prime market with Alt A and other non-conforming classes of loans particularly seeing significant price deterioration. In addition, wider economic concerns led to heavy fair value losses in the commercial mortgage backed securities (CMBS) market, in corporate debt and in leveraged loan exposures. Following this tightening of conditions, the Group incurred significant losses in March and took steps in April to materially strengthen its capital base through a £12 billion rights issue which was completed in June.

During the second quarter ABS prices initially rallied and steadied, however towards the end of the quarter a negative house price trend in the UK became clear, and in the US, market reaction to sub-prime mortgages extended to prime and near prime lending. Corporate credit spreads followed a similar pattern reacting to rising oil prices, inflationary pressures and continuing high LIBOR despite base rate cuts to 5% in April.

Credit spreads continued to widen across the market through the third quarter and liquidity levels reduced further, resulting in pressure on banks and economies worldwide. This culminated in the demise of Lehman Brothers in September and further market consolidation and global state intervention to provide support to the banking sector.

During the fourth quarter there was a continued lack of confidence in the inter-bank market, with demand for stable investments resulting in US treasuries reaching negative spreads. Corporate and ABS prices fell further particularly in the last two months of the year increasing pressure on banks' capital positions. The Group moved to strengthen its capital position through an open offer to raise £15 billion, underwritten by the UK government. The year concluded with S&P downgrading the credit ratings of eleven global banks, including the Group.

Asset-backed exposures

Significant risk concentrations (audited)

The Group's credit markets activities gives rise to risk concentrations that have been particularly affected by the market turmoil experienced since the second half of 2007. The Group structures, originates, distributes and trades debt in the form of loan, bond and derivative instruments in all major currencies and debt capital markets in North America, Western Europe, Asia and major emerging markets.

During 2008, certain assets identified as being high risk were also transferred to a centrally managed asset unit, set up to provide specific management of this portfolio of higher risk assets. Transferred assets are predominantly ABS and associated protection purchased from monoline insurers and other counterparties.

The tables below summarise the net exposures and balance sheet carrying values of these securities by measurement classification and references to sections with further information on specific products.

| | Held-for-trading | | Available-for-sale | | Loans and receivables | | Designated at fair value | | All ABS | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2008 | 2007 | 2008 | 2007 | 2008 | 2007 | 2008 | 2007 | 2008 | 2007 |
| Net exposure (1) | £m | £m | £m | £m | £m | £m | £m | £m | £m | £m |
| RMBS | 24,462 | 35,105 | 44,450 | 27,875 | 2,578 | 5 | 182 | 90 | 71,672 | 63,075 |
| CMBS | 1,178 | 2,749 | 918 | 977 | 1,437 | 626 | 13 | 47 | 3,546 | 4,399 |
| CDOs/CLOs | 2,463 | 7,288 | 2,538 | 2,174 | 1,282 | — | — | 23 | 6,283 | 9,485 |
| Other ABS | 195 | 3,479 | 6,572 | 5,579 | 3,621 | 72 | 40 | 186 | 10,428 | 9,316 |

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Total | 28,298 | 48,621 | 54,478 | 36,605 | 8,918 | 703 | 235 | 346 | 91,929 | 86,275 |
| | | | | | | | | | | |
| Carrying value (2) | | | | | | | | | | |
| RMBS | 27,849 | 37,280 | 44,791 | 27,880 | 2,618 | 5 | 182 | 90 | 75,440 | 65,255 |
| CMBS | 2,751 | 3,916 | 1,126 | 976 | 1,437 | 626 | 13 | 37 | 5,327 | 5,555 |
| CDOs/CLOs | 7,774 | 15,477 | 9,579 | 2,173 | 1,284 | — | — | 26 | 18,637 | 17,676 |
| Other ABS | 1,505 | 5,758 | 6,572 | 5,579 | 3,621 | 72 | 41 | 186 | 11,739 | 11,595 |
| Total | 39,879 | 62,431 | 62,068 | 36,608 | 8,960 | 703 | 236 | 339 | 111,143 | 100,081 |

Notes:

(1) Net exposure is carrying value after taking account of hedge protection purchased from monolines and other counterparties but excludes the effect of counterparty credit valuation adjustment. The protection provides credit protection against the notional and interest cash flows due to the holders of debt instruments in the event of default by the debt security counterparty. The value of the protection is based on the underlying instrument being protected.

(2) Carrying value is the amount recorded on the balance sheet.

(3) Certain instruments have been reclassified from the held-for-trading category to loans and receivables or available-for-sale categories, as permitted by the amendment to IAS 39 issued in October 2008, therefore affecting comparability by measurement classification.

Asset backed securities (ABS) are securities that represent an interest in an underlying pool of referenced assets. The referenced pool can comprise any assets which attract a set of associated cash flows but are commonly pools of residential or commercial mortgages and, in the case of Collateralised Debt Obligations (CDOs), the referenced pool may be ABS or other classes of assets. The process by which the risks and rewards of the pool are passed on to investors via the issuance of securities with varying seniority is commonly referred to as securitisation.

During 2008, as the problems in the sub-prime sector spread to other asset classes on a global basis and credit spreads widened due to concerns over creditworthiness of underlying assets, securitisation volumes continued to be thin. Over the preceding years GBM had established itself as an active arranger of third-party securitisations and a secondary dealer in these securities, and GBM had therefore accumulated assets that became difficult to sell given market conditions.

The Group has exposures to ABS which are predominantly debt securities but can be held in derivative form. These positions had been acquired primarily through the Group's activities in the US leveraged finance market which were expanded during 2007. These include residential mortgage backed securities ('RMBS'), commercial mortgage backed securities ('CMBS'), ABS CDOs and other ABS. In many cases the risk on these assets is hedged via credit derivative protection purchased over the specific asset or relevant ABS indices. The counterparty to some of these hedge transactions are monoline insurers (see Monoline insurers on page 114).

The net exposure of the Group's holdings of ABS increased from £86.3 billion at 31 December 2007 to £91.9 billion by 31 December 2008, where underlying reductions have been more than offset by the effect of exchange rates. The net exposure incorporates hedge protection but excludes counterparty credit valuation adjustments. All hedge protection referred to in the credit market and related exposures section relates to economic hedges that do not qualify for hedge accounting.

Through a sustained de-risking exercise the Group made reductions to the overall risk through a combination of direct asset sales and switching to lower risk assets through trading activities. As a large proportion of the ABS are denominated in US dollars, these reductions in exposure were partially offset due to the movement in the exchange rate against sterling.

The majority of the Group's RMBS portfolio at 31 December 2008, in terms of net exposure, was AAA rated guaranteed or effectively guaranteed securities of £51.1 billion, comprising:

- £33.5 billion of US agency securities
- £7.6 billion of Dutch government guaranteed RMBS
- £10.0 billion of European mortgage covered bonds issued by financial institutions

The tables below analyse carrying values of these debt securities by measurement classification and rating and fair value hierarchy level.

