

ROYAL BANK OF SCOTLAND GROUP PLC  
Form 20-F  
March 27, 2017

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

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**FORM 20-F**

(Mark One)

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

**OR**

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE  
ACT OF 1934**  
**For the fiscal year ended December 31, 2016**

**OR**

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

**OR**

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

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)

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**RBS Gogarburn, PO Box 1000, Edinburgh EH12 1HQ, United Kingdom**

(Address of principal executive offices)

**Aileen Taylor, Chief Governance Officer and Board Counsel, Tel: +44 (0) 131 626 4099, 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)

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

<b>Title of each class</b>	<b>Name of each exchange on which registered</b>
American Depositary Shares, each representing 2 ordinary shares, nominal value £1 per share	New York Stock Exchange
Ordinary shares, nominal value £1 per share	New York Stock Exchange*
American Depositary Shares Series F, H, L, S, and U each representing one Non-Cumulative Dollar Preference Share, Series F, H, L, S, and U respectively	New York Stock Exchange
Dollar Perpetual Regulatory Tier 1 Securities	New York Stock Exchange
Floating Rate Senior Notes due 2017	New York Stock Exchange
1.875% Senior Notes due 2017	New York Stock Exchange
4.70% Subordinated Notes due 2018	New York Stock Exchange
5.625% Senior Notes due 2020	New York Stock Exchange
6.125% Senior Notes due 2021	New York Stock Exchange
6.125% Subordinated Tier 2 Notes due 2022	New York Stock Exchange
6.000% Subordinated Tier 2 Notes due 2023	New York Stock Exchange
6.100% Subordinated Tier 2 Notes due 2023	New York Stock Exchange
5.125% Subordinated Tier 2 Notes due 2024	New York Stock Exchange
Leveraged CPI Linked Securities due January 13, 2020	NYSE MKT

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\* 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:**

Perpetual Subordinated Contingent Convertible Additional Tier 1 Capital Notes callable 2020	Irish Stock Exchange
	Irish Stock Exchange
Perpetual Subordinated Contingent Convertible Additional Tier 1 Capital Notes callable 2021	Irish Stock Exchange
Perpetual Subordinated Contingent Convertible Additional Tier 1 Capital Notes callable 2025	

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of December 31, 2016, the close of the period covered by the annual report:

(Title of each class)	(Number of outstanding shares)
Ordinary shares of £1 each	11,823,163,184
11% cumulative preference shares	500,000
5½% cumulative preference shares	400,000
Non-cumulative dollar preference shares, Series F, H, L and S to U	72,430,109
Non-cumulative convertible dollar preference shares, Series 1	64,772
Non-cumulative euro preference shares, Series 1 to 3	2,044,418
Non-cumulative convertible sterling preference shares, Series 1	14,866
Non-cumulative sterling preference shares, Series 1	54,442

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes     No

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     No

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*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     No

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     No

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     Accelerated filer     Non-Accelerated filer

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

U.S. GAAP

International Financial Reporting Standards as issued by the International Accounting Standards Board

Other

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     Item 18

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     No



**SEC Form 20-F cross reference guide**

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## Forward looking statements

### Cautionary statement regarding 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', 'commit', 'believe', 'should', 'intend', 'plan', 'could', 'probability', 'risk', 'Value-at-Risk (VaR)', 'target', 'goal', 'objective', 'may', 'endeavour', 'outlook', 'optimistic', 'prospects' and similar expressions or variations on these expressions.

In particular, this document includes forward-looking statements relating, but not limited to: future profitability and performance, including financial performance targets such as return on tangible equity; cost savings and targets, including cost:income ratios; litigation and government and regulatory investigations, including the timing and financial and other impacts thereof; structural reform and the implementation of the UK ring-fencing regime; the implementation of RBS's transformation programme, including the further restructuring of the NatWest Markets business; the satisfaction of the Group's residual EU State Aid obligations; the continuation of RBS's balance sheet reduction programme, including the reduction of risk-weighted assets (RWAs) and the timing thereof; capital and strategic plans and targets; capital, liquidity and leverage ratios and requirements, including CET1 Ratio, RWA equivalents (RWAE), Pillar 2 and other regulatory buffer requirements, minimum requirement for own funds and eligible liabilities, and other funding plans; funding and credit risk profile; capitalisation; portfolios; net interest margin; customer loan and income growth; the level and extent of future impairments and write-downs, including with respect to goodwill; restructuring and remediation costs and charges; future pension contributions; RBS's exposure to political risks, operational risk, conduct risk, cyber and IT risk and credit rating risk and to various types of market risks, including as interest rate risk, foreign exchange rate risk and commodity and equity price risk; customer experience including our Net Promotor Score (NPS); employee engagement and gender balance in leadership positions.

### Limitations inherent to forward-looking statements

These statements are based on current plans, estimates, targets and projections, and are subject to significant inherent risks, uncertainties and other factors, both external and relating to the Group's strategy or operations, which may result in the Group being unable to achieve the current targets, predictions, expectations and other anticipated outcomes expressed or implied by such forward-looking statements. In addition certain of these disclosures are dependent on choices relying on key model characteristics and assumptions and are subject to various limitations, including assumptions and estimates made by management. By their nature, certain of these disclosures are only estimates and, as a result, actual future gains and losses could differ materially from those that have been estimated. Accordingly, undue reliance should not be placed on these statements. Forward-looking statements speak only as of the date we make them and we expressly disclaim any obligation or undertaking to release publicly any updates or revisions to any forward-looking statements contained herein to reflect any change in the Group's expectations with

regard thereto or any change in events, conditions or circumstances on which any such statement is based.

### **Important factors that could affect the actual outcome of the forward-looking statements**

We caution you that a large number of important factors could adversely affect our results or our ability to implement our strategy, cause us to fail to meet our targets, predictions, expectations and other anticipated outcomes or affect the accuracy of forward-looking statements we describe in this document including in the risk factors set as set out on pages 509 to 578 and other uncertainties discussed in this document. These include the significant risks for RBS presented by the outcomes of the legal, regulatory and governmental actions and investigations that RBS is or may be subject to (including active civil and criminal investigations) and any resulting material adverse effect on RBS of unfavourable outcomes and the timing thereof (including where resolved by settlement); economic, regulatory and political risks, including as may result from the uncertainty arising from the EU Referendum; RBS's ability to satisfy its residual EU State Aid obligations and the timing thereof; RBS's ability to successfully implement the significant and complex restructuring required to be undertaken in order to implement the UK ring-fencing regime and related costs; RBS's ability to successfully implement the various initiatives that are comprised in its transformation programme, particularly the proposed further restructuring of the NatWest Markets business, the balance sheet reduction programme and its significant cost-saving initiatives and whether RBS will be a viable, competitive, customer focused and profitable bank especially after its restructuring and the implementation of the UK ring-fencing regime; the exposure of RBS to cyber-attacks and its ability to defend against such attacks; RBS's ability to achieve its capital and leverage requirements or targets which will depend in part on RBS's success in reducing the size of its business and future profitability as well as developments which may impact its CET1 capital including additional litigation or conduct costs, additional pension contributions, further impairments or accounting changes; ineffective management of capital or changes to regulatory requirements relating to capital adequacy and liquidity or failure to pass mandatory stress tests; RBS's ability to access sufficient sources of capital, liquidity and funding when required; changes in the credit ratings of RBS, RBS entities or the UK government; declining revenues resulting from lower customer retention and revenue generation in light of RBS's strategic refocus on the UK; as well as increasing competition from new incumbents and disruptive technologies.

## Forward looking statements

In addition, there are other risks and uncertainties that could adversely affect our results, ability to implement our strategy, cause us to fail to meet our targets or the accuracy of forward-looking statements in this document. These include operational risks that are inherent to RBS's business and will increase as a result of RBS's significant restructuring initiatives being concurrently implemented; the potential negative impact on RBS's business of global economic and financial market conditions and other global risks; the impact of a prolonged period of low interest rates or unanticipated turbulence in interest rates, yield curves, foreign currency exchange rates, credit spreads, bond prices, commodity prices, equity prices; basis, volatility and correlation risks; the extent of future write-downs and impairment charges caused by depressed asset valuations; deteriorations in borrower and counterparty credit quality; heightened regulatory and governmental scrutiny and the increasingly regulated environment in which RBS operates as well as divergences in regulatory requirements in the jurisdictions in which RBS operates; the risks relating to RBS's IT systems or a failure to protect itself and its customers against cyber threats, reputational risks; risks relating to increased pension liabilities and the impact of pension risk on RBS's capital position; risks relating to the failure to embed and maintain a robust conduct and risk culture across the organisation or if its risk management framework is ineffective; RBS's ability to attract and retain qualified personnel; limitations on, or additional requirements imposed on, RBS's activities as a result of HM Treasury's investment in RBS; the value and effectiveness of any credit protection purchased by RBS; risks relating to the reliance on valuation, capital and stress test models and any inaccuracies resulting therefrom or failure to accurately reflect changes in the micro and macroeconomic environment in which RBS operates, risks relating to changes in applicable accounting policies or rules which may impact the preparation of RBS's financial statements or adversely impact its capital position; the impact of the recovery and resolution framework and other prudential rules to which RBS is subject; the recoverability of deferred tax assets by the Group; and the success of RBS in managing the risks involved in the foregoing.

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

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

## Presentation of information

In this document, and unless specified otherwise, the term 'company' or 'RBSG' means The Royal Bank of Scotland Group plc, 'RBS', 'RBS Group' or the 'Group' means the company and its subsidiaries, 'the Royal Bank' or 'RBS plc' 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', and the abbreviations '€m' and '€bn' represent millions and thousands of millions of euros, respectively.

## Non-GAAP financial information

RBS prepares its financial statements in accordance with IFRS as issued by the IASB which constitutes a body of generally accepted accounting principles ('GAAP'). This document contains a number of non-GAAP (or non-IFRS) financial measures. A non-GAAP financial measure is defined as one that measures historical or future financial performance, financial position or cash flows but which excludes or includes amounts that would not be so adjusted in the most comparable GAAP measure.

The non-GAAP measures used in this document generally exclude certain items which management believe are not representative of the underlying performance of the business and which distort period-on-period comparison. These measures are used internally by management, in conjunction with IFRS financial measures, to measure performance and make decisions regarding the future direction of the business. Management believes these non-GAAP measures, when provided in combination with reported IFRS results, provide helpful supplementary information for investors. These adjusted measures, derived from the reported results are non-IFRS financial measures but are not a substitute to IFRS reported measures.

The main non-GAAP measures used in this document include:

- 'Adjusted' measures of financial performance, principally operating profit, operating expenses, total income and other performance measures before: own credit adjustments; gain or loss on redemption of own debt; strategic disposals, restructuring costs, litigation and conduct costs and write down of goodwill. RFS Holdings minority interest (RFS MI) was shown separately for 2014 only;

- Certain performance ratios based on the adjusted performance measures described above, including the adjusted cost:income ratio (calculated using adjusted operating income and costs), adjusted return on equity ratio (calculated using adjusted operating profit) and the 2016 cost saving progress and targets (calculated using operating expenses excluding litigation and conduct costs, restructuring costs, write down of goodwill, the impairment of other intangible assets, the operating costs of Williams & Glyn and the VAT recovery);
- Personal & Business Banking (PBB) franchise results, combining the reportable segments of UK Personal & Business Banking (UK PBB) and Ulster Bank RoI, Commercial & Private Banking (CPB) franchise results, combining the reportable segments of Commercial Banking, Private Banking and RBS International (RBSI) and 'core bank' results combining PBB, CPB and NatWest Markets results which are presented to provide investors with a summary of the Group's business performance (see page 172 for further business descriptions); and

Reconciliations of these non-GAAP measures to the closest equivalent GAAP measure are presented throughout this document and in the 2016 performance on page 6.

### Key operating indicators

This document includes a number of operational metrics which management believes may be helpful to investors in understanding the Group's business, including the Groups position against its own targets. These metrics include performance, funding and credit metrics such as 'return on tangible equity' and related RWA equivalents incorporating the effect of capital deductions (RWAs), total assets excluding derivatives (funded assets) and net interest margin (NIM) adjusted for items designated at fair value through profit or loss (non-statutory NIM), cost:income ratio, loan:deposit ratio and REIL/impairment provision ratios. These are internal metrics used to measure business performance.

### Capital and liquidity measures

Certain liquidity and capital measures and ratios are presented in this document as management believes they are helpful for investors' understanding of the liquidity and capital profile of the business and the Group's position against its own targets and applicable regulatory requirements. Some of these measures are used by management for risk management purposes and may not yet required to be disclosed by a government, governmental authority or self-regulatory organisation. As a result, the basis of calculation of these measures may not be the same as that used by the Group's peers. These capital and liquidity measures and ratios include: the liquidity coverage ratio, stressed outflow coverage and net stable funding ratio.

### Transfers

The year on year comparison of the Commercial Banking results is affected by a number of internal business transfers which took place in 2015 and 2016. In line with changes to the business model, the UK and Western European corporate loan portfolios were transferred to Commercial Banking in Q2 2015 and



Q4 2015. Ulster Bank NI transferred Q1 2016 and a transfer of clients to Retail Q2 2016. The prior period financials were not restated.

## Presentation of information

### Recent developments

#### Board Appointment

RBS announced on 24 February 2017 that Mark Seligman has been appointed as a Non-executive Director with effect from 1 April 2017.

#### Payment Protection Insurance (PPI)

On 2 March 2017, the FCA published Policy Statement 17/3 containing its final rules and guidance on PPI complaint handling. The Policy Statement made clear the FCA's intention to implement a two year PPI complaints deadline with effect from 29 August 2017, bringing an end to new PPI complaints in August 2019. New rules for the handling of Plevin complaints will also come into force on 29 August 2017. The proposals in the Policy Statement are largely as previously anticipated and RBS does not currently consider that an additional provision will be required.

#### London Interbank Offered Rate (LIBOR)

As previously disclosed, certain members of the Group have been named as defendants in US class actions relating to alleged manipulation of various interest rate benchmarks, each of which is pending in the United States District Court for the Southern District of New York. On 10 March 2017, the court in the action relating primarily to over-the-counter derivatives allegedly linked to JPY LIBOR and Euroyen TIBOR dismissed the case on the ground that the plaintiffs lack standing. The dismissal by the court may be subject to appeal.

#### Claim by the US Federal Deposit Insurance Corporation

On 10 March 2017, the US Federal Deposit Insurance Corporation, on behalf of 39 failed US banks, issued a claim in the High Court of Justice of England and Wales against RBS, other LIBOR panel banks and the British Bankers' Association, alleging collusion with respect to the setting of USD LIBOR. The action alleges that the defendants breached English and European competition law as well as asserting common law claims of fraud under US law.

#### Regulator requests concerning certain historic Russian transactions

Recent media coverage has highlighted an alleged money laundering scheme involving Russian entities between 2010 and 2014. Allegedly certain European banks, including 17 UK based financial institutions, and certain US banks, were involved in processing certain transactions associated with this scheme.

In common with other banks, in March 2017 RBS received a request for information from the FCA in relation to this matter. RBS has also received similar requests from regulators in other jurisdictions. RBS has responded to the FCA and is in the course of responding to the requests from other regulators.

## 2016 performance

RBS reported an operating loss before tax of £4,082 million for 2016 and an attributable loss(1) of £6,955 million, which included litigation and conduct costs of £5,868 million, restructuring costs of £2,106 million, the final Dividend Access Share (DAS) dividend of £1,193 million and Capital Resolution disposal losses and impairments of £825 million. Restructuring costs included a £750 million provision in respect of the 17 February 2017 update on RBS's remaining State Aid obligation regarding Williams & Glyn.