| | RMBS | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | | Non | Prime | | | | | |
| | | | | | | | Other | |
| | Sub-prime | conforming | Guaranteed | Other | CMBS | CDOs/CLOs | ABS | Total |
| 2008 | £m | £m | £m | £m | £m | £m | £m | £m |
| AAA rated (1) | | | | | | | | |
| Held-for-trading | 393 | 203 | 18,622 | 6,226 | 2,306 | 4,698 | 380 | 32,828 |
| Available-for-sale | 522 | 1,914 | 22,546 | 18,764 | 982 | 6,459 | 4,826 | 56,013 |
| Loans and receivables | 431 | 1,415 | — | 476 | 405 | 652 | 1,443 | 4,822 |
| Designated at fair value | 16 | — | — | 166 | 9 | — | — | 191 |
| | 1,362 | 3,532 | 41,168 | 25,632 | 3,702 | 11,809 | 6,649 | 93,854 |
| BBB- and above rated (1) | | | | | | | | |
| Held-for-trading | 564 | 79 | — | 985 | 407 | 1,439 | 890 | 4,364 |
| Available-for-sale | 267 | 194 | — | 338 | 144 | 1,642 | 1,292 | 3,877 |
| Loans and receivables | 105 | 64 | — | 94 | 1,031 | 561 | 1,296 | 3,151 |
| Designated at fair value | — | — | — | — | 4 | — | 41 | 45 |
| | 936 | 337 | — | 1,417 | 1,586 | 3,642 | 3,519 | 11,437 |
| Non-investment grade (1) | | | | | | | | |
| Held-for-trading | 636 | 69 | — | 59 | 38 | 1,299 | 120 | 2,221 |
| Available-for-sale | 124 | 74 | — | 47 | — | 1,057 | 50 | 1,352 |
| Loans and receivables | 30 | 3 | — | — | — | — | 72 | 105 |
| | 790 | 146 | — | 106 | 38 | 2,356 | 242 | 3,678 |
| Not publicly rated (1) | | | | | | | | |
| Held-for-trading | 1 | 1 | 9 | 2 | — | 338 | 115 | 466 |
| Available-for-sale | — | 1 | — | — | — | 421 | 404 | 826 |
| Loans and receivables | — | — | — | — | 1 | 71 | 810 | 882 |
| | 1 | 2 | 9 | 2 | 1 | 830 | 1,329 | 2,174 |
| Total | | | | | | | | |
| Held-for-trading | 1,594 | 352 | 18,631 | 7,272 | 2,751 | 7,774 | 1,505 | 39,879 |
| Available-for-sale | 913 | 2,183 | 22,546 | 19,149 | 1,126 | 9,579 | 6,572 | 62,068 |
| Loans and receivables | 566 | 1,482 | — | 570 | 1,437 | 1,284 | 3,621 | 8,960 |
| Designated at fair value | 16 | — | — | 166 | 13 | — | 41 | 236 |
| Total | 3,089 | 4,017 | 41,177 | 27,157 | 5,327 | 18,637 | 11,739 | 111,143 |
| Of which carried at fair value: | | | | | | | | |
| Level 2 (2) | 2,459 | 2,485 | 40,942 | 26,442 | 3,316 | 14,643 | 6,677 | 96,964 |
| Level 3 (3) | 64 | 50 | 235 | 145 | 574 | 2,710 | 1,441 | 5,219 |
| | 2,523 | 2,535 | 41,177 | 26,587 | 3,890 | 17,353 | 8,118 | 102,183 |

Notes:

(1) Credit ratings are based on those from S&P, Fitch or Moody’s and have been mapped on to S&P scale.

(2) Valued using techniques based significantly on observable market data. Instruments in this level are valued using:

(a) quoted prices for similar instruments in markets which are not considered to be active; or

(b) valuation techniques where all the inputs that have a significant effect on the valuation are directly or indirectly based on observable market data.

(3) Instruments in this category have been valued using a valuation technique where at least one input which could have a significant effect on the instrument’s valuation is not based on observable market data.

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| | RMBS | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | | | Prime | | | | | |
| | | Non | | | | | Other | |
| | Sub-prime | conforming | Guaranteed | Other | CMBS | CDOs/CLOs | ABS | Total |
| 2007(1) | £m | £m | £m | £m | £m | £m | £m | £m |
| Carrying value: credit rating and classification | | | | | | | | |
| AAA rated (2) | | | | | | | | |
| Held-for-trading | 1,790 | 2,093 | 15,502 | 12,952 | 3,285 | 12,067 | 3,495 | 51,184 |
| Available-for-sale | 139 | 865 | 16,545 | 10,313 | 964 | 2,152 | 5,073 | 36,051 |
| Designated at fair value | — | — | — | 72 | 37 | 7 | — | 116 |
| | 1,929 | 2,958 | 32,047 | 23,337 | 4,286 | 14,226 | 8,568 | 87,351 |
| BBB- and above rated (2) | | | | | | | | |
| Held-for-trading | 2,476 | 530 | — | 557 | 574 | 1,509 | 1,077 | 6,723 |
| Available-for-sale | — | — | — | 18 | 12 | 1 | 208 | 239 |
| Loans and receivables | — | — | — | — | 626 | — | — | 626 |
| Designated at fair value | 2 | — | — | — | — | 17 | — | 19 |
| | 2,478 | 530 | — | 575 | 1,212 | 1,527 | 1,285 | 7,607 |
| Non-investment grade (2) | | | | | | | | |
| Held-for-trading | 616 | 146 | — | 27 | 35 | 1,082 | 91 | 1,997 |
| Available-for-sale | — | — | — | — | — | — | 14 | 14 |
| Loans and receivables | 5 | — | — | — | — | — | 72 | 77 |
| Designated at fair value | 16 | — | — | — | — | — | — | 16 |
| | 637 | 146 | — | 27 | 35 | 1,082 | 177 | 2,104 |
| Not publicly rated | | | | | | | | |
| Held-for-trading | 191 | 144 | 125 | 131 | 22 | 819 | 1,095 | 2,527 |
| Available-for-sale | — | — | — | — | — | 20 | 284 | 304 |
| Designated at fair value | — | — | — | — | — | 2 | 186 | 188 |
| | 191 | 144 | 125 | 131 | 22 | 841 | 1,565 | 3,019 |
| Total | | | | | | | | |
| Held-for-trading | 5,073 | 2,913 | 15,627 | 13,667 | 3,916 | 15,477 | 5,758 | 62,431 |
| Available-for-sale | 139 | 865 | 16,545 | 10,331 | 976 | 2,173 | 5,579 | 36,608 |
| Loans and receivables | 5 | — | — | — | 626 | — | 72 | 703 |
| Designated at fair value | 18 | — | — | 72 | 37 | 26 | 186 | 339 |
| Total | 5,235 | 3,778 | 32,172 | 24,070 | 5,555 | 17,676 | 11,595 | 100,081 |
| Of which: | | | | | | | | |
| Level 2 (3) | 5,171 | 3,598 | 32,172 | 24,070 | 4,929 | 15,926 | 11,393 | 97,259 |
| Level 3 (4) | 59 | 180 | — | — | — | 1,750 | 130 | 2,119 |
| | 5,230 | 3,778 | 32,172 | 24,070 | 4,929 | 17,676 | 11,523 | 99,378 |

Notes:

(1) Carrying values at 31 December 2007 above include ABN AMRO's liquidity portfolio of £18.6 billion of ABS which were part of shared assets then; this portfolio was transferred to RBS Group Treasury in the first half of 2008.

(2) Credit ratings are based on those from rating agencies Standard & Poor's (S&P), Moody's and Fitch and have been mapped onto S&P scale.

(3) Valuation is based significantly on observable market data. Instruments in this category are valued using:

- quoted prices for similar instruments or identical instruments in markets which are not considered to be active; or

- valuation techniques where all the inputs that have a significant effect on the valuation are directly or indirectly based on observable market data.

(4) Instruments in this category have been valued using a valuation technique where at least one input which could have a significant effect on the instrument's valuation is not based on observable market data.

Residential mortgage-backed securities (audited)
Residential mortgage backed securities (RMBS) are securities that represent an interest in a portfolio of residential mortgages. Repayments made on the underlying mortgages are used to make payments to holders of the RMBS. The risk of the RMBS will vary primarily depending on the quality and geographic region of the underlying mortgage assets and the credit enhancement of the securitisation structure.

Several tranches of notes are issued, each secured against the same portfolio of mortgages, but providing differing levels of seniority to match the risk appetite of investors. The most junior (or equity) notes will suffer early capital and interest losses experienced by the referenced mortgage collateral, with each more senior note benefiting from the protection provided by the subordinated notes below. Additional credit enhancements may be provided to the holder of senior RMBS notes, including guarantees over the value of the exposures, often provided by monoline insurers.

The main categories of mortgages that serve as collateral to RMBS held by the Group are described below. As can be seen from the table below, the Group's RMBS portfolio covers a range of geographic locations and different categories are used to classify the exposures depending on the geographical region of the underlying mortgage. These categories are described below. The US market has more established definitions of differing underlying mortgage quality and these are used as the basis for the Group's RMBS categorisation.

Sub-prime mortgages: are loans to sub-prime borrowers typically having weakened credit histories that include payment delinquencies, and potentially more severe problems such as court judgements and bankruptcies. They may also display reduced repayment capacity as measured by credit scores, high debt-to-income ratios, or other criteria indicating heightened risk of default.

Non-conforming mortgages (or 'Alt-A' used for US exposure) have a higher credit quality than sub-prime mortgages, but lower than those prime borrowers. Within the US mortgage industry, non-conforming mortgages are those that do not meet the lending criteria for US agency mortgages (described below). For non-US mortgages, judgement is applied in identifying loans with similar characteristics to US non-conforming loans and also include self-certified loans. Alt-A describes a category of mortgages in which lenders consider the risk to be greater than prime mortgages though less than sub-prime. The offered interest rate is usually representative of the associated risk level.

Guaranteed mortgages are mortgages that form part of a mortgage backed security issuance by a government agency, or in the US an entity that benefits from a guarantee (direct or indirect) provided by the US government. For US RMBS, this category includes, amongst others, RMBS issued by Ginnie Mae, Freddie Mac and Fannie Mae. For European RMBS, this includes mortgages guaranteed by the Dutch Government.

Other prime mortgages are those of a higher credit quality than non-conforming and sub-prime mortgages, and exclude guaranteed mortgages.

Covered mortgage bonds are debt instruments that have recourse to a pool of mortgage assets, where investors have a preferred claim if a default occurs. These underlying assets are segregated from the other assets held by the issuing entity. These underlying assets are segregated from other assets held by the issuing entity.

The tables below show the Group's RMBS net exposures and carrying values by measurement classification, underlying asset type, the main geographical locations of the property that the mortgage is secured against, and the year in which the underlying mortgage was originated.

| | 2008 | | | | | 2007 | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | Prime | | | | | Prime | | |
| | | Non | Guaranteed | | | | Non | Guaranteed | | |
| | Sub-prime | conforming | (2) | Other(3) | Total | Sub-prime | conforming | (2) | Other(3) | Total |
| | £m | £m | £m | £m | £m | £m | £m | £m | £m | £m |
| Net exposure: (1) | | | | | | | | | | |
| Held-for-trading | 345 | 346 | 18,631 | 5,140 | 24,462 | 3,497 | 2,913 | 15,627 | 13,068 | 35,105 |
| Available-for-sale | 572 | 2,184 | 22,546 | 19,148 | 44,450 | 139 | 865 | 16,539 | 10,332 | 27,875 |
| Loans and receivables | 527 | 1,482 | — | 569 | 2,578 | 5 | — | — | — | 5 |
| Designated at fair value | 16 | — | — | 166 | 182 | 18 | — | — | 72 | 90 |
| | 1,460 | 4,012 | 41,177 | 25,023 | 71,672 | 3,659 | 3,778 | 32,166 | 23,472 | 63,075 |
| Carrying values: (2) | | | | | | | | | | |
| Held-for-trading | 1,594 | 352 | 18,631 | 7,272 | 27,849 | 5,073 | 2,913 | 15,627 | 13,667 | 37,280 |
| Available-for-sale | 913 | 2,183 | 22,546 | 19,149 | 44,791 | 139 | 865 | 16,545 | 10,331 | 27,880 |
| Loans and receivables | 566 | 1,482 | — | 570 | 2,618 | 5 | — | — | — | 5 |
| Designated at fair value | 16 | — | — | 166 | 182 | 18 | — | — | 72 | 90 |
| | 3,089 | 4,017 | 41,177 | 27,157 | 75,440 | 5,235 | 3,778 | 32,172 | 24,070 | 65,255 |

Notes:

(1) Net exposures reflect the effect of hedge protection purchased from monolines and other counterparties but excludes the effect of counterparty credit valuation adjustment. Carrying value is the amount recorded on the balance sheet.

(2) Prime guaranteed exposures and carrying values include:

- £7.6 billion (2007 – £6.0 billion) available-for-sale exposures guaranteed by the Dutch government
- £5.7 billion (2007 – £5.0 billion) guaranteed by US government via Ginnie Mae of which £0.5 billion (2007 – £0.3 billion) are held-for-trading
- £27.8 billion (2007 – £21.0 million) effectively guaranteed by the US government via its support for Freddie Mac and Fannie Mae of which £18.1 billon (2007 – £15.2 billion) are held-for-trading

(3) Other prime mortgage exposures include £10.0 billion (2007 – £7.8 billion) covered European mortgage bonds.

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| | 2008 | | | | | 2007 | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | Prime | | | | | Prime | | |
| | Sub-prime | Alt-A | Guaranteed | Other | Total | Sub-prime | Alt-A | Guaranteed | Other | Total |
| United States | £m | £m | £m | £m | £m | £m | £m | £m | £m | £m |
| Net exposure | | | | | | | | | | |
| Held-for-trading | 302 | 346 | 18,577 | 968 | 20,193 | 2,953 | 2,189 | 15,502 | 1,419 | 22,063 |
| Available-for-sale | 53 | 760 | 14,887 | 4,409 | 20,109 | — | 640 | 10,504 | 1,359 | 12,503 |
| Loans and receivables | 3 | — | — | 215 | 218 | — | — | — | — | — |
| | 358 | 1,106 | 33,464 | 5,592 | 40,520 | 2,953 | 2,829 | 26,006 | 2,778 | 34,566 |
| Carrying values | | | | | | | | | | |
| Held-for-trading | 1,427 | 352 | 18,577 | 1,043 | 21,399 | 4,277 | 2,189 | 15,502 | 1,419 | 23,387 |
| Available-for-sale | 394 | 760 | 14,887 | 4,409 | 20,450 | — | 640 | 10,504 | 1,359 | 12,503 |
| Loans and receivables | 3 | — | — | 215 | 218 | — | — | — | — | — |
| | 1,824 | 1,112 | 33,464 | 5,667 | 42,067 | 4,277 | 2,829 | 26,006 | 2,778 | 35,890 |
| Of which originated in: | | | | | | | | | | |
| – 2004 and earlier | 474 | 122 | 5,534 | 709 | 6,839 | 746 | 165 | 2,532 | 406 | 3,849 |
| – 2005 | 259 | 718 | 6,014 | 2,675 | 9,666 | 1,065 | 437 | 3,209 | 275 | 4,986 |
| – 2006 | 718 | 115 | 1,689 | 614 | 3,136 | 1,734 | 1,188 | 5,557 | 1,017 | 9,496 |
| – 2007 and later | 373 | 157 | 20,227 | 1,669 | 22,426 | 732 | 1,039 | 14,708 | 1,080 | 17,559 |
| | 1,824 | 1,112 | 33,464 | 5,667 | 42,067 | 4,277 | 2,829 | 26,006 | 2,778 | 35,890 |

| | 2008 | | | | 2007 | | | |
|---|---|---|---|---|---|---|---|---|
| | | Non | | | | Non | | |
| | Sub-prime | conforming | Prime | Total | Sub-prime | conforming | Prime | Total |
| United Kingdom | £m | £m | £m | £m | £m | £m | £m | £m |
| Net exposure | | | | | | | | |
| Held-for-trading | 33 | — | 258 | 291 | 150 | 724 | 2,411 | 3,285 |
| Available-for-sale | 154 | 1,423 | 3,446 | 5,023 | 7 | 157 | 931 | 1,095 |
| Loans and receivables | 205 | 1,482 | 118 | 1,805 | 5 | — | — | 5 |
| Designated at fair value | 16 | — | 166 | 182 | 18 | — | 72 | 90 |
| | 408 | 2,905 | 3,988 | 7,301 | 180 | 881 | 3,414 | 4,475 |
| Carrying values: | | | | | | | | |
| Held-for-trading | 70 | — | 1,345 | 1,415 | 150 | 724 | 2,740 | 3,614 |
| Available-for-sale | 154 | 1,423 | 3,446 | 5,023 | 7 | 157 | 935 | 1,099 |
| Loans and receivables | 205 | 1,482 | 118 | 1,805 | 5 | — | — | 5 |
| Designated at fair value | 16 | — | 166 | 182 | 18 | — | 72 | 90 |
| | 445 | 2,905 | 5,075 | 8,425 | 180 | 881 | 3,747 | 4,808 |
| Of which originated in: | | | | | | | | |
| – 2004 and earlier | 72 | — | 815 | 887 | 13 | 22 | 911 | 946 |
| – 2005 | 42 | 652 | 1,000 | 1,694 | 1 | 10 | 512 | 523 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| – 2006 | 209 | 756 | 2,308 | 3,273 | 49 | 110 | 1,256 | 1,415 |
| – 2007 and later | 122 | 1,497 | 952 | 2,571 | 117 | 739 | 1,068 | 1,924 |
| | 445 | 2,905 | 5,075 | 8,425 | 180 | 881 | 3,747 | 4,808 |