Across our Personal & Business Banking (PBB), (which includes the reportable segments UK PBB and Ulster Bank RoI Commercial & Private Banking (CPB) which includes the reportable segments Commercial Banking, Private Banking and RBSI and NatWest Markets (NWM) franchises), (together the 'core bank'), RBS reported a £602 million, or 41%, increase in operating profit before tax to £2,058 million in 2016. Adjusted operating profit before tax increased by £163 million, or 4%, to £4,249 million for 2016 (refer to segmental income statement reconciliations on page 6)

In 2016 RBS delivered against all of its operating financial targets; PBB and CPB had combined income growth of 3%. PBB and CPB had combined adjusted income growth of 2%, (including transfers of £98 million in 2015) underpinned by 10% net lending growth, expenses have been reduced by around £1 billion for the third year in succession as the bank continues to focus on digital channels and on simplification of its processes, and Capital Resolution RWAs have reduced by a further £14.5 billion, or 30%, to £34.5 billion, with 80% of RWAs now relating to PBB, CPB and NatWest Markets compared with 72% at the end of 2015 (refer to segmental income statement reconciliations on page 6). RBS is committed to achieving its sub 50% cost:income ratio and 12% return on tangible equity targets by 2020.

Common Equity Tier 1 ratio of 13.4% reduced by 210 basis points during 2016, but remains ahead of our target despite recognising significant charges relating to remaining legacy issues.

### Our 2016 performance at a glance

(£4,082m)	129%	£2,058m
Operating loss before tax (3)	Cost:income ratio - statutory (4)	PBB,CPB & NatWest Markets

		operating profit before tax
(£6,955m)	66%	£4,249m
Loss attributable to ordinary shareholders	Cost:income ratio – adjusted (3)	PBB,CPB & NatWest Markets adjusted operating profit before tax(2,4)
£228.2bn	2.18%	123%
Risk-weighted assets	Net interest margin	Liquidity coverage ratio (5)
13.4%	(17.9%)	£33.7bn
Common Equity Tier 1 ratio (6)	Return on tangible equity (7,8)	Gross new mortgage lending across England, Wales and Scotland (9)
75%	£1.32bn	
Employee engagement score	Total tax paid to the UK Government (10)	

## Notes:

(1) Attributable to ordinary shareholders.

(2) Personal & Business Banking consists of the reportable segments UK PBB and Ulster Bank Rol, and Commercial & Private Banking consists of the reportable segments Commercial Banking, Private Banking and RBSI.

(3) Adjusted operating profit before tax means operating profit before tax excluding own credit adjustments (2016 - £180 million; 2015 - £309 million), loss on redemption of own debt (2016 - £126 million; 2015 - £263 million), strategic disposals (2016 - £164 million gain; 2015 - £157 million loss), restructuring costs (£2,106 million; 2015 – £2,931 million), litigation and conduct costs (2016 - £5,868 million; 2015 – £3,568 million) and write down of goodwill (2016 – nil; 2015 – £498 million).

(4) Adjusted cost:income ratio means cost:income ratio excluding own credit adjustments (2016 - £180 million; 2015 - £309 million), loss on redemption of own debt (2016 - £126 million; 2015 - £263 million), strategic disposals (2016 - £164 million gain; 2015 - £157 million loss), restructuring costs (2016 - £2,106 million; 2015 – £2,931 million), litigation and conduct costs (2016 - £5,868 million; 2015 – £3,568 million) and write down of goodwill (2016 – nil; 2015 – £498 million).

(5) On 1 October 2015 the LCR became the Prudential Regulation Authority's (PRA) primary regulatory liquidity standard; UK banks are required to meet a minimum standard of 80% initially, rising to 100% by 1 January 2018. The published LCR excludes Pillar 2 add-ons. RBS calculates the LCR using its own interpretation of the EU LCR Delegated Act, which may change over time and may not be fully comparable with that of other institutions.

(6) Based on end-point Capital Requirements Regulation (CRR) Tier 1 capital and leverage exposure under the CRR Delegated Act.

(7) Tangible equity is equity attributable to ordinary shareholders less tangible assets.

(8) RBS's CET 1 target is 13% but for the purposes of computing segmental return on equity (ROE), to better reflect the differential drivers of capital usage, segmental operating profit after tax and adjusted for preference dividends is divided by notional equity allocated at different rates of 11% (Commercial Banking and Ulster Bank RoI), 12% (RBS International) and 15% for all other segments, of the monthly average of segmental risk-weighted assets incorporating the effect capital deductions (RWAs). RBS Return on equity is calculated using profit for the period attributable to ordinary shareholders.(2) Excluding own credit adjustments, (loss)/gain on redemption of own debt, strategic disposals, restructuring costs, litigation and conduct costs and write down of goodwill.

(9) Gross new mortgage lending in UK PBB, Ulster Bank RoI and RBS International (RBSI).

(10) Comprises 174 million corporate tax, 660 million irrecoverable VAT, 208 million bank levies and 279 million employer payroll taxes.

## Segmental income statement reconciliations

	PBB		CPB								
		Ulster							Central		
	UK	Bank	Commercial	Private			Capital		items	Total	
	PBB	Rol	Banking	Banking	RBSI	NWM	resolution	W&G	Other	RBS	
2016	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	
Total income - statutory	5,290	576	3,415	657	374	1,574	(362)	837	229	12,590	
Own credit adjustments	—	(3)	—	—	—	(53)	(134)	—	10	(180)	
Loss on redemption of own debt	—	—	—	—	—	—	—	—	126	126	
Strategic disposals	—	—	—	—	—	—	81	—	(245)	(164)	
Total income - adjusted	5,290	573	3,415	657	374	1,521	(415)	837	120	12,372	
Operating expenses - statutory	(3,826)	(669)	(2,467)	(549)	(174)	(1,960)	(4,255)	(450)	(1,844)	(16,194)	
Restructuring costs - direct	51	38	25	7	2	19	56	57	1,851	2,106	
- indirect	136	2	83	30	3	93	22	—	(369)	—	
Litigation and conduct costs	634	172	423	1	—	528	3,413	—	697	5,868	
Operating expenses - adjusted	(3,005)	(457)	(1,936)	(511)	(169)	(1,320)	(764)	(393)	335	(8,220)	
Impairment (losses)/releases	(83)	113	(206)	3	(10)	—	(253)	(42)	—	(478)	
Operating profit/(loss) - statutory	1,381	20	742	111	190	(386)	(4,870)	345	(1,615)	(4,082)	
Operating profit/(loss) - adjusted	2,202	229	1,273	149	195	201	(1,432)	402	455	3,674	
Additional information											

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Return on equity (1)	16.2%	0.7%	4.1%	5.6%	13.8%	(6.6%)	nm	nm	nm	(17.9%)
Return on equity - adjusted (1,2)	26.8%	8.4%	8.4%	7.8%	14.2%	1.1%	nm	nm	nm	1.6%
Cost income ratio	72%	116%	72%	84%	47%	125%	nm	54%	nm	129%
Cost income ratio - adjusted (2)	57%	80%	57%	78%	45%	87%	nm	47%	nm	66%
<b>2015</b>										
Total income - statutory	5,200	550	3,254	644	367	1,527	539	833	9	12,923
Own credit adjustments	—	—	—	—	—	(120)	(175)	—	(14)	(309)
Loss on redemption of own debt	—	—	—	—	—	—	—	—	263	263
Strategic disposals	—	—	—	—	—	—	38	—	119	157
Total income - adjusted	5,200	550	3,254	644	367	1,407	402	833	377	13,034
Operating expenses - statutory	(4,177)	(429)	(1,921)	(1,101)	(160)	(2,369)	(4,951)	(387)	(858)	(16,353)
Restructuring costs - direct	38	12	52	7	—	44	380	28	2,370	2,931
- indirect	129	3	17	66	4	480	927	—	(1,626)	—
Litigation and conduct costs	972	(13)	51	12	—	378	2,105	—	63	3,568
Write down of goodwill	—	—	—	498	—	—	—	—	—	498
Operating expenses - adjusted	(3,038)	(427)	(1,801)	(518)	(156)	(1,467)	(1,539)	(359)	(51)	(9,356)
Impairment releases/(losses)	7	141	(69)	(13)	—	5	725	(15)	(54)	727
Operating profit/(loss) - statutory	1,030	262	1,264	(470)	207	(837)	(3,687)	431	(903)	(2,703)
Operating profit/(loss) - adjusted	2,169	264	1,384	113	211	(55)	(412)	459	272	4,405
Additional information										
Return on equity (1)	11.7%	10.6%	9.8%	(27.7%)	18.5%	(11.1%)	nm	nm	nm	(4.7%)
Return on equity - adjusted (1,2)	26.2%	10.6%	10.9%	4.9%	18.9%	(2.0%)	nm	nm	nm	11.0%
Cost income ratio	80%	78%	59%	171%	44%	155%	nm	46%	nm	127%
Cost income ratio -	58%	78%	55%	80%	43%	104%	nm	43%	nm	72%



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adjusted (2)											
2014											
Total income - statutory	5,444	604	3,305	689	391	1,931	1,792	852	142	15,150	
Own credit adjustments	—	—	—	—	—	9	36	—	101	146	
Gain on redemption of own debt	—	—	—	—	—	—	—	—	(20)	(20)	
Strategic disposals	—	—	—	—	—	—	—	—	(191)	(191)	
Total income - adjusted	5,444	604	3,305	689	391	1,940	1,828	852	32	15,085	
Operating expenses - statutory	(4,157)	(421)	(1,964)	(595)	(160)	(2,650)	(2,497)	(330)	(1,085)	(13,859)	
Restructuring costs - direct	10	(8)	41	1	2	13	80	—	—1,015	1,154	
- indirect	101	21	67	—	5	89	105	—	—(388)	—	
Litigation and conduct costs	918	(19)	112	90	—	832	162	—	99	2,194	
Write down of goodwill	—	—	—	—	—	—	130	—	—	130	
Operating expenses - adjusted	(3,128)	(427)	(1,744)	(504)	(153)	(1,716)	(2,020)	(330)	(359)	(10,381)	
Impairment (losses)/releases	(154)	306	(85)	5	7	9	1,307	(55)	12	1,352	
Operating profit/(loss) - statutory	1,133	489	1,256	99	238	(710)	602	467	(931)	2,643	
Operating profit/(loss) - adjusted	2,162	483	1,476	190	245	233	1,115	467	(315)	6,056	
Additional information											
Return on equity (1)	11.9%	18.6%	10.2%	4.1%	24.2%	(7.9%)	nm	nm	nm	(8.2%)	
Return on equity - adjusted (1,2)	23.7%	18.4%	12.2%	9.1%	24.9%	1.3%	nm	nm	nm	(1.5%)	
Cost income ratio	76%	70%	59%	86%	41%	137%	nm	39%	nm	91%	
Cost income ratio - adjusted (2)	57%	71%	53%	73%	39%	88%	nm	39%	nm	69%	

Notes:

(1) RBS's CET 1 target is 13% but for the purposes of computing segmental return on equity (ROE), to better reflect the differential drivers of capital usage, segmental operating profit after tax and adjusted for preference dividends is divided by notional equity allocated at different rates of 11% (Commercial Banking and Ulster Bank RoI), 12% (RBS International) and 15% for all other segments, of the monthly average of segmental risk-weighted assets incorporating the effect capital deductions (RWAes). RBS Return on equity is calculated using profit for the period attributable to ordinary shareholders.

(2) Excluding own credit adjustments, (loss)/gain on redemption of own debt and strategic disposals, restructuring costs, litigation and conduct costs and write down of goodwill.

**Chairman's statement**

**Howard Davies**

Chairman

2016 was another difficult year for RBS shareholders, even though there is good progress to report on our strategy to rebuild a strong bank focused primarily on retail and commercial customers in the UK and Ireland.

The core bank(1) performed strongly, and adjusted operating profits were up by around 4%(2), in a year of political and economic uncertainty. That progress reflects growth in our market share in the mortgage market and a resumption of growth in business lending, after many years of decline. It shows, too, that the strong focus on reducing costs is beginning to pay off.

Nonetheless the attributable loss(3), at around £7 billion, was more than three times as large as in 2015. It is hard to present that as a positive outcome for shareholders, though in fact it does reflect the impact of stronger efforts to resolve the bank's legacy problems. We settled a number of regulatory and legal actions and made a large provision for future costs, we retired the Dividend Access Share and made a large number of disposals of legacy assets. Restructuring costs were also large in the year. As a result, the bank is better placed than it was a year ago, though there are still some sizeable legacy problems to resolve. The Board and I are determined to press ahead with resolution of those issues and to continue with the strategy Ross McEwan first outlined in 2014. We are confident that we have the right management team in place to deliver effectively in both areas.

### **The Economic and Regulatory Environment**

The UK economy grew by around 2% in 2016, a little less rapidly than in 2015, but still at a healthy rate in what is now a mature recovery. Unemployment remained low inflation stayed well below the Bank of England's target rate and house prices rose, on average, by around 5%, though the regional variations were wide. These might, overall, seem to be benign conditions for banks, but the low interest rate environment, and especially a relatively flat yield curve, are challenges to profitability. Some central banks are charging negative interest rates, and while the Bank of England has not followed them, the base rate was reduced from 0.5% to 0.25% in August, after the referendum on European Union (EU) membership. This lower interest rate environment puts further pressure on banks to control their costs.

The vote to leave the EU was widely expected to have a negative impact on the economy. So far, we have seen a significant fall in sterling, but consumer spending has remained robust, and growth has continued. Of course the UK has not yet left the EU, and we do not know the terms of our departure, so the long-term impact remains impossible to predict. The short-term effect on banks was felt primarily through the reduction in interest rates.

There has been much debate about the impact on the City, and on UK financial services in general, if, as now seems likely, we also leave the single market. As I write, the Article 50 negotiations have not yet begun, so it is idle to speculate. RBS as a primarily UK bank will be less affected than most, but we own Ulster Bank in Ireland and have modest presences in major EU corporate markets. We will take steps to protect those assets as the regulatory environment becomes clearer.

Our prime focus through this uncertain period has been, and will continue to be, to provide high quality banking services to our customers and to help them to understand the implications of change for their businesses and their families.



## **Chairman's statement**

The regulatory environment continues to be challenging for banks. The Basel Committee is discussing a new set of proposals which could have the effect of increasing capital requirements materially, though no agreement has yet been reached. In the UK, the Bank of England stress tests are built on very rigorous assumptions about growth and asset prices. RBS failed its stress test in 2016, primarily on the basis of assumptions reflecting the uncertainty of future conduct costs, especially from legacy problems in the US. We agreed measures to strengthen our balance sheet as a result, which are already underway.

UK banks are also now heavily engaged in preparations for the implementation of ring-fencing, as required by the legislation implementing the recommendation of the Independent Commission on Banking. We are implementing our own plans and expect to meet the statutory deadline of 1 January 2019.

## **Strategy**

Set against that backdrop our strategy remains consistent. The aim is to make RBS a simpler bank focused on doing fewer things, built around a low risk UK and Irish retail and commercial bank and markets business; a safer bank with a long-term target of a CET1 ratio of at least 13%; and a customer- focused bank that is easier to do business with. Our aspiration remains to be the best UK bank for customer service, trust and advocacy by 2020. We will retain a smaller markets business, which complements our strong domestic franchises. The Board are confident that this is the right path to follow and that the bank will deliver good returns for shareholders when its legacy problems have been resolved.

In early 2016 we renewed our long- term targets of 50% for the cost to income ratio and 12% for return on tangible equity. Given expected slower economic growth over the medium- term, we now think we will achieve those objectives in 2020, a year later than previously communicated. That change aligns the timing of our financial targets with our customer service ambitions. It is not yet possible to give a reliable forecast of when the bank will be able to restore a dividend.

## **Conduct, litigation and legacy issues**

As I have said, during the year we made good progress in dealing with a number of legacy issues that have been clouding our performance and shareholder investment case.

We were able to remove one of the main barriers to paying a dividend by paying the final £1.2 billion to retire the Dividend Access Share.

In January 2016, the Board took the decision to make an accelerated £4.2 billion payment to our main pension scheme. Taking this action reduced the scheme deficit considerably and helped provide certainty on our capital management of the pension scheme for both members and regulators. The next valuation is scheduled for 2018.

We also resolved a number of litigation cases relating to foreign exchange and interest rate fixing allegations. These settlements were costly reminders of past behaviours that have no place in the industry or the bank we are building.