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| | 2008 | | | | | 2007 | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | Prime | | | | | Prime | | | |
| | Sub-prime | Guaranteed | Covered | Other | Total | Sub-prime | Guaranteed | Covered | Other | Total |
| Europe | £m | £m | £m | £m | £m | £m | £m | £m | £m | £m |
| Net exposure | | | | | | | | | | |
| Held-for-trading | 10 | — | — | 3,898 | 3,908 | 321 | — | — | 9,157 | 9,478 |
| Available-for-sale | 57 | 7,642 | 10,040 | 1,106 | 18,845 | — | 6,012 | 7,822 | 57 | 13,891 |
| Loans and securities | 313 | — | — | 208 | 521 | — | — | — | — | — |
| | 380 | 7,642 | 10,040 | 5,212 | 23,274 | 321 | 6,012 | 7,822 | 9,214 | 23,369 |
| Carrying values | | | | | | | | | | |
| Held-for-trading | 30 | — | — | 4,839 | 4,869 | 324 | — | — | 9,429 | 9,753 |
| Available-for-sale | 57 | 7,642 | 10,040 | 1,107 | 18,846 | — | 6,012 | 7,822 | 57 | 13,891 |
| Loans and securities | 352 | — | — | 208 | 560 | — | — | — | — | — |
| | 439 | 7,642 | 10,040 | 6,154 | 24,275 | 324 | 6,012 | 7,822 | 9,486 | 23,644 |
| Of which originated in: | | | | | | | | | | |
| – 2004 and earlier | 48 | 418 | 702 | 954 | 2,122 | 81 | 367 | 577 | 1,395 | 2,420 |
| – 2005 | 17 | 1,165 | 2,993 | 1,090 | 5,265 | 33 | 1,117 | 2,160 | 1,946 | 5,256 |
| – 2006 | 148 | 2,059 | 4,466 | 2,466 | 9,139 | 63 | 1,780 | 3,801 | 3,897 | 9,541 |
| – 2007 and later | 226 | 4,000 | 1,879 | 1,644 | 7,749 | 147 | 2,748 | 1,284 | 2,248 | 6,427 |
| | 439 | 7,642 | 10,040 | 6,154 | 24,275 | 324 | 6,012 | 7,822 | 9,486 | 23,644 |

In other geographical regions not covered above, RMBS portfolios included:

- net RMBS exposures of £314 million (2007 – £205 million) comprising: held-for-trading nil (2007 – £73 million); available-for-sale £308 million (2007 – £132 million) and loans and receivables £6 million (2007 – nil).
- RMBS carrying values of £381 million (2007 – £454 million) comprising: held-for-trading £67 million (2007 – £322 million); available-for-sale £308 million (2007 – £132) and loans and receivables £6 million (2007 – nil).
- RMBS non-conforming available-for-sale net exposures and carry values of nil (2007 – £68 million).

The Group's largest concentration of RMBS assets relate to a portfolio of US agency asset backed securities comprising mainly current year vintage positions of £33.5 billion at 31 December 2008 (2007: £26.0 billion). Due to the US government backing explicit or implicit in these securities, the counterparty credit risk exposure is low. The losses arising from the movements in fair value recorded for these assets were comparatively lower than other RMBS. Financial markets and economic conditions have been extremely difficult in the US throughout 2008, particularly in the last quarter. Credit conditions have deteriorated and financial markets have experienced widespread illiquidity and elevated levels of volatility due to forced de-leveraging. Transaction activity in the securities portfolio has been reduced due to general market illiquidity. Residential mortgages have been affected by the stress that consumers experienced from depreciating house prices, rising unemployment and tighter credit conditions, resulting in higher levels of delinquencies and foreclosures. In particular, the deteriorating economy and financial markets have negatively impacted the valuation, liquidity, and credit quality of private-label securities.

Citizens maintains an available-for-sale investment securities portfolio to provide high-quality collateral to provide a liquidity buffer and to enhance earnings. The size of the portfolio has been relatively stable through 2008, but both the absolute and relative size (% of earning assets) declined in 2006-2007. The portfolio comprises high credit quality mortgage-backed securities, to ensure both pledgeability and liquidity. The U.S. Government guarantees on MBS, whether explicit or implicit, put most of the portfolio in a secure credit position. The non-agency MBS holdings derive credit support in two ways. Firstly, there is senior and subordinated structuring, and Citizens hold only the most senior tranches. Secondly, there is high quality supporting loan collateral. The collateral quality is evidenced (a) by the vintages, with 82% issued in 2005 and earlier, (b) by the borrower's weighted loan to value (LTV) ratio of 65%, and (c) by the borrower's weighted-average FICO score of 734.

£7.6 billion (2007 – £6.0 billion) of the RMBS exposure consists of available-for-sale portfolio of European RMBS in Group Treasury, referencing primarily Dutch and Spanish government-backed loans, and accordingly the quality of these assets has held up relative to other RMBS types. A further £10.0 billion (2007 – £7.8 billion) European RMBS comprised covered mortgage bonds.

The Group has other portfolios of RMBS from secondary trading activities, warehoused positions previously acquired with the intention of further securitisation and a portfolio of assets from the unwinding of a securities arbitrage conduit. This conduit was established to benefit from the margin between the assets purchased and the notes issued. The majority of these held-for-trading RMBS have been grouped together for management purposes.

Some of these assets (£7.0 billion) were reclassified from held-for-trading category to the loans and receivables (£1.8 billion) and available-for-sale categories during the year (£5.2 billion).

Overall, the Group has recognised significant fair value losses on RMBS assets during the year due to reduced market liquidity and deteriorating credit ratings of these assets. The Group has reduced its exposure to RMBS predominantly through fair value hedges and asset sales during the year. These decreases were partially offset by the weakening of sterling relative to the US dollar and euro.

Commercial mortgage-backed securities (audited)
Commercial mortgages backed securities (CMBS) are securities that are secured by mortgage loans on commercial land and buildings. The securities are structured in the same way as an RMBS but typically the underlying assets referenced will be of greater individual value. The performance of the securities are highly dependent upon the sector of commercial property referenced and the geographical region.

The Group accumulated CMBS for the purpose of securitisation and secondary trading. The largest holding of CMBS arose as a result of the Group's purchase of senior tranches in mezzanine and high grade CMBS structures from third parties. These securities are predominantly hedged with monoline insurers. As a result, the Group's risk is limited to the counterparty credit risk exposure to the hedge. The Group also holds CMBS arising from securitisations of European commercial mortgages originated by the Group.

The following table shows the composition of the Group's holdings of CMBS portfolios.

| | 2008 | | | | | 2007 | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | US | UK | Europe | ROW(1) | Total | US | UK | Europe | ROW | Total |
| | £m | £m | £m | £m | £m | £m | £m | £m | £m | £m |
| Office | 435 | 938 | 402 | — | 1,775 | 599 | 534 | — | — | 1,133 |
| Mixed use | 32 | 106 | 1,048 | 45 | 1,231 | — | 73 | 192 | — | 265 |
| Healthcare | 805 | 143 | — | — | 948 | 1,210 | — | — | — | 1,210 |
| Retail | 295 | 43 | 17 | 48 | 403 | 398 | 13 | — | — | 411 |
| Industry | 24 | 13 | 81 | — | 118 | 61 | — | — | 100 | 161 |
| Multi-family | 40 | — | 49 | — | 89 | 48 | — | — | — | 48 |
| Leisure | — | 76 | — | — | 76 | — | — | — | — | — |
| Hotel | 40 | 35 | — | — | 75 | 36 | — | — | — | 36 |
| Other | 474 | 41 | 49 | 48 | 612 | 932 | 530 | 765 | 64 | 2,291 |
| | 2,145 | 1,395 | 1,646 | 141 | 5,327 | 3,284 | 1,150 | 957 | 164 | 5,555 |

Note:

(1) Rest of the World.

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Asset-backed collateralised debt and loan obligations (audited)
Collateralised debt obligations are securities whose performance is dependant on a portfolio of referenced underlying securitised assets. The referenced assets generally consist of ABS, but may also include other classes of assets. Collateralised loan obligations represent securities in special purpose entities, the assets of which are primarily cash flows from underlying leveraged loans.

The Group's ABS CDO and CLO net exposures comprised:

| | 2008<br>£m | 2007<br>£m |
|---|---|---|
| Super senior CDOs | 1,375 | 3,834 |
| Other CDOs | 1,465 | 1,569 |
| CLOs | 3,443 | 4,082 |
| | 6,283 | 9,485 |

The Group's CDO exposures comprise CDOs structured by the Group from 2003 to 2007 that were unable to be sold to third parties due to prevailing illiquid markets with net exposures of £1.4 billion (2007 – £3.8 billion), as well as other CDO net exposures of £1.5 billion (2007 – £1.6 billion) purchased from third parties some of which are fully hedged through CDSs with other banks or monoline insurers.

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Super senior CDOs
Super senior CDOs represent the most senior positions in a CDO, having subordination instruments (usually represented by a combination of equity, mezzanine and senior notes) which absorb losses before the super senior note is affected. Losses will only be suffered by the super senior note holders after a certain threshold of defaults of the underlying reference assets has been reached. The threshold is usually referred to in percentage terms of defaults of the remaining pool, and known as the ‘attachment point’. These super senior instruments carry an AAA rating at point of origination, or are senior to other AAA rated notes in the same structure. The level of defaults occurring on recent vintage sub-prime mortgages and other asset classes has been higher than originally expected. This has meant that the subordinate positions have diminished significantly in value, credit quality and rating and, as a result, the super senior tranches of the CDOs have a higher probability of suffering losses than at origination. The ratings of the majority of the underlying collateral are now below investment grade.

Depending on the quality of the underlying reference assets at issuance, the super senior tranches will be either classified as high grade or mezzanine. The majority of the Group’s total exposure relates to high grade super senior tranches of ABS CDOs. This is based upon the original classification of the deals derived from the underlying reference asset rating quality. The table below summarises the carrying amounts and net exposures after hedge protection of the Group’s super senior CDOs as at 31 December 2008. The collateral rating is determined with reference to S&P ratings where available. Where S&P ratings are not available the lower of Moody’s and Fitch ratings have been used.

| | 2008 | | | 2007 | | |
|---|---|---|---|---|---|---|
| | High grade £m | Mezzanine £m | Total £m | High grade £m | Mezzanine £m | Total £m |
| Gross exposure | 7,673 | 3,720 | 11,393 | 6,420 | 3,040 | 9,460 |
| Fair value adjustment | (3,423) | (691) | (4,114) | (3,347) | (1,250) | (4,597) |
| | 4,250 | 3,029 | 7,279 | 3,073 | 1,790 | 4,863 |
| Write-downs on net open position | (3,019) | (2,885) | (5,904) | (492) | (537) | (1,029) |
| Net exposure after hedges | 1,231 | 144 | 1,375 | 2,581 | 1,253 | 3,834 |
| | % | % | % | % | % | % |
| Average price | 29 | 6 | 21 | 84 | 70 | 79 |
| Underlying RMBS sub-prime assets (origination) | 69 | 91 | 79 | 69 | 91 | 79 |
| Of which originated in: | | | | | | |
| 2005 and earlier | 24 | 23 | 24 | 24 | 23 | 24 |
| 2006 | 28 | 69 | 46 | 28 | 69 | 46 |
| 2007 | 48 | 8 | 30 | 48 | 8 | 30 |
| Collateral by rating at reporting date: (2) | | | | | | |
| AAA | 14 | — | 9 | 36 | — | 23 |
| BBB- and above | 35 | 5 | 24 | 62 | 31 | 51 |
| Non-investment grade | 51 | 95 | 67 | 2 | 69 | 26 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Attachment point (3) | 29 | 46 | 36 | 29 | 46 | 35 |
| Attachment point post write down | 77 | 97 | 88 | 40 | 62 | 50 |

Notes:

(1) The above table includes data for two trades liquidated in the last quarter of 2008 to provide consistency with comparatives.

(2) Credit ratings are based on those from rating agencies Standard & Poor's (S&P), Moody's and Fitch and have been mapped onto S&P scale.

(3) Attachment point is the minimum level of losses in a portfolio which a tranche is exposed to, as a percentage of the total notional size of the portfolio. For example, a 5 – 10% tranche has an attachment point of 5% and a detachment point of 10%. When the accumulated loss of the reference pool is less than 5% of the total initial notional of the pool, the tranche will not be affected. However, when the loss has exceeded 5%, any further losses will be deducted from the tranche's notional principal until detachment point, 10%, is reached.

The change in net exposure during the year is analysed below.

| | High grade £m | Mezzanine £m | Total £m |
|---|---|---|---|
| Net exposure at 1 January 2008 | 2,581 | 1,253 | 3,834 |
| Net income statement effect | (1,836) | (1,140) | (2,976) |
| Foreign exchange and other movements | 486 | 31 | 517 |
| Net exposure at 31 December 2008 | 1,231 | 144 | 1,375 |

High grade super senior exposures

As shown in the table below, the majority of the Group's high grade super senior exposures, represent securities retained in CDO structures originated by the Group.

| | Gross exposure £m |
|---|---|
| Group originated deals | 6,776 |
| Third party structures | 897 |
| | 7,673 |

At origination, the reference assets of the high grade structures predominantly comprised investment grade tranches of sub-prime residential mortgage securitisations along with other senior tranches of some combination of ABS assets, including prime and Alt-A RMBS, CMBS, trust preferred ABS, student loan backed ABS and CDO assets. The underlying assets referenced by these super senior securities are primarily more recent vintages (the year the underlying loan was originated), with 48% being 2007. Generally, loans with more recent vintages carry greater discounts, reflecting the market perception of greater default levels than on earlier loan vintages.

The fair value of these assets has fallen significantly during the period, representing the decline in performance in the underlying reference assets and the lack of an active market for the securities. Some of the Group's holdings (£3.4 billion) have been hedged with monoline counterparties (see page 114).

Mezzanine super senior CDOs

The tranches of CDOs have suffered a greater level of price decline than high grade tranches due to the relative credit quality of the underlying assets. As shown in the table below, the majority of the Group's mezzanine super senior net exposures represent securities retained in CDO structures originated by the Group.

| | Gross exposure £m |
|---|---|
| Group originated deals | 3,565 |
| Third party structures | 155 |
| | 3,720 |

Other CDOs
The net exposure of the Group's other senior CDOs was £1.5 billion after hedge protection with bank or monoline counterparties. The unhedged exposures comprise CDOs representing smaller positions with various types of underlying collateral, rating and vintage characteristics. The positions hedged with derivative protection from banks include a number of positions referencing early vintages of RMBS and other ABS assets. The Group therefore has no net exposure to certain CDOs before credit valuation adjustment. Due to the early vintage, the assets underlying these structures have not deteriorated to the same degree as the more recently issued securities. The protection purchased is from banks as opposed to monoline insurers and the credit valuation adjustment on banks is less than on monoline insurers.