The treatment of some of our small business customers has been under scrutiny. Although the Financial Conduct Authority (FCA) review into the historical operation of our former Global Restructuring Group (GRG) continues, I am pleased that with the endorsement of the FCA we were able to announce a new complaints process, led by Sir William Blackburne, a retired High Court judge, alongside an automatic refund for some of the complex fees charged to customers who were in GRG between 2008 - 2013. While we have acknowledged we did not treat all these troubled business customers as well as we should have done, we do not accept that the bank artificially distressed otherwise viable SME businesses or deliberately caused them to fail. The FCA's skilled person and our independent investigators have also found no evidence that the bank either inappropriately targeted businesses to transfer them into GRG or drove them to insolvency.

Another legacy problem on the way to resolution is the shareholder litigation related to the 2008 rights issue. We announced in December that we made an offer to affected shareholders to resolve that litigation and four out of five groups involved have already accepted it.

Following the Government's injection of capital into the bank in 2008, RBS undertook to carry out five major divestments as part of the State Aid commitments agreed with the European Commission (EC). Four have been successfully implemented. The fifth entailed a divestment of assets to enhance competition in the UK's SME banking market. The bank identified a collection of branches and customer relationships, identified as a new bank to be known as Williams & Glyn.

## **Chairman's statement**

Implementing that divestment has proved extremely difficult, partly for technological reasons. In addition, the lower interest rate environment threatened the viability of the new bank.

In the light of these changed circumstances, on 17 February this year, the EC and HM Treasury announced a consultation on a plan, intended to promote competition in different ways, which can be implemented more easily and rapidly. The plan is not yet firm, but we have prudently provided for its cost to the bank in our accounts. We are grateful to the EC for its willingness to consider alternative means to the same end. If carried through, they will relieve the bank of a major operational burden which has constrained our ability to upgrade and enhance our IT systems in the interests of our customers.

But there are other issues from the past which remain to be resolved, and where it has been frustratingly difficult to make progress. By a distance the most financially significant relates to the bank's participation in the US subprime mortgage market in the run up to the financial crisis, and especially in 2007. The Massachusetts Attorney General's Office has been investigating the circumstances of some of the transactions for some years, and we have been in parallel discussions with the Federal Housing Finance Agency. Shareholders will be aware that a number of other banks, both US and European, have settled their claims over the past year, but RBS remains under investigation and as we have said, faces potential criminal and civil action. At this point we cannot say when the issues will be resolved, as the timing is out of our hands.

## **Remuneration**

While RBS continues to report losses it is vital that the bank remains disciplined in its approach to remuneration. On the other hand, we need to fairly reward our colleagues who work with customers from day to day and who bear no responsibility for the decisions which led to those losses, and it is important for the long-term value of shareholders' investment in the company that we attract and retain well-qualified and motivated people. We believe the decisions we have made this year, on the bonus pool (which has been further reduced) and on the proposed new long-term incentive scheme, strike that balance appropriately. They are more fully explained in the 2016 Remuneration report.

## **Supporting our communities**

We refreshed our main customer facing brands during the year, with a new advertising campaign, emphasising their contribution to the communities in which they operate. In England our principal brand is NatWest, in Ireland it is Ulster Bank, and of course in Scotland it is The Royal Bank of Scotland, which has been providing banking services to the country since 1727. We also have a vital role to play in these communities that goes beyond traditional banking activity. Our support of small businesses continues to



strengthen through our partnership with Entrepreneurial Spark. In 2016 we opened a further six accelerator hubs. These accelerator hubs, which are based in our buildings, provide start-ups with free office space, mentoring and access to our networks. Over 7,000 entrepreneurs will be supported in this way over five years, helping to grow the economy and create thousands of jobs.

Our financial education programme, MoneySense, continues to deliver vital skills to young people that will help them be more financially aware in later life. This year we have helped over 300,000 young people in the UK.

In 2016 we also celebrated our 40th anniversary of supporting The Prince's Trust. To mark this milestone, we raised over £470,000 in just five days, with 566 colleagues cycling across the country in fundraising efforts.

This year, we have taken the first step towards combining our 2016 Sustainability and Strategic reports, bringing together in one place our financial and non financial performance to demonstrate how we are building a more sustainable bank to deliver long term value to all our stakeholders.

## **Stakeholder Engagement**

We welcomed the opportunity to participate in the Department for Business, Energy and Industrial Strategy's (BEIS) Green Paper consultation on Corporate Governance Reform. The chapter on strengthening the employee, customer and wider stakeholder voice was of particular interest. This is a cause that we care about. As noted in our response to BEIS, we are looking at ways of improving and building upon our existing arrangements in order to promote the stakeholder voice at board level. We are supportive of the proposal to increase wide stakeholder engagement, including via a panel arrangement. As an organisation, we have maintained active engagement with stakeholders over several years through our Sustainable Banking Committee which, since 2011, has regularly met with external stakeholders and asks them to challenge the most senior decision makers in RBS. We see increased formal engagement as the natural evolution of that committee's work.

## Chairman's statement

### Board changes

Frank Dangeard is the one new face around the boardroom table since last year. He joined the Board in May 2016 and brings a wealth of experience from a number of senior roles and directorships across a range of technology and financial services companies. This knowledge is vital as the bank adapts to increasing customer use of digital channels, and to the need for ever heightened awareness of the risk of cyber attacks.

### Conclusion

I am uncomfortably aware that the reconstruction and rehabilitation of RBS has taken longer than expected, and is still not complete. We can now see clearly the shape of a profitable bank which serves its customers and communities well. There is still a road to travel before we reach that destination, and of course the competitive environment for banks continues to evolve. I assure you that the Board and management are single-mindedly focused on delivering value for our shareholders, and are grateful for your patience as we proceed.

### Notes:

(1) The core bank consists of the reportable segments UK PBB, Ulster Bank RoI, Commercial Banking, Private Banking, RBSI and NatWest Markets.

(2) Adjusted operating profit before tax - UK PBB up by £33 million, 2%, to £2,202 million, Ulster Bank RoI down by £35 million, 13%, to £229 million, Commercial Banking down by £111 million, 8%, to £1,273 million, Private Banking up £36 million, 32%, to £149 million, RBSI down by £16 million, 8%, to £195 million and NatWest Markets up by £256 million to £201 million. See page 6 for segmental income statement reconciliations.

(3) Attributable to ordinary shareholders.

**Chief Executive's review**

**Ross McEwan**

Chief Executive

In 2016 RBS made an attributable loss(1) of £7.0 billion, mostly reflecting charges for outstanding litigation and conduct, and costs associated with restructuring of the bank. The financial impact of these issues is a difficult but necessary step in working through the bank's legacy issues. These costs are a stark reminder of what happens to a bank when things go wrong and you lose focus on the customer, as this bank did before the financial crisis. The more progress we have made on clearing these past issues, enables us to sharpen our focus on the core bank.

Our service level and product improvements are already delivering benefits for both customers and the core bank. In 2017 our focus will turn to going even further on reducing costs and faster on digital transformation in order to deliver a more simple, safe and customer-focused bank.

### **The bank we were**

I joined RBS because I could see that underneath all the troubles it faced, there was a strong bank, with excellent brands and great colleagues, doing outstanding things for customers each day. This underlying strength is still evident today.

In 2014 I announced a three phase strategy. We are moving to the final phase of this, after delivering much during the first two phases, which were about building a platform of strength and stripping away unnecessary complexity. Our CET1 ratio has now materially improved to 13.4% from 8.6% at the start of 2014. We have thoroughly reshaped our investment banking business, now rebranded NatWest Markets. We have sold Citizens in the US, completing the largest bank IPO in US history in the process, and also sold our international private banking business. We have ended active operations in 26 countries, decommissioned 30% of our IT systems and applications, and almost halved the number of legal entities. We have also completed the run-down or sale of over three quarters of Capital Resolution legacy and non-core assets. We have reduced our cost base by over £3 billion, exceeding our target for the third consecutive year, with an operating cost reduction of £985 million(2).

The past is not completely behind us, with our dealings on Residential Mortgage Backed Securities (RMBS) and Williams & Glyn, our residual European Commission State Aid obligations, two significant issues that we still need to resolve. The recent proposal by HM Treasury on an alternative way to increase competition to allow us to meet our State Aid commitments would deliver an outcome more quickly, and with more certainty than undertaking a complex sale. We have been able to provide for both of these in our accounts, though there may still be substantial additional provisions on RMBS.

### **The bank we are today**

We are now in a much better position to focus on our long term aspiration – to transform the bank into the number one for customer service, trust, and advocacy. While the signs of this transformation have at times been masked by our wider organisational changes, the core bank(3) has already evolved materially since 2014. Our decision to refocus on the UK has seen our balance sheet shrink by £229 billion since the start

of our plan. This is net of the continued growth in our Personal and Business Banking and Commercial and Private Banking franchises(4). We are seeing the benefits of our service-led strategy in the financial performance of the core bank, generating £4.2 billion in adjusted pre-tax operating profit(5) for the year, an average of £1 billion per quarter for the last eight quarters and 4% up on 2015.

## Chief Executive's review

While Q4 was down from the levels seen earlier this year, our Net Promoter Scores for Commercial and NatWest Personal in 2016 were the highest they have ever been. With £30 billion of gross new mortgage lending in UK PBB, we helped 320,000 customers with their mortgage in 2016, growing our market share for the fourth consecutive year without leading on price or risk. We are the largest commercial bank in the UK, and are ranked joint number one by Net Promoter Score. Our ability to generate value here is shown by the scale of support we have provided to the economy in the past year, with almost £9 billion of new net commercial lending.

## The bank we are becoming

We still have more work to do. In part, that means finishing the restructuring of RBS, resolving the remaining legacy issues, and preparing the bank for ring-fencing. In the main, however, it is about adapting to the changing nature of the UK and Irish banking sectors, and investing to meet our customers' evolving needs.

Digital innovation means customers are doing more of their transactions online. We interact with our customers over 20 times more through digital channels than physical ones. 35% of all new products were taken out digitally in UK PBB, and this is rising steadily. A fifth of our customers now solely use mobile and digital to interact with us. As customers change the way they bank with us, we must change the way we serve them. This means continuing to simplify for our customers, and accelerating our deployment of digital and mobile capabilities. The role of the branch is fast moving to an advice and service centre, away from transactions. While the branch will still be a core part of our offering to customers, inevitably some branches will have to close.

We're working to blur the line between traditional and digital banking channels. We are investing in a video sales and service proposition that will connect customers, no matter where they are, to the right specialist. This shift isn't only in personal banking. We are aiming to service 95% of our commercial customers' needs through mobile and online by 2020, up from nearly 80% today, by introducing a new digital banking service that will greatly improve experience. We're also responding to customer preferences for more innovative lending platforms and products.

We are investing heavily in technology in our NatWest Markets business. Hundreds of separate product databases will be replaced with a single, scalable platform, which will help reduce costs significantly and dramatically increase the speed at which we can deploy new capabilities for our customers. We are also introducing a single dealer platform, an electronic front door, through which we can provide FX and Rates solutions to our clients. These are the kind of changes that will lower costs while protecting revenue and delivering even better customer service at the same time.

We are committed to running the bank as a more sustainable and responsible business, serving today's customers in a way that also helps future generations, generating long term value for all of our stakeholders and society. In 2016, we improved on our position in a number of rankings, including achieving our highest ever score in the Dow Jones Sustainability Index. We continued with our commitment to manage our impacts on climate change and support our customers to move towards the transition to a low-carbon economy. We continue to support financial education and our goal is to help a further one million more young people understand all about money by the end of 2018.

Our commitment to sustainability is also evident in our annual results, where we have replaced our annual Sustainability Report with a more integrated approach. You will see a number of new elements in the Strategic Report that explain the key influences on our operating environment, and some of the impact we have had over the past year. This is an important step towards fully integrated reporting over the coming years.

### **Delivering our strategy**

The decision last summer by UK voters to leave the EU will have wide-reaching consequences. In light of this, we reviewed our plan to ensure that it remained valid in a changed macro and political environment. Following that review, I want to re-iterate our commitment to the strategy we have been pursuing since I became CEO – we firmly believe that our aspiration to reach No.1 for customer service, trust and advocacy will maximise value for our shareholders.

This year we have met all our operating financial targets, though the results of some of our customer NPS and employee engagement surveys show we still have work to do. After the EU referendum result, we promised an update on our targets. We are targeting an unadjusted 12% or greater return on tangible equity, and a below 50% cost to income ratio by 2020, one year later than envisaged when we first set out our plan in 2014.

## Chief Executive's review

Our service levels are improving and we believe we can meet our 2020 aspirational customer and colleague targets. Our focus on capital strength remains a cornerstone of our plan. In 2017, we will continue to reduce legacy RWAs, and we will target a CET1 ratio of at least 13%.

This has also been another tough year for our colleagues. I am grateful for their determination in serving our millions of customers every day, despite many negative headlines. Our colleagues are the face of the bank for our customers, and their engagement is critical to our success. One of our five key targets in 2017 is to improve employee engagement.

We no longer have global aspirations and we need to go further still on our operating costs. We expect to take out an additional £750 million of operating costs(6) in 2017 through our focus on simplification and digital transformation. A simpler bank is a more profitable bank and a bank that delivers a better customer experience. Where we can make it easy for our customers, the more business they will do with us and the more sustainable our earnings will become.

## Looking ahead

The progress of the last three years positions us well to achieve our vision for the future. We have the right strategy, and it is starting to deliver results. Now, we need to go further on cost reduction and faster on digital transformation.

We aren't alone in searching for efficiency gains and investing in digital capability, but the unique strength of this bank lies in the fact that we have a diverse business profile, with scale in all of our chosen markets. Investment in our market leading brands and better customer service will deliver steadier, higher quality earnings. Our focus on service rather than price has also shown that we can continue to grow in areas of strategic opportunity, such as mortgages, without compromising on risk. All of this will deliver a sustainable competitive advantage and a compelling investment case in the longer term.

This is a bank that has been on a remarkable journey. We still have further to go. But the next three years will not be the same as the past three. Legacy issues will take up a decreasing amount of our time and focus. Our customers, our cost base and the measures we plan to implement to return the bank to sustainable headline profits will be where we focus our efforts. Assuming we can conclude our issues on RMBS this year and resolve our residual State Aid obligations, we aim to have RBS back into profit in 2018 representing a significant step towards being able to start repaying UK taxpayers for their support.



Notes:

(1) Attributable to ordinary shareholders.

(2) Cost saving target and progress 2016 calculated using operating expenses excluding restructuring costs of £2,106 million (2015 – £2,931 million), litigation and conduct costs of £5,868 million (2015 – £3,568 million), write down of goodwill nil (2015 – £498 million), write down of other intangible assets of £117 million (2015 – £75 million), the operating costs of Williams & Glyn £393 million (2015 – £359 million) and the VAT recovery of £227 million.

(3) The core bank consists of the reportable segments UKPBB, Ulster Bank RoI, Commercial Banking, Private Banking, RBSI and NatWest Markets.

(4) Personal & Business Banking consists of the reportable segments UK PBB and Ulster Bank RoI, and Commercial & Private Banking consists of the reportable segments Commercial Banking, Private Banking and RBSI.

(5) Adjusted operating profit before tax - UK PBB up by £33 million, 2%, to £2,202 million, Ulster Bank RoI down by £35 million, 13%, to £229 million, Commercial Banking down by £111 million, 8%, to £1,273 million, Private Banking up £36 million, 32%, to £149 million, RBSI down by £16 million, 8%, to £195 million and NatWest Markets up by £256 million to £201 million. See page 6 for segmental income statement reconciliations.

(6) Cost saving target and progress 2017 calculated using operating expenses excluding restructuring costs, litigation and conduct costs, write down of goodwill and the 2016 VAT recovery.

## 2016 performance summary

RBS reported a loss attributable to ordinary shareholders of £6,955 million compared with £1,979 million in 2015. The loss attributable to ordinary shareholders for the year included; litigation and conduct costs of £5,868 million, restructuring costs of £2,106 million, payment of the final DAS dividend of £1,193 million, Capital Resolution disposal losses and impairments of £825 million and a £300 million deferred tax asset impairment.

The 2016 operating loss before tax of £4,082 million compared with an operating loss before tax of £2,703 million in 2015. Adjusted operating profit before tax, excluding own credit adjustments (2016 - £180 million; 2015 - £309 million), loss on redemption of own debt (2016 - £126 million; 2015-£263 million loss), strategic disposals (2016 - £164 million gain; 2015 - £157 million loss), restructuring costs (2016 - £2,106 million (2015 – £2,931 million), litigation and conduct costs £5,868 million (2015 – £3,568 million) and write down of goodwill nil (2015 – £498 million), of £3,674 million was £731 million, or 17%, lower than 2015.

The net interest margin (NIM) of 2.18% for 2016 was 6 basis points higher than 2015, as the benefit associated with the reduction in low yielding assets more than offset modest asset margin pressure and mix impacts across the core franchises.

Excluding expenses associated with Williams & Glyn(1,5), write-down of intangible assets and the VAT recovery in Q2, adjusted operating expenses have reduced by £985 million, or 11%, compared with 2015, exceeding our target of £800 million. RBS has reduced adjusted operating expenses(5) by over £3 billion in the last three years. Cost income ratio for 2016 was 129% compared with 127% in 2015 and the adjusted cost:income ratio was 66% compared with 72% in 2015.

Risk elements in lending (REIL) as a % of gross customer loans was 3.1%, 80 basis points lower than 31 December 2015 as RBS continues to de-risk its balance sheet.

## PBB, CPB and NatWest Markets delivered increased profits and strong lending growth

RBS reported a £602 million, or 41%, increase in operating profit before tax to £2,058 million in 2016 and an adjusted operating profit before tax of £4,249 million across PBB, CPB and NatWest Markets, 4% higher than 2015 and an average of over £1 billion a quarter.

Income across PBB and CPB increased by 3% in 2016 compared with 2015. PBB and CPB had combined adjusted income growth of 2%, (including transfers of £98 million in 2015), as increased lending volumes more than offset reduced margins. NatWest Markets income of £1,574 million increased by 3% compared with 2015. Adjusted income of £1,521 million increased by 16% compared with 2015, including transfers (2), driven by Rates and Currencies.

PBB and CPB net loans and advances of £272.1 billion have increased by 10%(7) in 2016, compared with a target of 4%, reflecting strong growth across both residential mortgages and commercial lending.

The cost income ratio improved to 81% compared with 88% in 2015. Adjusted cost income ratio improved to 63% compared with 65% in 2015 as we continue to deliver efficiencies across PBB, CPB and NatWest Markets.

### **RBS continues to address its remaining legacy issues and drive forward its restructuring programme**

Restructuring costs were £2,106 million for 2016, compared with £2,931 million in 2015, and included a £750 million provision in respect of the plan by the Commissioner responsible for EU competition policy to propose to the College of Commissioners to open proceedings to gather evidence on an alternative plan for RBS to meet its remaining State Aid obligations in respect of Williams & Glyn. If adopted, this alternative plan would replace the existing requirement to achieve separation and divestment by 31 December 2017. In addition, £706 million of the remaining restructuring costs related to Williams & Glyn, including £146 million of termination costs associated with the decision to discontinue the programme to create a cloned banking platform.

Litigation and conduct costs of £5,868 million included; a £3,107 million provision in relation to various investigations and litigation matters relating to RBS's issuance and underwriting of residential mortgage-backed securities (RMBS), an additional charge in respect of the settlement with the National Credit Union Administration Board to resolve two outstanding RMBS lawsuits, a provision in respect of the UK 2008 rights issue shareholder litigation, additional PPI provisions, a provision in respect of the FCA review of RBS's treatment of SMEs and a provision in Ulster BankRoI in respect of an industry wide examination of tracker mortgages.

A net strategic disposal gain of £164 million includes a £246 million gain on disposal of RBS's stake in Visa Europe partially offset by losses associated with the sale of our Russian subsidiary and exit of Kazakhstan.

### **PBB, CPB and NatWest Markets operating performance**

Across our three customer facing franchises, PBB, CPB and NatWest Markets, operating profit before tax increased by £602 million, or 41%, to £2,058 million in 2016. Adjusted operating profit before tax, which excluded own credit adjustments (2016 - £56 million; 2015 - £120 million), restructuring costs (2016 - £489 million; 2015 – £852 million), litigation and conduct costs (2016 - £1,758 million; 2015 – £1,400 million) and write down of goodwill nil (2015 – £498 million), was £4,249 million, £163 million, or 4% higher than 2015.

## 2016 performance summary

UK PBB operating profit before tax was £1,381 million compared with £1,030 million in 2015. Adjusted operating profit before tax, which excludes restructuring costs of £187 million (2015 - £167 million) and litigation and conduct costs of £634 million (2015 - £972 million), of £2,202 million was £33 million, or 2%, higher than 2015 as increased income and reduced costs were partially offset by increased impairments. Total income increased by £90 million, or 2%, to £5,290 million compared with 2015 as the benefit of increased lending more than offset reduced margins, down 17 basis points to 3.01%, and lower fee income, reflecting reduced credit card interchange fees and increased cash back payments following the launch of the Reward account. Net loans and advances increased by 10% to £132.1 billion in 2016 principally driven by mortgage growth.

Ulster Bank RoI operating profit before tax was £20 million compared with £262 million in 2015. Adjusted operating profit before tax which excluded restructuring costs of £40 million (2015 - £15 million) and litigation and conduct costs of £172 million (2015 - £13 million credit), of £229 million was £35 million lower than 2015 principally reflecting a £28 million reduction in net impairment releases. REIL decreased by £1.3 billion in Q4 2016 largely driven by the sale of a portfolio of distressed loans.

Commercial Banking profit before tax was £742 million compared with £1,264 million in 2015. Adjusted operating profit before tax which excluded restructuring costs of £108 million (2015 - £69 million) and litigation and conduct costs of £423 million (2015 - £51 million), of £1,273 million was £111 million, or 8%, lower than 2015 primarily reflecting a £137 million increase in net impairment losses, largely driven by a single name charge in respect of the oil and gas portfolio. Excluding the business transfers, a benefit of £218 million (2015 - £79 million), total income increased by £21 million, or 1%, reflecting higher asset and deposit volumes partially offset by asset margin pressure. Net loans and advances increased by 10% in 2016 to £100.1 billion.

Private Banking(3) operating profit before tax was £111 million compared with an operating loss before tax of £470 million in 2015. Adjusted operating profit before tax which excluded restructuring costs of £37 million (2015 - £73 million) and litigation and conduct costs of £1 million (2015 - £12 million) and write down of goodwill (2015 - £498 million), of £149 million increased by £36 million, or 32%, compared with 2015 as increased asset volumes drove a £13 million, or 2%, uplift in income and cost efficiencies resulted in a £7 million, or 1%, reduction in adjusted operating expenses. In addition, net impairment losses reduced by £16 million.

RBS International operating profit before tax was £190 million compared with £207 million in 2015. Adjusted operating profit before tax which excluded restructuring costs of £5 million (2015 - £4 million), of

£195 million was £16 million, or 8%, lower than 2015 largely reflecting a £13 million, or 8%, increase in adjusted operating expenses which excluded restructuring costs of £5 million (2015 - £4 million), driven by a number of one-off charges, and a £10 million net impairment loss in 2016. Partially offsetting, total income increased by £7 million, or 2%, driven by increased asset volumes.

NatWest Markets total income was £1,574 million compared with £1,527 million in 2015. Adjusted income of £1,521 million which excluded the impact of transfers, £98 million in 2015 and own credit adjustments of £53 million (2015 - £120 million), was 16% higher than 2015, driven by Rates and Currencies, which benefited from sustained customer activity and favourable market conditions following the EU referendum and subsequent central bank actions. An adjusted operating profit of £201 million compared with a loss of £55 million in 2015.

### **Capital Resolution & Central items operating performance**

Capital Resolution operating loss before tax was £4,870 million compared with £3,687 million in 2015. Adjusted operating loss before tax which excluded restructuring costs of £78 million (2015 - £1,307 million) and litigation and conduct costs of £3,413 million (2015 - £2,105 million), of £1,432 million compared with a loss of £412 million in 2015 and included disposal losses and impairments of £825 million, of which £683 million related to the shipping portfolio. RWAs reduced by £14.5 billion in 2016 to £34.5 billion.

Central items operating loss before tax was £1,615 million compared with £903 million in 2015. Adjusted operating profit which excluded own credit adjustments, £10 million credit (2015 - £14 million charge), loss on redemption of own debt £126 million (2015 - £263 million), strategic disposals resulting in a £245 million gain (2015 - £119 million loss), restructuring costs of £1,482 million (2015 - £744 million) and litigation and conduct costs of £697 million (2015 - £63 million), of £455 million compared with £272 million in 2015 and included a £349 million FX gain, principally associated with the weakening of sterling against the US dollar, a £227 million VAT recovery, a £97 million foreign exchange reserve recycling gain and other gains, partially offset by a £510 million loss in respect of IFRS volatility(4) due to reductions in long term interest rates (2015 – £15 million profit).

**2016 performance summary**

## Delivery against our 2016 targets

Strategy goal	2016 target	2016
Strength and sustainability	Maintain Bank CET1 ratio of 13%	CET1 ratio of 13.4%
	£2 billion AT1 issuance	£2 billion equivalent AT1 issued in Q3 2016
	Capital Resolution RWAs around £30-35 billion	RWAs down £14.5 billion to £34.5 billion
Customer experience	Narrow the gap to No.1 in NPS in every primary UK brand	Year on year Commercial Banking have narrowed the gap. NatWest Personal, Ulster Business & Commercial in Northern Ireland and Ulster Business Direct in Republic of Ireland, have seen improvements in NPS
Simplifying the bank	Reduce operating expenses by £800 million	Operating expenses down £985 million (5)
Supporting sustainable growth	Net 4% growth in PBB and CPB customer loans	Net lending in PBB and CPB up 10%
Employee engagement	Raise employee engagement to within two points of the Global Finance Services (GFS) norm	Down 3 points to be 6 points adverse to GFS norm

## Notes:

(1) Williams & Glyn refers to the business formerly intended to be divested as a separate legal entity and comprises RBS England and Wales branch-based businesses, along with certain small and medium enterprises and corporate activities across the UK. During the period presented Williams & Glyn has not operated as a separate legal entity.

(2) NatWest Markets' results include the following financials for businesses subsequently transferred to Commercial Banking: total income of £98 million for the year ended 2015.

(3) Private Banking serves high net worth individuals through Coutts and Adam & Company.

(4)IFRS volatility arises from the changes to fair value of hedges of loans which do not qualify for hedge accounting under IFRS.

(5)Cost saving target and progress 2016 calculated using operating expenses excluding restructuring costs of £2,106 million (2015 – £2,931 million), litigation and conduct costs of £5,868 million (2015 – £3,568 million), write down of goodwill nil (2015 – £498 million), write down of other intangible assets of £117 million (2015 – £75 million), the operating costs of Williams & Glyn £393 million (2015 – £359 million) and the VAT recovery of £227 million.

(6)Personal & Business Banking consists of the reportable segments UK PBB and Ulster Bank RoI, and Commercial & Private Banking consists of the reportable segments Commercial Banking, Private Banking and RBSI.

(7)Net loans and advances - UK PBB up from £119.8 billion, 10%, to £132.1 billion, Ulster Bank RoI up from £16.7 billion, 13%, to £18.9 billion, Commercial Banking up from £91.3 billion, 10%, to £100.1 billion, Private Banking up from £11.2 billion, 9%, to £12.2 billion and RBSI up from £7.4 billion, 19% to £8.8 billion.



## 2016 performance summary

### Building a stronger RBS

RBS is progressing with its plan to build a strong, simple, fair bank for customers and shareholders. During 2016, RBS narrowed the range of uncertainty around its capital position by addressing a number of legacy issues, and continued to strengthen its capital base.

CET1 ratio remains ahead of our 13.0% target at 13.4%, a 210 basis points reduction compared with Q4 2015 principally reflecting the loss attributable to ordinary shareholders of £6,955 million, equivalent to c.300 basis points, partially offset by a £14.4 billion reduction in RWAs, c.100 basis points. During Q4 2016, the CET1 ratio reduced by 160 basis points as the benefit of the reduction in RWAs was more than offset by the loss attributable to ordinary shareholders.

RWAs reduced by £14.4 billion, or 6%, during 2016 to £228.2 billion driven by £14.5 billion of disposals and run-off in Capital Resolution and a £3.9 billion reduction associated with the removal of Citizens operational risk RWAs, partially offset by an increase associated with the weakening of sterling and lending growth across our core franchises.

On 10 August 2016 RBS announced that it had successfully completed the pricing of \$2.65 billion 8.625% AT1 capital notes, with £4.0 billion equivalent issued since August 2015 (1.8% of Q4 2016 RWAs).

Leverage ratio reduced by 50 basis points during 2016 to 5.1% reflecting the loss attributable to ordinary shareholders for the year partially offset by the AT1 issuance and reduction in leverage exposure.

RBS issued £4.2 billion equivalent senior debt, which it expects to be eligible to meet its 'Minimum Requirement for Own Funds and Eligible Liabilities' (MREL), in line with our targeted £3-5 billion senior debt issuance for the year. €1.5 billion seven year 2.5% notes and \$1.5 billion ten year 4.8% notes were issued in Q1 2016 and \$2.65 billion seven year 3.875% notes were issued in Q3 2016.

In addition, RBS successfully completed the cash tender of £2.3 billion of certain US dollar, sterling and euro senior debt securities. The tender offers were part of the ongoing transition to a holding company capital and term funding model in line with regulatory requirements and included securities that RBS considers non-compliant for MREL purposes. In total, during 2016, £10 billion has matured across our funding pools and we have redeemed £8.2 billion through calls and repurchase.

As part of the 2016 Bank of England stress testing exercise RBS submitted a revised capital plan, incorporating further capital strengthening actions, which was accepted by the PRA Board.

RBS has successfully addressed a number of the remaining legacy issues and continues to de-risk its balance sheet.

During Q1 2016 RBS made the final dividend payment in respect of the DAS, £1,193 million, an action that was taken to normalise the ownership structure of the Bank.

In June 2016, the triennial funding valuation of the Main scheme of The Royal Bank of Scotland Group Pension Fund was agreed which showed that as at 31 December 2015 the value of liabilities exceeded the value of assets by £5.8 billion. In March 2016, to mitigate this anticipated deficit, RBS made a cash payment of £4.2 billion.

The next triennial valuation is due to occur at the end of 2018 with agreement on any additional contributions by the end of March 2020. As at 31 December 2016, the Main scheme had an unrecognised surplus reflected by a ratio of assets to liabilities of c.115% under IAS 19 valuation principles.

On 11 April 2016, RBS completed the successful transfer of the Coutts International businesses in Asia and the Middle East to Union Bancaire Privée, the final milestone in the sale of our International Private Bank. During 2016 we also completed the sale of our Russia and Kazakhstan subsidiaries.

Risk elements in lending (REIL) of £10.3 billion were £1.8 billion lower than 31 December 2015 and represented 3.1% of gross customer loans, compared with 3.9% as at 31 December 2015 and 3.8% at 30 September 2016.

In line with the progress to de-risk the balance sheet, exposures to the shipping and oil and gas sectors continued to reduce during 2016, with potential exposures declining by 29% to £5.2 billion and by 22% to £5.3 billion respectively. As at the end of 2016, our total exposure to the coal mining, oil and gas and power generation sectors represented 1.4% of our total lending.



## **2016 performance summary**

Building the number one bank for customer service, trust and advocacy in the UK

### **Supporting households and business customers**

RBS continued to deliver strong support for both household and business customers. Within UK PBB, gross new mortgage lending of £29.8 billion was 29% higher than 2015. Across 2016, our market share of new mortgages was 12%, supporting a growth in stock share to 8.8% at end 2016 from 8.2% at end 2015. As a result, total UK PBB net loans and advances increased by 10% compared with 2015. Commercial Banking net loans and advances have also grown by 10% over the course of 2016 reflecting increased borrowing across a number of sectors.

The Reward account continued to show positive momentum and now has 1,149,000 fee-paying customers compared with 202,000 at 31 December 2015. We have seen positive evidence of increased levels of engagement, with overall current account attrition levels falling by 7% in the year. This is particularly evident across our Private and Premium customer, with attrition 12% lower. We continue to embed the product across our population of valuable main bank customers.