Additionally, the Group has one exposure that, while not structured as a super senior security, incorporates similar risk characteristics. The exposure results from options sold to a third-party conduit structure on a portfolio of ABS. The Group assumed the risk of these securities only after the first loss protection of had been eroded. The Group also has protection purchased against the remainder of this exposure through a CDS purchased from a monoline insurer.

The Group holds other subordinated note positions in CDO vehicles which have experienced significant reductions in value since inception. The majority of these positions are junior notes that have been fully written down by the Group with no ongoing exposure remaining at the balance sheet date.

CLOs
Collateralised loan obligations represent securities in special purpose entities (SPEs), the assets of which are primarily cash flows from underlying leveraged loans.

The Group has CLO exposures resulting from a number of trading activities. They consist of exposures retained by the Group and from notes purchased from third-party structures. The Group holds super senior securities in two CLO structures which were originated by the Group in 2005 and 2007. The underlying collateral of these structures predominantly references leveraged loans.

£2.3 billion of these assets were reclassified from the held-for-trading category to the loans and receivables (£0.8 billion) and available-for-sale (£1.5 billion) categories during the year.

Other asset backed securities (audited)
Other assets backed securities are securities issued from securitisation vehicles, similar to those in RMBS and CMBS structures, which reference cashflow generating assets other than mortgages. The wide variety of referenced underlying assets result in diverse asset performance levels.

The Group has accumulated these assets from a range of trading and funding activities. The Group's other asset-backed securities (carrying value) by underlying asset type and geographical region are shown below.

| | 2008 | | | | | 2007 | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | US | UK | Europe | ROW | Total | US | UK | Europe | ROW | Total |
| | £m | £m | £m | £m | £m | £m | £m | £m | £m | £m |
| Covered bonds | — | — | 3,301 | — | 3,301 | — | — | 2,895 | — | 2,895 |
| Auto | 97 | 29 | 466 | 13 | 605 | 156 | 36 | 108 | 13 | 313 |
| Equipment | 15 | — | — | 16 | 31 | 60 | 20 | 20 | 7 | 107 |
| Other consumer | 956 | 428 | 118 | 729 | 2,231 | 384 | 17 | 56 | 6 | 463 |

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Utilities and energy | 47 | 19 | 48 | 143 | 257 | 99 | 35 | 34 | 13 | 181 |
| Aircraft leases | 459 | 24 | — | 273 | 756 | 287 | 36 | 36 | 141 | 500 |
| Other leases | 1 | 525 | 455 | — | 981 | 378 | 135 | 133 | 50 | 696 |
| Trade receivables | 15 | 8 | — | — | 23 | 68 | 24 | 24 | 9 | 125 |
| Film / entertainment | 134 | — | — | — | 134 | 84 | 30 | 29 | 11 | 154 |
| Student loans | 953 | — | — | — | 953 | 629 | 32 | 32 | 12 | 705 |
| Other | 905 | 588 | 711 | 263 | 2,467 | 2,797 | 1,120 | 1,200 | 339 | 5,456 |
| | 3,582 | 1,621 | 5,099 | 1,437 | 11,739 | 4,942 | 1,485 | 4,567 | 601 | 11,595 |

The covered bonds comprise asset-backed securities issued by several Spanish financial institutions. These securities benefit from additional credit enhancement provided by the issuing institutions. The other major asset types that increased since 2007 include other consumer loans by £1.8 billion, leases by £0.5 billion and student loans by £0.2 billion. These and other increases were driven by the weakening of sterling against the US dollar and euro.

Other mortgage-related exposures (unaudited)

The Group's whole loans and warehouse facilities collateralised by mortgages are analysed below. These facilities primarily relate to UK and European mortgages with US mortgages representing £260 million of whole loans, of which more than 75% comprised prime mortgages.

| | 2008 | | 2007 | |
|---|---|---|---|---|
| | Whole loans £m | Warehouse facilities £m | Whole loans £m | Warehouse facilities £m |
| Prime | 1,905 | 1,731 | 453 | 575 |
| Commercial | 1,262 | 409 | 2,200 | 900 |
| Non-conforming | 1,396 | 1,019 | 57 | 1,445 |
| Sub-prime | 27 | — | 97 | — |
| | 4,590 | 3,159 | 2,807 | 2,920 |

Counterparty valuation adjustments (audited)

Credit valuation adjustments

Credit valuation adjustments (CVAs) represent an estimate of the adjustment to fair value that a market participant would make to incorporate the credit risk inherent in counterparty derivative exposures. During 2008, as credit spreads have widened, there has been a significant increase in the CVA as set out in the table below.

| | 2008 £m | 2007 £m |
|---|---|---|
| Monoline insurers | 5,988 | 862 |
| CDPCs | 1,311 | 44 |
| Other counterparties | 1,738 | 263 |
| Total CVA adjustments | 9,037 | 1,169 |

The widening of credit spreads of corporate and financial institution counterparties during the year contributed to a significant increase in the level of CVA adjustments recorded across all counterparties particularly monoline insurers and credit derivative product companies.

The monoline insurer CVA is calculated on a trade-by-trade basis, and is derived using market observable monoline credit spreads. The majority of the monoline CVA is taken against credit derivatives hedging exposures to ABS. The CDPC CVA is calculated using a similar approach. However, in the absence of market observable credit spreads, the cost of hedging the counterparty risk is estimated by analysing the underlying trades and the cost of hedging expected default losses in excess of the capital available in each vehicle.

The CVA for all other counterparties, including those in respect of derivatives with banks, is calculated either on a trade-by-trade basis, reflecting the estimated cost of hedging the risk through credit derivatives, or on a portfolio basis reflecting an estimate of the amount a third party would charge to assume the risk.

Monoline insurers

The Group has purchased protection from monoline insurers, mainly against specific ABS, CDOs and CLOs. Monoline insurers are entities which specialise in providing credit protection against the notional and interest cash flows due to the holders of debt instruments in the event of default by the debt security counterparty. This protection is typically held in the form of derivatives such as credit default swaps (CDS) referencing the underlying exposures held by the Group.

During the year the market value of securities protected by monoline insurers continued to decline as markets deteriorated. As the fair value of the protected assets declined, the fair value of the CDS protection from monoline insurers increased. As the monoline insurers had concentrated their exposures to credit market risks, their perceived credit quality has deteriorated as concerns increased regarding the ability of these counterparties to meet their contractual obligations. This resulted in increased levels of CVA being recorded on the protection asset.

The change in exposure during the year has been driven by the increased value of purchased derivative protection and the strengthening of the US dollar against sterling as significantly all of the exposures are US dollar denominated. The combination of greater exposure and widening credit spreads has increased the level of CVA required. Towards the end of the year the Group reached settlement on a group of contracts with one monoline counterparty, thereby reducing the overall exposure.

The tables below analyse the Group's holdings of CDS with monoline counterparties.

| | 2008 | 2007 |
|---|---|---|
| | £m | £m |
| Gross exposure to monolines | 11,581 | 3,409 |
| Hedges with bank counterparties | (789) | — |
| Credit valuation adjustment | (5,988) | (862) |
| Net exposure to monolines | 4,804 | 2,547 |