RBS continues to support UK business growth through the launch of 6 new business accelerator hubs in 2016, bringing the total to 12. This included the opening of an Entrepreneurial Centre in our Edinburgh headquarters. In addition, NatWest launched a £1 billion lending fund to support small businesses.

### **Investing in our operational capabilities and enhancing digital channels**

RBS continued to make better use of our digital channels to make it simpler to serve our customers and easier for them to do business with us. We now have 4.2 million customers regularly using our mobile app in the UK, 19% higher than the end of 2015, and around 60% of our personal customers used a digital channel within the last 90 days. In 2016, we more than doubled the number of customers who purchased a product through our mobile channel compared with 2015. NatWest customers can now apply for personal loans, credit cards and overdrafts via the mobile app, facilitating approximately 8% of total applications. Our new business banking 'Online Account Opening' service now allows start up business customers to submit an application online in just ten minutes and get a sort code and account number in under an hour.

Nearly 80% of our commercial customers' interaction with us is via digital channels, with 270,000 payments processed every day.

In addition to our digital channels, RBS continues to provide multiple physical channels for serving customers, including access to a network of c.11,500 Post Office branches in the UK, c.1,000 An Post branches in the Republic of Ireland, and 41 mobile banking vans, alongside our existing network of 1,425 branches and 4,646 ATMs across PBB.

RBS became the first UK Bank to be accredited by the Royal National Institute for Blind People for having an accessible mobile app for blind and partially sighted customers. In addition, we launched a new service for British Sign Language (BSL) customers, making it possible to instantly chat with an advisor through a BSL interpreter.

Coutts won the best private bank in the UK for the fifth year running, best private bank for philanthropy services and best initiative of the year in client facing technology at the Global Private Banking Awards, and was highly commended for innovation for its 'Coutts Concierge Online'.

### **Investing in our people**

In 2016, RBS was one of only two banks to achieve formal recognition from the Chartered Banker Professional Standards Board for excellence in implementing, monitoring, reporting and commitment to the Foundation Standard for Professional Bankers.

Delivered leadership training to almost 16,000 leaders through a comprehensive 'Determined to Lead' programme.

We continue to work towards our goal of having at least 30% senior women in our top three leadership layers across each business by 2020 and to be fully gender balanced (50/50) by 2030. As at 31 December 2016, in aggregate terms 34% of our top three leadership layers were female.

RBS has attained silver status in the Business Disability Forum's Disability Standard, scoring 88% in its assessment of accessibility and inclusion in the workplace.

RBS has moved up to 13th place, from 32nd last year, in Stonewall's annual Top 100 employers for lesbian, gay, bi and trans (LGBT) staff, the highest position it has achieved in the index to date.



## 2016 performance summary

Looking forward

### Capital reorganisation

It is our intention to implement a capital reorganisation in 2017 in order to increase the distributable reserves of the parent company, RBSG plc, providing greater flexibility for future distributions and preference share redemptions. We intend to seek shareholder approval to reduce the share premium account by around £25 billion and to cancel the capital redemption reserve, around £5 billion. This will, subject to approval by shareholders and regulators, and confirmation by the Court of Session in Edinburgh, increase RBSG plc distributable reserves by around £30 billion.

### Ring-fenced structure

As previously announced, on 1 January 2017, RBS made a number of changes to its legal entity structure to support the move towards a ring-fenced structure, with further changes planned prior to 1 January 2019. Our new brand strategy is designed to align with our business strategy and future ring-fenced structure. NatWest will be our main customer facing brand in England, Wales and Western Europe, and in Scotland, Royal Bank of Scotland will be our core brand. In addition, our Corporate & Institutional Banking business has been rebranded as NatWest Markets in readiness for our future ring-fenced structure. The ring-fenced banking group is expected to comprise of 80% of RBS risk-weighted assets.(1)

### IFRS9

RBS continues to develop its processes to enable IFRS 9 Financial Instruments to be implemented on 1 January 2018; an estimate of the initial impact will be included in 2017 H1 interim reporting.

### Williams & Glyn

On 17 February 2017, RBS announced that it had been informed by HM Treasury (“HMT”) that the Commissioner responsible for EU competition policy plans to propose to the College of Commissioners to open proceedings to gather evidence on an alternative plan for RBS to meet its remaining State Aid obligations. If adopted, this alternative plan would replace the existing requirement to achieve separation and divestment by 31 December 2017 of Williams & Glyn. As previously disclosed, none of the proposals to acquire the business received by RBS can deliver a full separation and divestment before the 31 December 2017 deadline.

RBS has agreed that HMT will now seek formal amendment to RBS's State Aid commitments to pave the way for the Commissioner to propose to open proceedings, as described above. In addition to the Commission's proceedings, HMT will carry out a market testing exercise in parallel. The opening of the Commission's proceedings does not prejudice the outcome of the investigation.

The plan envisages that RBS will deliver the following revised package of remedies to promote competition in the market for banking services to small and medium enterprises ("SMEs") in the UK:

- A fund, administered by an independent body, that eligible challenger banks can access to increase their business banking capabilities;
- Funding for eligible challenger banks to help them incentivise SMEs to switch their accounts from RBS paid in the form of "dowries" to eligible challenger banks;
- RBS granting business customers of eligible challenger banks access to its branch network for cash and cheque handling, to support the measures above; and
- An independent fund to invest in fintech to support the business banking of the future.

The 2016 Annual Results include a £750 million restructuring provision as a consequence of this proposal.

## **2017 Outlook <sup>(2)</sup>**

Subject to providing fully for the remaining legacy issues, RMBS exposures in particular, RBS currently expects that 2017 will be its final year of substantive legacy clean up with significant one-off costs. Consequently, we anticipate that the bank will be profitable in 2018.

We are targeting net loans and advances growth of 3% across PBB and CPB, including taking into account the impact of balance sheet reductions associated with the RWA reduction target. We anticipate that this growth will be largely within PBB as we expect to see moderate growth in some segments in CPB, whilst at the same time selectively reducing exposures with weak returns and continuing to actively manage certain legacy loan exposures.

We expect that income in 2017 will continue to be supported by balance sheet growth across PBB and CPB. Within UK PBB, we anticipate that income will increase in 2017 compared with 2016, as we have already absorbed significant margin pressure from the changing mortgage mix and the impact of the sharp fall in interchange rates. Across CPB, we expect income to be broadly stable with continued competitive



pressure on margins, given the interest rate environment. NatWest Markets is expected to continue to benefit from increased market volatility and customer activity and we anticipate that 2017 income will be above previously indicated targets of £1.3 -£1.4 billion.

RBS plans to reduce adjusted operating expenses<sup>(3)</sup> by a further £750 million in 2017, in addition to the £3.1 billion achieved across 2014 to 2016, and we expect that the adjusted cost:income ratio<sup>(3)</sup> will improve across our combined PBB, CPB and NatWest Markets franchises in 2017 compared with 2016.

## 2016 performance summary

Net impairment charges should remain meaningfully below normalised levels in 2017. However, we expect the level of net impairment charges to be driven by a combination of increased gross charges and a materially reduced benefit from releases. Recent UK economic performance has been better than previous forecasts leading to improved expectations for the 2017 economic outlook. However, the medium term outlook remains less certain, and together with the increased volatility expected with the introduction of IFRS 9, quantification of future credit losses is more challenging beyond 2017 at this point. We continue to remain mindful of potential downside risks including from single name / sector driven events and lower releases of provisions.

We continue to expect that cumulative Capital Resolution disposal losses will total approximately £2.0 billion since the beginning of 2015, with £1,192 million of losses incurred to date (2016; £825 million, 2015; £367 million) with most of the balance expected to be incurred during 2017. Excluding RBS's stake in Alawwal Bank (previously Saudi Hollandi Bank, £7.9 billion at 31 December 2016), we expect Capital Resolution RWAs to be in the range £15-£20 billion by the end of 2017, at which point we plan to wind up Capital Resolution and transfer the assets back into the rest of the bank.

Excluding restructuring costs associated with the State Aid obligations relating to Williams & Glyn, we expect to incur restructuring costs of approximately £1 billion in 2017 and approximately a further £1 billion in aggregate during 2018 and 2019. Approximately 40% of this cost is expected to relate to the optimisation of our property portfolio.

Further to the update on 17 February 2017 in respect of the remaining State Aid obligations regarding the business known as Williams & Glyn, and subject to the alternative plan being finalised and adopted by the European Commission (EC) and further discussions with the EC and HMT, RBS will assess the timing and manner in which it would reincorporate the business into the RBS franchises. This reintegration would likely create some additional restructuring charges during 2017 and 2018.

We are targeting a CET1 ratio of at least 13% at the end of 2017. As part of the 2016 Bank of England stress testing exercise, RBS submitted a revised capital plan, incorporating further capital strengthening actions, which was accepted by the PRA Board.

RBS issuance plans for 2017 focus on issuing £3-£5 billion MREL-compliant Senior holding company (RBSG) securities. We do not currently anticipate the need for either AT1 or Tier 2 issuances. In addition, and reflecting our strategic progress, we also target a progressive return to other funding markets to support our lending growth.

RBS continues to deal with a range of significant risks and uncertainties in the external economic, political and regulatory environment and manage conduct-related investigations and litigation, including RMBS. Substantial additional charges and costs may be recognised in the coming quarters which would have an impact on RBS's level of capital and financial performance and condition.

## 2016 performance summary

### Medium term outlook <sup>(2)</sup>

We now target achieving our sub 50% cost:income ratio<sup>(3)</sup> and 12% return on tangible equity targets in 2020, one year later than originally planned. Our confidence in achieving the targets is underpinned by our ability to protect income and drive cost reductions whilst managing credit and market risk and driving further capital efficiency.

We expect to be able to grow volumes faster than market growth rates over the coming years in chosen segments across PBB and CPB.

We plan to reduce adjusted operating expenses<sup>(3)</sup> in the order of £2 billion in the next four years with around two thirds of this from the core bank.

We are targeting a gross RWA reduction of approximately £20 billion across PBB, CPB and NatWest Markets by the end of 2018, with some offsetting volume growth. We expect that the reduction will be largely achieved through improvements in the quality of our risk models, exiting low return, non strategic and risk intensive asset pools, improved risk metrics in certain portfolios and benefits from data clean-up. We estimate that the income loss associated with this reduction will be in the range £250 million – £300 million on an annualised, pre tax, basis.

We continue to monitor the ongoing discussions around the potential further tightening of regulatory capital rules and recognise that this could result in RWA inflation in the medium term.

In view of the significant risks and uncertainties in the external economic, political and regulatory environment including uncertainties around the resolution of RMBS, the timing of returning excess capital to shareholders through dividends or buybacks remains uncertain was accepted by the PRA Board.

Notes:

(1) Based on RBS future business profile business and excludes Capital Resolution.

(2) The targets, expectations and trends discussed in this section represent management's current expectations and are subject to change, including as a result of the factors described in this document and

in the “Risk Factors” on pages 509 to 578 of the Annual Report 2016 on Form 20-F. These statements constitute forward looking statements, please see Forward Looking Statements on pages 1 and 2 of the Annual Report 2016 on Form 20-F.

(3) Cost saving target and progress 2017 calculated using operating expenses excluding restructuring costs, litigation and conduct costs, write down of goodwill and the 2016 VAT recovery.

## 2017 targets

As we works towards our long-term goals, we have set the following targets for 2017.

Strategy goal	Our long-term targets	Our 2017 goals
Strength and sustainability	CET1 ratio of 13% RoTE (1,2) $\geq$ 12%	Maintain bank CET1 ratio of 13%
Customer experience	Number 1 for service, trust and advocacy	Significantly increase NPS or maintain No.1 in chosen customer segments
Simplifying the bank	Headline cost:income ratio <50%	Reduce operating expenses by at least £750 million (3)
Supporting sustainable growth	Leading market positions in every franchise	Net 3% growth in total PBB and CPB loans to customers (4)
Employee engagement	Employee engagement in upper quartile of Global Financial Services (GFS) norm	Improve employee engagement

Notes:

(1) Calculated using (loss)/profit for the period attributable to ordinary shareholders.

(2) Tangible equity is equity attributable to ordinary shareholders less intangible assets.

(3) Cost saving target and progress 2017 calculated using operating expenses excluding restructuring costs, litigation and conduct costs, write down of goodwill and the 2016 VAT recovery.

(4) Lending growth target is after including the impact of balance sheet reductions associated with the RWA reduction target across PBB, CPB and NatWest Markets as outlined in the outlook statement.

## **Business model and strategy**

### Our strategy

We are building a better bank for our customers, and one that will deliver sustainable returns for shareholders. Our purpose is to serve customers well, and to do so, we are becoming a safer, simpler, customer-focused UK and Ireland bank.

### Our plan

Underpinning that ambition is our blueprint for success. This is our plan which drives our strategic decision making.

RBS is continuing to build a bank that is easy to do business with, and meets customers' continually evolving needs. Our plan focuses on delivering excellent customer service through all of our brands. Creating lasting relationships with our customers, who advocate for our bank, is the key to generating sustainable values.

Notes:

(1) Cost saving target and progress calculated using operating expenses excluding restructuring costs, litigation and conduct costs, write down of goodwill and the 2016 VAT recovery.

(2) Lending growth target is after including the impact of balance sheet reductions associated with the RWA reduction target across PBB, CPB and NatWest Markets as outlined in the outlook statement.

## **Business model and strategy**

Our priorities

### **Strength and sustainability**

We remain focused on building a strong and stable bank. We have continued to improve the fundamentals, by increasing our capital strength, building a robust liquidity position and balancing our loan to deposit ratio.

### **Customer experience**

We are investing in our people, service, and product proposition to ensure we provide market leading technology and signature customer experiences, through a wide variety of channels.

### **Simplifying the bank**

Streamlining of processes and removing unnecessary complexity lowers our operating costs, and makes our customer interactions more straightforward.

### **Supporting sustainable growth**

A strong sustainable business grows with its customers. We continue to support our customers through offering products and services which meet their needs.

### **Employee engagement**

Engaged colleagues lead to engaged customers. At RBS we are committed to investing in our colleagues and creating leaders who inspire and empower their teams.





## Business model and strategy

### Our structure

We have three customer franchises, and each is underpinned by a range of distinct brands, which are the route through which we engage with our customers.

Our franchises share operational and control functions, deriving economies of scale and diversification benefits. Our brands are personalised and each reflects a particular targeted customer segment.

**Personal and Business Banking (PBB)** With a branch network and mobile, telephone and online banking propositions, PBB services our retail banking, mass affluent and small business customers in both the UK and Republic of Ireland. PBB provides a simple range of products, including current accounts, loans and mortgages, to meet all core banking needs.

**Commercial and Private Banking (CPB)** CPB serves our commercial and our high net worth customers in the UK and Western Europe. Commercial Banking supports our corporate clients by providing comprehensive commercial banking and financing services with sector expertise. This includes specialist finance such as invoice finance, asset finance and leasing. Our Private Banking business offers high net worth clients private banking, wealth planning and investment management services. RBS International (RBSI) continues to focus on supporting retail, commercial, corporate and financial institution customers in Jersey, Guernsey, Isle of Man, Gibraltar and Luxembourg.

### NatWest Markets

Focusing on our core markets in the UK and Western Europe, NatWest Markets provides financing and risk management to our UK and Western Europe corporate customers and global financial institutions.

## **Franchises**

Our franchises bring together customers determined by the scale and complexity of their financial needs. This groups our business units that have the greatest economies of scale and synergies.

Teams define and deliver the customer proposition, and are accountable for end-to-end customer processes and products. The teams partner with functions and services to develop cost-effective propositions that meet customer needs.

## **Services**

Services provide business-aligned technology, operations and property services across the bank. Operations are centralised to provide cost-efficient and consistently strong customer service, through simple processes and economies of scale. It is also accountable for technology risk, payments, data, change management and the bank's fraud and security functions.

## **Functions**

These teams define functional strategy and the financial plan to support the franchises and other functions. Most functions are a mix of control, expertise and advisory. All common support activities across the organization are included.

**Business model and strategy**

## **Business model and strategy**

### **Product and services**

Our products and services are designed to ensure that we can create sustainable value for both our shareholders and our customers. We believe that keeping our product range simple and accessible is crucial to our success.

## **Business model and strategy**

### Our brands

Our brands are our main connection with customers. Each takes a clear and differentiated position that will help us strengthen our relationships with our customers, stand out in the market, and build the value of our brands.

## Business model and strategy

### Case Study - Flying High

Sarah-Jane Anthony saw her first falconry display aged seven and was hooked. Twenty years later, she decided to follow her dream and start her own business. Now she runs her own award-winning falconry centre in Essex.

“I’ve banked with NatWest all my life and when I needed a business account, Khaled, the local at West Women in Business specialist, was really supportive. Without his help and advice, I don’t think I’d be here today.”

Through our Chartered Banker accreditation programme in association with Everywoman, we’ve trained 400 Women in Business specialists across the bank. Their knowledge makes them ideally placed to help female business owners and budding entrepreneurs with their banking needs.

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## Business model and strategy

### Building a more sustainable bank

Our goal is to be No.1 for customer service, trust and advocacy. We are changing our culture and priorities for the better. We are committed to building a bank that works for all stakeholders.

By delivering the best possible service for customers to meet their needs, we aim to achieve a return for our shareholders. At the same time, we recognise our responsibility towards the society we serve and operate in. It is only by supporting our customers and communities to succeed that we will be able to become a more sustainable bank.

### Our key resources and relationships

RBS provides financial services to individuals and businesses, primarily in the UK and Ireland. We rely on financial, human, intellectual, social, infrastructure and natural capital to do so. We leverage these forms of capital through our expertise, technology and customer focus across our different brands. This helps to improve customer service quality, personalised through our brands. We also seek to create sustainable value for our shareholders and other stakeholders, including customers, employees, and civil society.

### Our business model

Our purpose is to serve our customers well; we earn income by providing lending and deposit services to our customers. We incur operating expenses in providing these services, and accept risk; including credit risk, liquidity risk and currency risk. The operating profit generated by the bank is targeted to compensate shareholders for the cost of these risks. Building a safe and customer-focused bank is central to our ability to create value.

The main source of our income is the interest income earned from loans and advances to our personal, business and commercial customers. We also earn fees from transactions and other services provided to our customers.

We pay interest to customers and other investors who have placed deposits with us and bought our debt securities. The difference between these is our net interest income. We also pay benefits to our customers, through loyalty products such as our Reward Account.

NatWest Markets puts its customers at the centre of the way it does business, making working with the bank easy and rewarding. The bank is organised around providing the right solution to meet its customers' needs. It anticipates emerging issues and provides depth of insight and innovative ideas.



## Business model and strategy

### How we create value for customers and society

Financial	Social and Relationship	Infrastructure	Natural	Human and Intellectual
We make use of shareholder capital and other forms of financial capital, including £353.5 billion in customer deposits (1).	18.9 million customers in the UK and Republic of Ireland. In 2016, we opened 40,860 Foundation Accounts(2), helping customers who may otherwise face difficulties when opening a bank account.	We continue to provide multiple physical channels for serving customers, including access to a network of c.12,500 Post Office and An Post branches(3) and 41 mobile banking vans alongside our existing network of 1,425 branches and 4,646 ATMs.	754 GWh of energy consumed and 9,965 tonnes of paper used in 2016(4).	A capable and caring workforce of 79,099 (permanent headcount). In 2016 we recruited 254 graduates and 283 apprentices.

### How we create value for customers and society

Our activities generate outcomes across all parts of the economy

- Keeping money safe and accessible for our depositors, including preventing 498,000 cases of attempted fraud amounting to £303 million in the UK(5).
- Offering lending, advice and services to individuals. Supporting customers with financial life events, including £33.7 billion of gross new mortgage lending(6) to help our customers buy homes.
- Enabling individuals and businesses to make payments effectively and efficiently, including more than doubling the number of products sold through our mobile channel compared with 2015.
- Providing working capital and lending to help businesses meet their goals, including £30.5 billion(7) in lending to small and medium-sized enterprises across England, Scotland and Wales, and c.£1.0 billion in lending to infrastructure projects.
- Supporting local communities, including £2.5 million(8) of grants made by our Skills & Opportunities Fund to 125 organisations, who support people from disadvantaged communities start-up in business or get into employment.
- Supporting entrepreneurs to start up in business, including 1,736 businesses(9) helped through Entrepreneurial Spark powered by NatWest.
- Investing in our people and partners to develop a skilled workforce, including the delivery of leadership training to almost 16,000 leaders through a comprehensive 'Determined to Lead' programme.
- Payment of £1.32 billion(10) in tax to the UK Government, which supports central government and local authority spending.

Notes:

- (1) Customer deposits excluding repurchase agreements and stock lending.
- (2) Number of new Foundation Accounts opened across NatWest Plc, Royal Bank of Scotland plc and Ulster Bank Ireland DAC.
- (3) Comprises c.11, 500 Post Office branches in the UK and c.1000 An Post branches in the Republic of Ireland.
- (4) For further details refer to page 39.
- (5) Data relates to reported attempted fraud cases and prevented third party losses in the UK (not including policy declines for debit cards).
- (6) Gross new mortgage lending across UK PBB, Ulster Bank RoI and RBSI.
- (7) SME lending balances in over 9,960 postcode sectors across England, Scotland & Wales.
- (8) Data is compiled by Project North East (PNE) and is based on the total spend allocated by each Regional Board.
- (9) Data is compiled by Entrepreneurial Spark. The data includes all businesses which have been part of the programme since launch in 2012.
- (10) Comprises £174 million corporate tax, £660 million irrecoverable VAT, £208 million bank levies and £279 million employer payroll taxes.

## **Our Approach**

### Our Values

Our Values guide our actions every day, in every part of our business. The values are the foundation of how we work at RBS.

## Our Approach

### Case Study - Power to the people

We continue to play a key role in the transition to a low carbon economy by helping our customers to mitigate their emissions, save energy and reduce costs.

We have over 25 years experience in helping our customers to fund renewable energy and energy efficiency measures. According to InfraDeals, RBS has been the leading lender to the UK renewables sector by number of transactions over the past five years (2012-2016). During 2016 RBS took a lead role in financing the Beatrice Offshore Wind Farm, located 13.5km from the Caithness Coast.

This wind farm projected to power approximately 450,000 homes (around three times the number of homes in the Moray and Highland region). It was one of the first eight UK projects to be awarded an Investment Contract under the Contract for Difference feed in tariff. It will contribute £680m in the construction phase to the economy through supply chain opportunities and employment.

It is estimated to have an on-going £400-525 million impact on the economy over the windfarm's 25 year operational life. An integrated approach was delivered by RBS through close collaboration between teams highlighting the breadth, strength and market leadership of the RBS franchise and ensuring a successful outcome for our customer. An integrated approach was delivered by RBS through close collaboration between teams highlighting the breadth, strength and market leadership of the RBS franchise and ensuring a successful outcome for our customer.

### Our Colleagues

Engaging our colleagues is critical to delivering on our strategy and ambition as a bank. Being better for our colleagues means we are better for our customers, and this makes us a better bank.

- Platinum ranking from Opportunity Now (gender)
- Gold ranking for Race for Opportunity (race)
- Time Top 50 Employers for Women
- Top Ten Global Employer in Stonewall's Global Equality Index (LBGT)
- Silver Status from the Business Disability Forum
- Top 10 Employer by Working Families

### Creating a Healthy Culture

Building a healthy culture that embodies Our Values is one of our core priorities. Our Values guide the way we identify the right people to serve our customers well, and how we manage, engage and reward our

colleagues. Our Values are at the heart of both Our Standards, the bank-wide behavioural framework and Our Code, the bankwide Code of Conduct.

Our values are integral to the way we behave and do business and we continue to reinforce them in our systems, our policies and processes, our communications and our training and leadership role modelling.

We monitor our progress against our goals and gather feedback from our colleagues. Through metrics and key performance indicators we are able to assess our progress and respond accordingly. We measure our progress through internal reporting and report on progress quarterly. We participate in external benchmarking exercises and fully support the Banking Standards approach.

Our most recent survey, in which almost 63,000 colleagues took part, showed that we are changing the culture of RBS for the better. We remain above the Global Financial Services Norm for wellbeing, our inclusion scores continue to improve and there is a strong sense that managers act consistently with Our Values. However, the choices we've had to make as we move RBS forward have taken a toll on our colleagues. The scaling down of RBS and the impact of dealing with some difficult legacy issues have contributed to a decline in the improvements in engagement, pride and leadership that we saw in 2015.

We encourage colleagues to tell us what they think via the annual colleague survey and our regular comments boards. When colleagues wish to report concerns relating to wrong doing or misconduct they can raise concerns via Speak Up, the bank's whistleblowing service. In 2016 213 cases were raised compared to 142 in 2015.

## Our Approach

### Performance and Reward

Our approach to performance management provides clarity for our colleagues about how their contribution links to our ambition and all our colleagues have goals set across a balanced scorecard of measures. In 2016 we refreshed our behavioural framework to create one framework for all our colleagues (Our Standards).

We strive to pay the right wage to colleagues and continue to exceed the Living Wage Foundation Benchmarks. We have removed sales incentives for front line colleagues so they can concentrate on great customer service. For 2017, we have simplified how we pay our clerical colleagues, consolidating bonuses, making pay fairer and easier to understand. More information on our remuneration policies can be found on pages 101 to 149 of the Annual Report 2016 on Form 20-F.

### Learning

We continue to embed 'Determined to lead' (DtI), our core leadership programme across the bank. DtI provides consistent tools to lead and engage our colleagues and is transforming the way we operate. In 2016 almost 16,000 leaders participated in the programme.

In October, we launched Service Excellence training, our new customer service programme. The first module introduces our Core Service Behaviours and provides an awareness of the tools and techniques that will help us to deliver the best possible service, every time. Since October over 34,000 colleagues have completed this module.

We work closely with the Chartered Banker Institute (CBI) and Chartered Banker Professional Standards Board (CB:PSB) to professionalise our colleagues. In 2016 we achieved an Excel rating in the CB:PSB Foundation Standard review, one of only two CB:PSB member firms to have secured 'Earned Autonomy'.

We also offer a wide range of learning opportunities which can be mandatory, role specific or related to personal development. Our mandatory learning is focused on keeping our customers, our colleagues and the bank safe.

## Health and Wellbeing

Wellbeing is a fundamental part of creating a great place to work. We offer a wide range of wellbeing initiatives and benefits to help maintain physical and mental health and support our colleagues if they become unwell.

In 2016, we focused on physical, mental health and social wellbeing. More than 50,000 colleagues took part in the Global Corporate Challenge (GCC), helping us to win the GCC World Most Active Organisation Gold Award.

## Our Approach

To support our colleagues through change we continue to promote our Employee Assistance Programme, where we have continued to see a high utilisation rate. We have supported Time to Change (the UK's biggest programme to challenge mental health stigma) since 2014 and launched a number of mindfulness support tools this year.

### Inclusion

Building a more inclusive RBS is essential for our customers and colleagues.

Our inclusion policy applies to all our colleagues globally to make sure everyone feels included and valued, regardless of their background.

As at 31 December 2016, our permanent headcount was 79,099. 48% were male and 52% female.

We continue to work towards our goal of having at least 30% senior women in our top three leadership layers across each business by 2020 and to be fully gender balanced by 2030. We have a positive action approach in place, tailored by business, according to the specific challenges they face.

During 2016, we continued to roll out unconscious bias learning to all our colleagues to create a solid platform for the wider inclusion agenda. Almost 30,000 colleagues participated in unconscious bias training in 2016.

Our disability plan will support us becoming a disability smart organisation by 2018. It addresses areas for improvement including branch access, accessible services, improving colleague adjustment processes and inserting disability checkpoints into our key processes and practices.

We continue to focus on building an ethnically diverse RBS. Our plan focuses on positive action and includes reciprocal mentoring, targeted development workshops and leadership programmes and ensuring we have a Black, Asian and Minority Ethnic (BAME) focus on recruitment, talent identification and promotion.



Our LGBT agenda continues to deliver a better experience for our LGBT colleagues and customers. We have processes in place to support updating gender and title on customers' banking records and to support colleagues undergoing gender transition. And, we continue to support our 16,000-strong colleague networks.

Historically we have reported by grade, which has enabled us to track trend year on year, however as the structure of our business has changed, we have evolved our approach to reflect our organisational (CEO) levels. This method more accurately describes our gender balance at leadership/pipeline levels and is reflective of how work gets done across the bank.

Grade	#Women	#Men	%Women
CEO – 1	3	10	23
CEO – 2	33	73	31
CEO – 3	232	443	34
CEO – 4	1512	1891	44
Target population (CEO – 3 and above)	268	526	34

	Male	Female
Executive Employees	113 (78%)	32 (22%)
Directors of Subsidiaries	481 (84%)	90 (16%)

There were 716 senior managers (in accordance with the definition contained within the relevant Companies Act legislation), which comprises our executive population and individuals who are directors of our subsidiaries. The RBS Board of directors has twelve members, consisting of nine male and three female directors.

## Our Approach

## Our Customers

**RBS remains committed to achieving its target of being the number one bank for customer service, trust and advocacy by 2020.**

We use independent surveys to measure our customers' experience and track our progress against our goal in each of our markets.

### Net Promoter Score (NPS)

Customers are asked how likely they would be to recommend their bank to a friend or colleague, and respond based on a 0-10 scale with 10 indicating 'extremely likely' and 0 indicating 'not at all likely'. Customers scoring 0 to 6 are termed detractors and customers scoring 9 to 10 are termed promoters. NPS is established by subtracting the proportion of detractors from the proportion of promoters.

The table below lists all of the businesses for which we have an NPS for 2016. Year-on-year, NatWest Personal and Commercial Banking have improved, along with Ulster Bank Business and Commercial in Northern Ireland and Ulster Bank Business Direct in the Republic of Ireland. In Great Britain, we have also narrowed the gap to number one in Commercial Banking. We do, however, acknowledge that there is still work to do, with four brands missing their year end targets.

In recent years, RBS has launched a number of initiatives to make it simpler, fairer and easier for customers to do business with the bank.

		Q4 2015	Q3 2016	Q4 2016	Year end 2016 target
Personal Banking	NatWest (England & Wales) (1)	9	11	13	15
	Royal Bank of Scotland (Scotland) (1)	-9	-2	-4	-5
	Ulster Bank (Northern Ireland) (2)	-9	-16	-16	-3
	Ulster Bank (Republic of Ireland) (2)	-14	-8	-7	-10
	NatWest (England & Wales) (3)	9	4	-2	13
	Royal Bank of Scotland (Scotland)	-7	-4	-5	2

Business Banking	(3)				
Business Direct	Ulster Bank (Republic of Ireland) (5)	-21	n/a	-2	-15
Business & Commercial	Ulster Bank (Northern Ireland) (4)	-19	0	0	-4
Commercial Banking (6)		9	21	20	17

## Customer Trust

We also use independent experts to measure our customers' trust in the bank. Each quarter we ask customers to what extent they trust or distrust their bank to do the right thing. The score is a net measure of those customers that trust their bank (a lot or somewhat) minus those that distrust their bank (a lot or somewhat).

Customer trust in NatWest in England & Wales has exceeded its 2016 target, improving from 48% at Q4 2015 to 55% at Q4 2016. Trust in RBS in Scotland has fallen year on year (from 14% in Q4 2015 to 13% in Q4 2016) and has fallen behind its target for 2016. This is primarily due to ongoing reputational and legacy issues that the bank continues to work to resolve.

		Q4 2015	Q3 2016	Q4 2016	Year end 2016 target
	NatWest (England & Wales)	48%	48%	55%	51%
Customer trust (7)	Royal Bank of Scotland (Scotland)	14%	13%	13%	26%

## Notes:

(1) Source: GfK FRS 6 month rolling data. Latest base sizes: NatWest (England & Wales) (3313) Royal Bank of Scotland (Scotland) (527). Based on the question: "How likely is it that you would recommend (brand) to a relative, friend or colleague in the next 12 months for current account banking?"