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The change in CVA is analysed in the table below:

| | £m |
|---|---|
| At 1 January 2008 | 862 |
| CVA realised in 2008 | (1,737) |
| Net benefit on counterparty hedges | 304 |
| Foreign currency movements | 1,086 |
| Net benefit on reclassified debt securities | 1,916 |
| Net income statement effect | 3,557 |
| Balance at 31 December 2008 | 5,988 |

| | 2008 | | | | 2007 | | | |
|---|---|---|---|---|---|---|---|---|
| | Notional amount protected assets £m | Fair value protected assets £m | Gross exposure £m | Credit valuation adjustment £m | Notional amount protected assets £m | Fair value protected assets £m | Gross exposure £m | Credit valuation adjustment £m |
| AAA/AA rated | | | | | | | | |
| CDOs | — | — | — | — | 4,976 | 3,006 | 1,970 | 150 |
| RMBS | 3 | 2 | 1 | — | 73 | 73 | — | — |
| CMBS | 613 | 496 | 117 | 51 | 3,731 | 3,421 | 310 | 34 |
| CLOs | 6,506 | 4,882 | 1,624 | 718 | 9,941 | 9,702 | 239 | 44 |
| Other ABS | 1,548 | 990 | 558 | 251 | 4,553 | 4,388 | 165 | 14 |
| Other | 267 | 167 | 100 | 47 | 622 | 516 | 106 | 1 |
| | 8,937 | 6,537 | 2,400 | 1,067 | 23,896 | 21,106 | 2,790 | 243 |
| A/BBB rated | | | | | | | | |
| CDO of RMBS | 5,385 | 1,363 | 4,022 | 1,938 | — | — | — | — |
| RMBS | 90 | 63 | 27 | 10 | — | — | — | — |
| CMBS | 4,236 | 1,892 | 2,344 | 1,378 | — | — | — | — |
| CLOs | 6,009 | 4,523 | 1,486 | 778 | — | — | — | — |
| Other ABS | 910 | 433 | 477 | 243 | — | — | — | — |
| Other | 265 | 122 | 143 | 79 | — | — | — | — |
| | 16,895 | 8,396 | 8,499 | 4,426 | — | — | — | — |
| Sub-investment grade | | | | | | | | |
| CDO of RMBS | 394 | 32 | 362 | 263 | 918 | 453 | 465 | 465 |
| RMBS | — | — | — | — | — | — | — | — |
| CMBS | — | — | — | — | — | — | — | — |
| CLOs | 350 | 268 | 82 | 60 | — | — | — | — |
| Other ABS | 1,208 | 1,037 | 171 | 123 | — | — | — | — |
| Other | 237 | 169 | 68 | 49 | 154 | — | 154 | 154 |
| | 2,189 | 1,506 | 683 | 495 | 1,072 | 453 | 619 | 619 |
| Total | | | | | | | | |
| CDO of RMBS | 5,779 | 1,395 | 4,384 | 2,201 | 5,894 | 3,459 | 2,435 | 615 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| RMBS | 93 | 65 | 28 | 10 | 73 | 73 | — | — |
| CMBS | 4,849 | 2,388 | 2,461 | 1,429 | 3,731 | 3,421 | 310 | 34 |
| CLOs | 12,865 | 9,673 | 3,192 | 1,556 | 9,941 | 9,702 | 239 | 44 |
| Other ABS | 3,666 | 2,460 | 1,206 | 617 | 4,553 | 4,388 | 165 | 14 |
| Other | 769 | 458 | 311 | 175 | 776 | 516 | 260 | 155 |
| | 28,021 | 16,439 | 11,582 | 5,988 | 24,968 | 21,559 | 3,409 | 862 |

The Group also has indirect exposure through wrapped securities and assets which have an intrinsic credit enhancement from a monoline insurer. These securities are traded with the benefit of this credit enhancement and therefore any deterioration in the credit rating of the monoline is reflected in the market prices for these assets.

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Credit derivative product companies
A credit derivative product company (CDPC) is a company that sells protection on credit derivatives. CDPCs are similar to monoline insurers. However, unlike monoline insurers, they are not regulated as insurers.

The Group has £4.8 billion of exposures with CDPCs which predominatly relates to tranched credit derivatives. Tranched credit derivatives have exposure to certain default losses that arise in reference portfolio of assets. The Group has bought protection on tranched credit derivatives from CDPCs. The reference portfolios of assets are predominantly investment grade loans and bonds and on average, the trades have exposure to total portfolio default losses that exceed 16% of the portfolio notional up to a level of 50%. CDS spreads have widened and credit protection has become more valuable and the gross exposure to CDPC counterparties has increased. At the same time, the credit quality of CDPC counterparties has declined, reflecting the negative impact of their concentrated credit risk in a declining market. As a result CVA adjustments taken against exposures to these counterparties have increased significantly as described above.

The tables below present a comparison of the protected assets and the fair value and CVA of the CDPC protection.

| | 2008 £m | 2007 £m |
|---|---|---|
| Gross exposure to CDPCs | 4,776 | 863 |
| Credit valuation adjustment | (1,311) | (44) |
| Net exposure to CDPCs | 3,465 | 819 |

| | 2008 | | | | 2007 | | | |
|---|---|---|---|---|---|---|---|---|
| | Notional amount protected assets £m | Fair value protected assets £m | Gross exposure £m | Credit valuation adjustment £m | Notional amount protected assets £m | Fair value protected assets £m | Gross exposure £m | Credit valuation adjustment £m |
| AAA/AA rated | 19,092 | 15,466 | 3,626 | 908 | 20,605 | 19,742 | 863 | 44 |
| A/BBB rated | 6,147 | 4,997 | 1,150 | 403 | — | — | — | — |
| | 25,239 | 20,463 | 4,776 | 1,311 | 20,605 | 19,742 | 863 | 44 |

The movement in the year in CDPC CVA is analysed below:

| | £m |
|---|---|
| At 1 January 2008 | 44 |
| Net benefit on CVA hedges | 533 |
| Net benefit on FX hedges | 119 |
| Net income statement effect | 615 |
| Balance at 31 December 2008 | 1,311 |

Leverage finance (audited)
Leveraged finance is commonly employed to facilitate corporate finance transactions, such as acquisitions or buy-outs. A bank acting as a lead manager will typically underwrite the loan, alone or with others, and then syndicate the loan to other participants.

The Group's syndicated loan book represent amounts retained from underwriting positions where the Group was lead manager or underwriter, in excess of the Group's intended long term participation.

Since the beginning of the credit market dislocation in the second half of 2007, investor appetite for leveraged loans and similar risky assets has fallen dramatically, with secondary prices falling due to selling pressure and margins increasing, thus also affecting the primary market. There were a small number of deals executed in the first half of 2008 which were much less significant in overall quantum and leverage and which were priced at less than mid-2007 levels. Concerted efforts to sell positions during the first half of 2008 were only partially successful due to the rapid change in market conditions since origination of the loans. Most of the leveraged finance loans were reclassified from the held-for-trading category to loans and receivables category in the second half of 2008.

The table below shows the carrying value of leveraged finance exposures by industry and geography.

| | | | | | 2008 | | | | | 2007(1) |
|---|---|---|---|---|---|---|---|---|---|---|
| | Americas | UK | Europe | ROW | Total | Americas | UK | Europe | ROW | Total |
| | £m | £m | £m | £m | £m | £m | £m | £m | £m | £m |
| TMT | 1,681 | 628 | 402 | 45 | 2,756 | 6,924 | 424 | 482 | 25 | 7,855 |
| Retail | 166 | 550 | 707 | 21 | 1,444 | 542 | 1,318 | 800 | 49 | 2,709 |
| Industrial | 280 | 391 | 413 | — | 1,084 | 249 | 2,003 | 1,074 | 44 | 3,370 |
| Other | 11 | 552 | 141 | 35 | 739 | 25 | 339 | 271 | 13 | 648 |
| | 2,138 | 2,121 | 1,663 | 101 | 6,023 | 7,740 | 4,084 | 2,627 | 131 | 14,582 |
| Of which: | | | | | | | | | | |
| Held-for-trading | 31 | 31 | 41 | — | 103 | 7,607 | 3,694 | 689 | 51 | 12,041 |
| Loan and receivables | 2,107 | 2,090 | 1,622 | 101 | 5,920 | 133 | 390 | 1,938 | 80 | 2,541 |
| | 2,138 | 2,121 | 1,663 | 101 | 6,023 | 7,740 | 4,084 | 2,627 | 131 | 14,582 |
| Of which: | | | | | | | | | | |
| Drawn | 2,081 | 2,090 | 1,453 | 94 | 5,718 | 2,249 | 4,025 | 2,478 | 122 | 8,874 |
| Undrawn | 57 | 31 | 210 | 7 | 305 | 5,491 | 59 | 149 | 9 | 5,708 |
| | 2,138 | 2,121 | 1,663 | 101 | 6,023 | 7,740 | 4,084 | 2,627 | 131 | 14,582 |

Note:

(1) Leveraged finance as disclosed above for 31 December 2007 has been aligned with definitions used in 2008 and is consequently £76 million higher than previously published.