(2) Source: Coyne Research 12 month rolling data. Latest base sizes: Ulster Bank NI (375) Ulster Bank Rol (322) Question: "Please indicate to what extent you would be likely to recommend (brand) to your friends or family using a scale of 0 to 10 where 0 is not at all likely and 10 is extremely likely".

(3) Source: Charterhouse Research Business Banking Survey (GB), based on interviews with businesses with an annual turnover up to £2 million. Quarterly rolling data. Latest base sizes: NatWest England & Wales (1258), RBS Scotland (422). Weighted by region and turnover to be representative of businesses in England & Wales/Scotland, 4 quarter rolling data.

(4) Source: Charterhouse Research Business Banking Survey (NI), based on interviews with businesses with an annual turnover up to £1 billion. Latest base size: Ulster (399) Weighted by

turnover and industry sector to be representative of businesses in Northern Ireland, 4 quarter rolling data.

(5) Source: PWC ROI Business Banking Tracker 2016 (annual study only). Latest sample size: Ulster Bank (218) In 2017 we will be switching the source of advocacy measurement for Ulster Bank Business in ROI to Red C. Red C is a recognised research agency that will provide more frequent reporting of NPS, as well as additional diagnostic customer feedback to help us improve the customer experience.

(6) Source: Charterhouse Research Business Banking Survey (GB), based on interviews with businesses with annual turnover between £2 million and £1 billion. Latest base size: RBSG Great Britain (935). Weighted by region and turnover to be representative of businesses in Great Britain, 4 quarter rolling data.

(7) Source: Populus. Latest quarter's data. Measured as a net of those that trust RBS/NatWest to do the right thing, less those that do not. Latest base sizes: NatWest, England & Wales (871), RBS Scotland (226).

## **Our operating environment**

### Key influences in our operating environment

Our ability to serve customers and create value for the long term is heavily influenced by the environment in which we operate. We have assessed the importance of these influences both in terms of their relevance to our stakeholders (including customers, investors, UK government, employees and civil society) and their potential commercial impact on us. We have categorised them accordingly, shown in the diagram below. This provides additional context for our performance and future strategy. Each influence is briefly described on the following pages, with links provided to the relevant parts of the Strategic Report for more detail.



## **Our operating environment**

Influences explained and where to find out more.





**Our operating enviroment**





## **Our operating environment**

### **Our direct environmental footprint**

RBS is committed to reducing the environmental impact of serving our customers. We outperformed our 2020 targets of 20% carbon, 5% water and 50% paper reduction during 2016 and we will increase our ambition in these areas during 2017. Our decrease in total carbon emissions is largely attributable to a 15% per full time equivalents reduction in energy consumption since 2014. We are containing growth in Data Centre energy consumption through legacy IT decommissions and energy reduction initiatives. The rationalisation of property space and investment in building management systems in 384 branches and 17 offices are examples of a number of projects delivering energy reductions. We buy renewable electricity in the UK, reflected in our market-based CO<sub>2</sub>e emissions figure. Scope 3 business travel emissions are being driven down by a reduction in long haul flights, a focus on associated cost and improved virtual collaboration tools.

In 2016 we diverted 96% of waste from landfill in the UK, 70% globally. An increase in waste volume compared with 2015 is partly attributed to the destruction of outdated paper records which are recycled along with all paper waste. Removing paper hand towels from 800 branches and 22 offices has helped keep waste volume down. Sending food waste to anaerobic digestion and coffee waste for bio-fuel improves our recycling rate. Paper usage is linked to use of digital channels with approximately 55% of personal and business banking customers receiving online statements and a reduction in internal print of 20% in 2016.

We collaborate with colleagues and suppliers to improve performance in all areas. Our Innovation Gateway crowdsourcing community is a partnership with corporates and universities, now sourcing new solutions from 1,300 SMEs. We've tested 34 of these new products in our facilities since 2014 with notable success in reducing water usage. We engage colleagues via bank wide 'Determined to Make a Difference' campaigns. In 2016, 1,200 colleagues logged over 2500 activities to reduce our environmental impact, via our green reward app JUMP.

### **Carbon emissions disclosure**

Notes:

\*Scope 1: Emissions from fluorinated gas loss and fuel combustion in RBS premises/vehicles. \*\*Scope 2: Emissions from electricity, district heating and district cooling used in RBS premises. \*\*\*Scope 3: Emissions associated with business travel (air, rail and road) by RBS employees. \*\*\*\* Scope 3 emissions have been restated and rebaselined to include Taxis in India.

\*\*\*\*\* market-based emissions have been calculated using the GHG Protocol guidelines. RBS has purchased renewable electricity that meets the Good Quality Criteria since March 2016. Paper and business travel targets have a baseline year of 2011.

## **Our operating environment**

### **Our approach to human rights and modern slavery**

RBS takes a proactive approach to upholding our commitment to respect human rights. This includes regular review of our policies and procedures. Our approach is centred on identifying and mitigating potential human rights risks across our business and our sphere of influence.

A main focus during 2016 has been to meet our new obligations under the Modern Slavery Act 2015 (MSA), which aims to protect victims, bring perpetrators to justice and provide more effective tools for law enforcement. We welcome the MSA and its aim to eradicate forced labour and human trafficking.

In accordance with the requirements of the MSA, our first annual statement will be published and available on our website in Spring 2017. Ahead of this we published an interim statement in December 2016 setting out our approach and seeking the input of external stakeholders.

We are taking a human rights approach to understand the impacts of our operations and supply chain. We are also working to ensure our employees, suppliers and customers are aware of the risks and are able to address any issues when they arise.

These steps include: reviewing and updating our policy commitments; raising awareness among employees; targeted training to relevant employees, such as supply chain managers and relationship managers; incorporating requirements under the MSA into our supplier sourcing process; and embedding MSA commitments within our Environment, Social and Ethical (ESE) Risk Policy and processes. Modern slavery, forced labour and harmful child labour are prohibited within our reputational and ESE risk framework, and our Sustainable Procurement Code.

RBS's international human rights' commitments are set out in our Human Rights Position Statement. Our approach is underpinned by our values and standards. For employees this is via the RBS Code of Conduct – 'Our Code' which was updated in 2016. Our Code includes a clear commitment to respect human rights, and the Yes Check, a tool to guide good decision-making. Employees are consulted on key aspects of their working environment, and they can utilise a confidential helpline to discuss any matters of concern. We are an accredited Living Wage employer, and the process of extending the Living Wage to our suppliers continued through 2016.

For suppliers, our Sustainable Procurement Code sets out the international human rights commitments we expect of the companies that we work with, including labour standards and non-discrimination.

Our ESE Risk Policy applies to our customers, and is kept under review. Alongside our sector specific risk appetite positions we have outlined ESE risk concerns for customers operating outside of these sectors. Our policy identifies human rights risks and due diligence is carried out on clients when human rights risks are identified. We expect our customers to share our commitment to respecting human rights within their operations.

Our commitment to the international progress of human rights includes being a signatory of the United Nations Global Compact since 2003, and we reaffirm our commitment to the ten principles of the Global Compact. We are committed to the implementation of the UN Guiding Principles on Business and Human Rights and participate with our peers in initiatives such as the Thun Group and United Nations Environment Programme Finance Initiative, to understand how these can best be applied. We have adopted the Equator Principles, since their inception in 2003, to manage social and environmental risks, including human rights, in project-related transactions.

## Our operating environment

### Independent assurance

The Royal Bank of Scotland Group plc appointed Ernst & Young LLP to provide limited independent assurance over selected sustainability content within the Strategic Report (“the Report”), as at and for the period ended 31 December 2016. The assurance engagement was planned and performed in accordance with the International Standard for Assurance Engagements (ISAE) 3000 Revised, Assurance Engagements Other Than Audits or Reviews of Historical Financial Information.

These procedures were designed to conclude on:

The consistency of selected narrative claims on sustainability with underlying performance information, and;

The accuracy and completeness of the sustainability performance indicators listed below:

- Value (£) of attempted fraud prevented in UK;
- Number of cases raised via Speak Up, the bank’s whistleblowing service;
- Total gender balance in top 3 senior layers;
- Customer Trust score;
- % personal customers who are digitally active;
- Total scope 1 and 2 location based CO2e emissions and Scope 3 emissions from business travel;
- Number of Foundation accounts opened; and
- Lending to small and medium sized enterprises (SMEs) across England, Scotland and Wales.

An unqualified opinion was issued and is available on rbs.com, along with further details of the scope, respective responsibilities, work performed, limitations and conclusions.



## Our operating environment

### Key economic indicators

The UK economy grew by 2.1% in 2016, down from 2.2% in 2015 and close to its long-run average.

In a healthy job market, the number of people in work increased by 350,000 and unemployment fell below 5% for the first time since 2005. With inflation of 1.6%, wage growth of 2.8% provided a modest boost to consumers' spending power. Business profitability remained strong and business investment fell by around 2%. House price inflation moderated, but at 5% remained high.

### Summary

The main development in 2016 was the fall in the value of sterling, which finished the year down 15%, 10% of that happening after the EU referendum. That quickly fed through to higher import costs, with producers' input prices rising by 16%, squeezing firms' margins. The Bank of England expects consumer price inflation to reach around 2.75% in 2017 and 2018, above the target set by Parliament. However, the Bank of England has not raised interest rates to moderate inflation. Rather, in August it cut Bank Rate to 0.25%. That reflected its concern that leaving the European Union would lead growth to slow and inflation to undershoot the target. In addition, the Bank of England tends to disregard inflation caused by a currency change unless it feeds through to wages.

The Republic of Ireland continued to grow at around 4%, with domestic demand contributing more, and exports less to growth than in recent years. Unemployment continued to fall, ending the year at 7.2%. House price inflation accelerated to 9% from 4.6% in 2015.

Eurozone area growth slowed slightly to 1.7% from 1.8%. Unemployment remained close to 10%. With inflation still close to zero, the European Central Bank reduced interest rates and expanded its quantitative easing programme.

Reflecting continued modest growth 1.6%, rising employment two million, and falling unemployment 4.7%, the US Federal Reserve raised the target range for its main interest rate by 0.25% to 0.5-0.75% in December.

While the year opened with considerable market volatility, which reflected concerns about the outlook for China, growth there was 6.7%, reflecting actions by the authorities to boost activity. That had beneficial

spillover effects among some of China's trading partners.

Despite continued growth and low unemployment in the UK, markets continue to expect interest rates to remain low. At the year's end, the first rise in Bank Rate was expected around mid-2019. While that partly reflects the Bank of England's response to the EU referendum result, more important are structural factors; slower global growth, higher levels of desired saving and lower levels of desired investment, which have been pushing down real interest rates for some time and which are likely to persist.

**Our operating enviroment**

## **Our operating environment**

### **Risk overview**

Effective risk management plays a central role in the successful development and execution of our strategy. Our Risk appetite is set in line with the overall strategy and approved by the board while the risk management framework identifies and manages current and emerging risks that could materially affect the delivery of the RBS strategy.

### **Progress in 2016**

RBS has continued to make progress against its strategic objectives of reducing risk and strengthening both the balance sheet and the capital position. Against a backdrop of uncertainty in the wider political and economic environment, risk management played a key role in positioning RBS to prepare for, and respond to developments.

In particular, there has been a focus on enhancing our risk appetite framework and communicating and embedding it across the bank. For each of our material risks, significant emphasis has been placed on reviewing current measures along with associated limits and triggers and also the way our risk profile compared to risk appetite is reported across RBS. Risk culture has continued to be at the forefront of our work as RBS moves towards the achievement of its strategic objectives. To that end, the ambition is to make risk management simply part of the way colleagues across RBS work and think. In support of this, during 2016 the RBS-wide action plan focused on assessment, identifying and taking actions to build clarity, develop capability and motivate staff.

Similarly, activity has been underway to enhance our operational risk management framework to help ensure our businesses maintain a safe and secure environment for our customers. As part of this, during 2016 there was a focus on risk and control assessment, particularly relating to our most material products, processes and services. In addition, there continued to be an emphasis on understanding and managing the risks relating to RBS's transformation agenda.

In market risk, sustained effort has been necessary to anticipate and respond to major developments in the wider environment. Managing this has required close collaboration between our first and second lines of defence but, in turn, has demonstrated RBS's continued commitment to its wholesale banking proposition.

RWAs continued to decline (6%), ending the year at £228 billion (from £243 billion in 2015). The decline was driven by continued run down in Capital Resolution, where RWAs fell by £14.5 billion during the year, offset in part by an increase in RWAs in the core franchises.

The Common Equity Tier 1 (CET1) ratio decreased by 210 basis points to 13.4% in 2016, reflecting lower CET1 capital partially offset by a reduction in RWAs. Litigation and conduct charges of £5.9 billion in 2016 contributed to a significant reduction in the CET1 capital. Management actions to normalise the ownership structure and improve the long-term resilience of RBS also contributed to the reduction. These actions included the final Dividend Access Share payment of £1.2 billion and the impact of the accelerated pension payment of £4.2 billion. Tier 1 capital benefitted from the successful issuance of £2 billion of Additional Tier 1 (AT1) capital notes.

The leverage ratio fell by 50bps to 5.1% during 2016. This reflected the fall in the CET1 position, partly offset by the successful issuance of an additional £2 billion equivalent of AT1 instruments as planned at the beginning of the year. The Bank of England leverage ratio benefitted from an additional 50bps uplift following the FPC's guidance on 4 August that allowed banks, under certain conditions, to exclude central bank reserves from the leverage exposure measure. RBS also issued £4.2 billion of MREL-eligible senior debt as part of the issuance plan to meet its steady-state bail-in requirements by 2022.

In the Bank of England 2016 stress test, RBS did not meet its common equity Tier 1 (CET1) capital or Tier 1 leverage hurdle rates before additional Tier 1 (AT1) conversion under the hypothetical adverse scenario. After AT1 conversion, it did not meet its CET1 systemic reference point or Tier 1 leverage ratio hurdle rate. Based on RBS's own assessment of its resilience identified during the stress-testing process, RBS has already updated its capital plan to incorporate further capital strengthening actions and this revised plan has been accepted by the PRA Board. The PRA will continue to monitor RBS's progress against its revised capital plan.

## **Our operating environment**

RBS maintained a robust liquidity and funding risk profile in 2016. Its loan-to-deposit-ratio was 91% at 31 December 2016, compared with 89% in 2015. The latest Internal Liquidity Adequacy Assessment Process (ILAAP) showed that RBS is in a strong position to withstand liquidity stress scenarios. It suggested that RBS's liquidity portfolio was large enough to cover more than 139% of the expected outflows in the worst of three severe scenarios.

Litigation and conduct costs of £5,868 million included a £3,107 million provision in relation to various investigations and litigation matters relating to RBS's issuance and underwriting of residential mortgage-backed securities (RMBS), an additional charge in respect of the settlement with the National Credit Union Administration Board to resolve two outstanding RMBS lawsuits, a provision in respect of the UK 2008 rights issue shareholder litigation, additional PPI provisions, a provision in respect of the FCA review of RBS's treatment of SMEs and a charge in Ulster Bank RoI in respect of an industry-wide examination of tracker mortgages.

## **Top and emerging risks**

RBS employs a continuous process for identifying and managing its top and emerging risks. These are defined as scenarios that could have a significant negative impact on RBS's ability to operate or meet its strategic objectives. A number of scenarios attracted particular attention in 2016.

### **Macro-economic and political risks:**

RBS remains vulnerable to changes and uncertainty in the external economic and political environment, which have intensified in the past year. To mitigate these risks, RBS has taken actions in 2016 with its capital, liquidity and leverage positions. A number of higher-risk portfolios have been exited or reduced. Stress testing and scenario planning is used extensively to inform strategic planning and risk mitigation relating to a range of macro-economic and political risks. Scenarios identified as having a potentially material negative impact on RBS include: the impact of the UK's exit from the EU; a second Scottish independence referendum; a UK recession including significant falls in house prices; global financial market volatility linked to advanced economy interest rate increases or decreases; a protracted period of low interest rates in the UK; vulnerabilities in emerging market economies resulting in contagion in RBS's core markets; a eurozone crisis; and major geopolitical instability.