The table below analyses the movement in the amounts reported above.

| | Held-for-trading | | | Loans and receivables | | |
|---|---|---|---|---|---|---|
| | Drawn | Undrawn | Total | Drawn | Undrawn | Total |

| | £m | £m | £m | £m | £m | £m |
|---|---|---|---|---|---|---|
| At 1 January 2008 | 6,516 | 5,525 | 12,041 | 2,358 | 183 | 2,541 |
| Reclassifications | (3,602) | — | (3,602) | 3,602 | — | 3,602 |
| Reclassifications – income effect | 216 | — | 216 | 19 | — | 19 |
| Additions | 1,171 | 682 | 1,853 | 235 | — | 235 |
| Sales | (3,826) | (1,882) | (5,708) | (473) | (81) | (554) |
| Realised losses on sales | (298) | — | (298) | (197) | — | (197) |
| Funded deals | 1,298 | (1,298) | — | — | — | — |
| Lapsed/collapsed deals | (415) | (3,738) | (4,153) | (173) | — | (173) |
| Change in fair value | (462) | (156) | (618) | n/a | n/a | n/a |
| Impairment provisions | n/a | n/a | n/a | (1,191) | — | (1,191) |
| Exchange and other movements | 211 | 161 | 372 | 1,603 | 35 | 1,638 |
| Presentation changes | (778) | 778 | — | (96) | 96 | — |
| At 31 December 2008 | 31 | 72 | 103 | 5,687 | 233 | 5,920 |

In addition to the leveraged finance syndicated portfolio discussed above, the Group has £7 billion of portfolio positions, mostly to European companies, that have been classified as loans and receivables since origination.

SPEs and conduits

SPEs (audited)

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

It is primarily the extent of risks and rewards assumed that determines whether these entities are consolidated in the Group’s financial statements. The following section aims to address the significant exposures which arise from the Group’s activities through specific types of SPEs.

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

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

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

The Group sponsors own-asset securitisations as a way of diversifying funding sources, managing specific risk concentrations, and achieving capital efficiency. The Group purchases the securities issued in own-asset securitisations set up for funding purposes. During 2008, the Group was able to pledge AAA-rated asset-backed securities as collateral for repurchase agreements with major central banks under schemes such as the Bank of England’s Special Liquidity Scheme, launched in April 2008, which allowed banks to temporarily swap high-quality mortgage-backed and other securities for liquid UK Treasury Bills. This practice has contributed to the Group’s sources of funding during 2008 in the face of the contraction in the UK market for inter-bank lending and the investor base for securitisations.

The Group typically does not retain the majority of risks and rewards of own-asset securitisations set up for the purposes of risk diversification and capital efficiency, where the majority of investors tend to be third parties. Therefore, the Group is typically not required to consolidate the related SPEs.

The Group has also established whole loan securitisation programmes in the US and UK where assets originated by third parties are warehoused by the Group for securitisation. The majority of these vehicles are not consolidated by the Group, as it is not exposed to the risks and rewards of ownership.

Conduits (audited)

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

The Group's conduits can be divided into multi-seller conduits and own- asset conduits. In line with market practice, the Group consolidates both types of conduit where it is exposed to the majority of risks and rewards of ownership of these entities. The Group also extends liquidity commitments to multi-seller conduits sponsored by other banks, but typically does not consolidate these entities as it is not exposed the majority of the risks and rewards.

Funding and liquidity

The Group's most significant multi-seller conduits have thus far continued to fund the vast majority of their assets solely through ABCP issuance. There were significant disruptions to the liquidity of the financial markets during the year following the bankruptcy filing of Lehman Brothers in September 2008 and this required a small amount of the assets held in certain conduits to be funded by the Group rather than through ABCP issuance. By the end of 2008 there had been an improvement in market conditions, supported by central bank initiatives, which enabled normal ABCP funding to replace this Group funding of the conduits.

The average maturity of ABCP issued by the Group's conduits as at 31 December 2008 was 72.1 days (2007 – 60.9 days).

The total assets held by the Group's sponsored conduits are £49.9 billion (2007 – £48.1 billion). Since these liquidity facilities are sanctioned on the basis of total conduit purchase commitments, the liquidity facility commitments will exceed the level of assets held, with the difference representing undrawn commitments.

The Group values the funding flexibility and liquidity provided by the ABCP market to fund client- and Group-originated assets. Whereas there are plans to decrease the multi-seller conduit business in line with the Group's balance sheet, the Group is reviewing the potential for new own-asset conduit structures to add funding diversity.

Multi-seller conduits

The multi-seller conduits were established by the Group for the purpose of providing its clients with access to diversified and flexible funding sources. A multi-seller conduit typically purchases or funds assets originated by the banks' clients. The multi-seller conduits form the vast majority of the Group's conduit business (69.4% of the total liquidity and credit enhancements committed by the Group). The Group sponsors six multi-seller conduits which finance assets from Europe, North America and Asia-Pacific.

Assets purchased or financed by the multi-seller conduits include auto loans, residential mortgages, credit card receivables, consumer loans and trade receivables. All assets held by the conduits are recorded on the Group's balance sheet either as loans and receivables or debt securities.

The third-party assets financed by the conduits are structured with a significant degree of first-loss credit enhancement provided by the originators of the assets. This credit enhancement, which is specific to each transaction, can take the form of over-collateralisation, excess spread or subordinated loan, and typically ensures the conduit asset has a rating equivalent to at least a single-A credit. In addition, and in line with general market practice, the Group provides a small second-loss layer of programme-wide protection to the multi-seller conduits. Given the nature and investment grade equivalent quality of the first loss enhancement provided to the structures, the Group has only a minimal risk of loss on its program wide exposure. The issued ABCP is rated P-1/A1 by Moody's and Standard & Poor's.

The Group provides liquidity back-up facilities to the conduits it sponsors. These facilities can be drawn upon by the conduits in the event of a disruption in the ABCP market, or when certain trigger events occur such that ABCP cannot be issued. For a very small number of transactions within two of the multi-seller conduits sponsored by the Group these liquidity facilities have been provided by third-party banks. This typically occurs on transactions where the third-party bank does not use, or have, its own conduit vehicles. Conduit commercial paper issuance is managed such that the spread of maturity dates of the issued ABCP mitigates the short-term contingent liquidity risk of providing back-up facilities. Limits sanctioned for such facilities as at 31 December 2008 totalled approximately £42.9 billion (2007 – £49.2 billion).

The Group's maximum exposure to loss on its multi-seller conduits is £43.2 billion (2007 – £49.4 billion), being the total amount of the Group's liquidity commitments plus the extent of programme-wide credit enhancements which relate to conduit assets for whom liquidity facilities were provided by third parties.

Own-asset conduits

The Group also holds three own-asset conduits which fund assets which have been funded at one time by the Group. These vehicles represent 25% of the Group's conduit business (as a percentage of the total liquidity and credit enhancements committed by the Group), with £14.8 billion of ABCP outstanding at 31 December 2008 (2007 – £10.4 billion). The Group's maximum exposure to loss on its own-asset conduits is £15.9 billion (2007 – £13.5 billion), being the total drawn and undrawn amount of the Group's liquidity commitments to these conduits.

Securitisation arbitrage conduits

The Group no longer sponsors any securitisation arbitrage conduits. As part of the integration of ABN AMRO and a strategic review of the conduit business, the sole securitisation arbitrage conduit was dissolved in 2008. All of its assets were transferred to a centrally managed asset unit for run-off or sale.

The Group's exposure from both its consolidated conduits, including those to which the Group is economically exposed and those which are shared with the other consortium members, and its involvement with third-party conduits are set out in the following table.

| | 2008 | | | 2007 (1) | | |
|---|---|---|---|---|---|---|
| | Consolidated conduits £m | Third party £m | Total £m | Consolidated conduits £m | Third party £m | Total £m |
| Total assets held by the conduits | 49,857 | | | 48,070 | | |