### **Risks related to the competitive environment:**

RBS's target markets are highly competitive, which poses challenges in terms of achieving some strategic objectives. Moreover, changes in technology, customer behaviour and business models in these markets have accelerated. RBS monitors the competitive environment and associated technological and customer developments as part of its strategy development and makes adjustments as appropriate.

### **An increase in obligations to support pension schemes:**

If economic growth stagnates and interest rates continue to remain low, the value of pension scheme assets may not be adequate to fund pension scheme liabilities. The actuarial deficit in RBS pension schemes – as determined by the most recent triennial valuations – has increased, requiring RBS to increase its current and future cash contributions to the schemes. An acceleration of certain previously-committed pension contributions was made in Q1 2016 to reduce this risk. Depending on the economic and monetary conditions and longevity of scheme members prevailing at that time, the actuarial deficit may increase at subsequent valuations and is expected to be affected by ring-fencing.

### **Regulatory and legal risks**

**The impacts of past business conduct:** Future litigation and conduct charges could be substantial. RBS is involved

in a number of investigations, including: ongoing class action litigation, securitisation and mortgage-backed securities related litigation, investigations into foreign exchange trading and rate-setting activities, continuing LIBOR-related litigation and investigations, investigations into the treatment of small and medium-sized business customers in financial difficulty, anti-money laundering, sanctions, mis-selling (including mis-selling of payment protection insurance products). Settlements may result in additional financial penalties, non-monetary penalties or other consequences, which may be material.

More detail on these issues can be found in the Litigation, Investigations and Reviews and Risk Factors sections of the 2016 Annual Report on Form 20-F. To prevent future conduct from resulting in similar impacts, RBS continues to embed a strong and comprehensive risk and compliance culture.

## **Our operating environment**

### **Risks to income, costs and business models arising from regulatory requirements:**

RBS is exposed to the risk of further increases in regulatory capital requirements as well as risks related to new regulations that could affect its business models, such as Open Banking. RBS considers and incorporates the implications of proposed or potential regulatory activities in its strategic and financial plans.

### **Operational and execution risks increased losses arising from a failure to execute major projects successfully:**

The successful execution of major projects, including the transformation plan, the restructuring of NatWest Markets, meeting the final European Commission State Aid requirements relating to Williams & Glyn compliance with structural reform requirements including the statutory ring-fencing requirements implemented as a result of the Independent Commission on Banking; delivering a robust control environment and the embedding of a strong and pervasive, customer centred organisational and risk culture, are essential to meet RBS's strategic objectives. These projects cover organisational structure, business strategy, information technology systems, operational processes and product offerings. RBS is working to implement change in line with its project plans while assessing the risks to implementation and is taking steps to mitigate those risks where possible.

### **Impact of cyber attacks:**

Cyber attacks are increasing in frequency and severity across the industry. RBS has participated in industry-wide cyber attack simulations in order to help test and develop defence planning. To mitigate the risks, a large scale programme to continue to improve controls, enhance protections and educate staff on the threat is underway.

### **Inability to recruit or retain suitable staff:**

There is a risk that RBS lacks sufficient capability or capacity at a senior level to deliver – or to adapt to – change.

RBS monitors people risk closely and has plans in place to support retention of key roles, with wider programmes supporting engagement and training for all staff.

### **Failure of information technology systems:**

RBS's information technology systems may be subject to failure. As such systems are complex, recovering from failure is challenging. To mitigate these risks, a major investment programme has significantly improved the resilience of the systems and further progress is expected. Back-up system sustainability has improved, and a 'mirror bank' system, to provide basic services, if needed, has been created.



Full risk factors are discussed on pages 509 to 578 of the 2016 Annual Report on Form 20-F

### **Case Study - Making sense of money**

MoneySense is our flagship financial education programme for young people aged between 5 and 18. It aims to help young people towards a better financial future. Since we started providing financial education in schools over 22 years ago, we've helped an estimated 4.5 million young people understand all about money. By the end of 2018, we'll have helped a further one million young people.

Our programme is used to deliver lessons in primary and secondary schools in the UK and Ireland, thanks to the support of registered teachers and our dedicated volunteer network of over 2,800 employees.

We're proud of the work MoneySense does in our communities. By helping young people understand things like budgeting, saving and online security we're supporting them to become financially independent and confident money managers.

## **Business review**

RBS is structured around becoming number one for service, trust and advocacy as we meet the ambitions and needs of our retail, business, commercial and corporate customers. Organised under three customer-facing franchises, our core businesses are centred around the UK and Ireland markets with a focused international capability.

## **Personal & Business Banking**

Personal & Business Banking (includes reportable segments UK PBB and Ulster Bank RoI); contribution to income of 47%

## Les Matheson

CEO, Personal & Business Banking

## Personal & Business Banking

Personal & Business Banking (PBB) serves individual and mass affluent customers together with small businesses (generally up to £2 million turnover). Our principal brands are NatWest in England and Wales, Royal Bank of Scotland in Scotland, and Ulster Bank RoI in the Republic of Ireland. The operations of Ulster Bank in Northern Ireland have been combined with the main UK businesses.

## Performance overview

PBB recorded an operating profit of £1,401 million in 2016 compared with £1,292 million in 2015 (UK PBB £1,381 million compared with £1,030 million in 2015; Ulster Bank RoI £20 million compared with £262 million in 2015).

Adjusted operating profit which excluded own credit adjustments, restructuring costs and litigation and conduct costs of £2,431 million was in line with 2015 (UK PBB operating profit excluding restructuring costs of £187 million (2015 - £167 million) and litigation and conduct costs of £634 million (2015 - £972 million) was £2,202 million (2015 - £2,169 million; Ulster Bank RoI operating profit excluding own credit adjustments of £3 million (2015 – nil), restructuring costs £40 million (2015 - £15 million) and litigation and conduct costs £172 million (2015 - £13 million credit) was £229 million (2015 - £264 million), as a reduction in net impairment releases was offset by higher income associated with volume growth.

Total income increased by £116 million, or 2%, to £5,866 million compared with 2015 (UK PBB increased by £90 million, or 2%, to £5,290 million compared with 2015 and Ulster Bank RoI increased by £26 million, or 5%, to £576 million compared with 2015) as the benefit of asset volume growth has more than offset margin compression. Net interest margin declined by 13 basis points to 2.80% (UK PBB declined 17 basis points to 3.01% and Ulster Bank RoI increased by 5 basis points to 1.62%) reflecting the impact of the overall portfolio mix being increasingly weighted towards secured lending and mortgage customers switching from standard variable rate (SVR) to lower rate products.

Net loans and advances of £151.0 billion were £14.5 billion, or 11%, higher than in 2015 (UK PBB net loans and advances of £132.1 billion were £12.3 billion, or 10%, higher; Ulster Bank RoI net loans and advances of £18.9 billion were £2.2 billion or 13% higher), principally reflecting mortgage growth.

## Business review

Operating expenses were £4,495 million (UK PBB £3,826 million (2015 - £4,177 million); Ulster Bank RoI £669 million; (2015 - £429 million)). Adjusted operating expenses, which exclude restructuring and litigation and conduct costs, were £3,462 million (UK PBB adjusted operating expenses, which exclude restructuring costs of £187 million (2015 - £167 million) and litigation and conduct costs of £634 million (2015 - £972 million) were £3,005 million (2015 - £3,038 million; Ulster Bank RoI adjusted operating expenses, which exclude restructuring costs £40 million (2015 - £15 million) and litigation and conduct costs £172 million (2015 - £13 million credit) were £457 million (2015 - £427 million), in line with 2015.

Credit conditions remained benign, with a net impairment release of £30 million in 2016 compared with £148 million in 2015. (UK PBB net impairment losses were £83 million compared with £7 million releases in 2015; Ulster Bank ROI net impairment releases were £113 million compared with £141 million in 2015).

### Case Study - Upwardly mobile

Whether it's logging in with your fingerprint, paying your contacts through your phone, cancelling a direct debit or amending standing orders, we've been working hard to make our apps even more convenient for customers, by making them easier to use and giving them increased functionality. In fact, over a third of all personal product sales are now completed digitally.

We're investing in our apps because increasing numbers of our customers want to be able to do their banking on the move. 4.2 million customers in the UK now use our apps.

## Performance highlights

	2016			2015		
	UK PBB	Ulster Bank RoI	PBB	UK PBB	Ulster Bank RoI	PBB
Return on equity (%)	16.2	0.7	11.6	11.7	10.6	11.4
Net interest margin (%)	3.01	1.62	2.80	3.18	1.57	2.93
Cost:income ratio (%)	72	116	77	80	78	80
Operating profit (£m)	1,381	20	1,401	1,030	262	1,292
Operating expenses (£m)	(3,826)	(669)	(4,495)	(4,177)	(429)	(4,606)
Restructuring costs (£m)	(187)	(40)	(227)	(167)	(15)	(182)
Litigation and conduct costs (£m)	(634)	(172)	(806)	(972)	13	(959)

Operating profit excluding own credit adjustments, restructuring and litigation and conduct costs (£m)	2,202	229	2,431	2,169	264	2,433
Operating expenses excluding restructuring and litigation and conduct costs (£m)	(3,005)	(457)	(3,462)	(3,038)	(427)	(3,465)
Net loans and advances to customers (£bn)	132.1	18.9	151.0	119.8	16.7	136.5
Customer deposits (£bn)	145.8	16.1	161.9	137.8	13.1	150.9
Loan:deposit ratio (%)	91	117	93	87	127	90
Risk-weighted assets (£bn)	32.7	18.1	50.8	33.3	19.4	52.7

### Building a better bank that serves customers well

PBB continue to make the bank simpler and fairer for customers by simplifying processes, professional standards training and removing sales based incentives for frontline staff.

## Business review

We continued to make better use of our digital channels to make it simpler to serve our customers and easier for them to do business with us. We now have 4.2 million customers in the UK regularly using our mobile app, 19% higher than the end of 2015, and around 60% of our personal customers used a digital channel within the last 90 days. In 2016, we more than doubled the number of customers who purchased a product through our mobile channel compared with 2015. NatWest customers can now apply for personal loans, credit cards and overdrafts via the mobile app, facilitating approximately 8% of total applications. Advocacy amongst our active mobile customers increased significantly over 2016 with NatWest mobile NPS at an all time high of +52.

Our new business banking 'Online Account Opening' service now allows start up business customers to submit an application online in just ten minutes and get a sort code and account number in under an hour. RBS was awarded a Moneyfacts 5 star rating for Business Banking accounts.

In addition to our digital channels, PBB continues to provide multiple physical channels for serving customers, including access to a network of c.11,500 Post Office branches in the UK, c.1,000 An Post branches in the Republic of Ireland, and 41 mobile banking vans alongside our existing network of 1,425 branches and 4,646 ATMs.

PBB continues to help people manage their money better through; MoneySense, First Saver accounts, offering impartial advice, text alerts to customers and in-house Citizens Advice Bureau advisors to help distressed customers.

RBS enhanced its support for social enterprises in 2016. In May, RBS launched a new SE100 Social Business Club with communications agency Matter & Co. The partnership offers a package of business support plus a special programme of regional events. In addition, RBS also increased its support to social enterprises through its lending charity Social & Community Capital.

Following the launch of the Foundation account, an improved version of our Basic bank account, we opened a further 40,860 Foundation accounts in 2016, helping customers who would generally be declined a bank account.

Our customers, the bank and our entire industry faced a bigger threat from fraud, scams and cyber attacks in 2016. In response, we trained our staff to spot phishing e-mails and we ran security awareness seminars and events for around 12,800 customers, staff and industry partners.

### **Case Study - Committed to service**

In 2015, Chief Executive, Ross McEwan, signed the Armed Forces Covenant, pledging that no customers or colleagues would be disadvantaged because of their involvement with the military.

Our Holt's Military Banking colleagues have specialist knowledge of the armed forces, which helps them to better understand, and serve, our armed forces customers. Many bank colleagues are also associated with the armed forces – whether they are reservists, veterans or family members – and need support too.

This year, the bank's support of these customers and colleagues was rewarded, when we were awarded the Gold Award by the Ministry of Defence Employer Recognition scheme.

Defence Secretary Michael Fallon said: "This commitment is making a real difference to everyone who serves and their families – whether giving Reservists more time to train or supporting veterans".

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**Business review**

**Commercial & Private Banking (CPB)**

**Commercial & Private Banking (includes reportable segments Commercial Banking, Private Banking and RBSI) contribution to income of 35%**

## **Alison Rose**

CEO, Commercial & Private Banking

### **Commercial & Private Banking**

Commercial & Private Banking (CPB) serves commercial and corporate customers, operating principally through the NatWest, Royal Bank of Scotland and Lombard brands, and high net worth individuals, through Coutts and Adam & Company. RBS International (RBSI) continues to focus on supporting retail, commercial, corporate and financial institution customers in Jersey, Guernsey, Isle of Man, Gibraltar and Luxembourg. CPB aims to support the UK and Western European economies through its provision of credit and banking services to help businesses grow.

### **Performance overview**

Commercial & Private Banking (CPB) serves commercial and corporate customers, operating principally through the NatWest,

Royal Bank of Scotland and Lombard brands, and high net worth individuals, through Coutts and Adam & Company. RBS International (RBSI) continues to focus on supporting retail, commercial, corporate and financial institution customers in Jersey, Guernsey, Isle of Man, Gibraltar and Luxembourg. CPB aims to support the UK and Western European economies through its provision of credit and banking services to help businesses grow.

CPB recorded an operating profit of £1,043 million compared with £1,001 million in 2015 (Operating profit for Commercial Banking was £742 million (2015 - £1,264million); Private Banking, £111 million (2015 - £470 million loss) and RBSI, £190 million (2015 - £207 million). Adjusted operating profit which excludes restructuring costs, litigation and conduct costs and write down of goodwill was £1,617 million, £91 million lower than 2015 (Commercial Banking adjusted operating profit which excludes restructuring costs of £108 million (2015 - £69 million) and litigation and conduct costs of £423 million (2015 - £51 million) was £1,273 million compared with £1,384 million in 2015; Private Banking adjusted operating profit which excludes restructuring costs of £37 million (2015 - £73 million), litigation and conduct costs of £1 million (2015 - £12 million) and in 2015 write down of goodwill of £498 million, was £149 million compared with £113 million in 2015; RBSI adjusted operating profit which excludes restructuring costs of £5 million (2015 - £4 million) was £195 million compared with £211 million in 2015), largely reflecting an increase in net impairment losses.

Total income of £4,446 million was 1% higher than 2015. (Commercial Banking was £3,415 million, 5% higher than 2015 including the impact of business transfers(1) ; Private Banking was £657 million, 2% higher than 2015; and RBSI was £374 million, 2% higher than 2015.) Good growth was achieved in lending to UK businesses, with net loans and advances increasing by £11.3 billion, or 10%, to £121.1 billion, (Commercial Banking net loans and advances increased by £8.8 billion, or 10% to £100.1 billion; Private Banking net loans and advances increased by £1.0 billion, or 9%, to £12.2 billion; and RBSI net loans and advances increased by £1.5 billion, or 21%, to £8.8 billion), driven by increased borrowing across a number of sectors.

## Business review

Operating expenses remained stable at £3,190 million (Commercial Banking £2,467 million (2015 - £1,921 million); Private Banking £549 million (2015 - £1,101 million); RBSI £174 million (2015 - £160 million)). Adjusted operating expenses, which exclude restructuring costs, litigation and conduct costs and write down of goodwill and including the impact of business transfers(1) , increased by 6% to £2,616 million (Commercial Banking adjusted operating expenses, which exclude restructuring costs of £108 million (2015 - £69 million) and litigation and conduct costs of £423 million (2015 - £51 million and including the impact of business transfers £109 million (2015 - £25 million) was £1,936 million compared with £1,801 million in 2015; Private Banking adjusted operating expenses, which exclude restructuring costs of £37 million (2015 - £73 million), litigation and conduct costs of £1 million (2015 - £12 million) and in 2015 write down of goodwill of £498 million, was £511 million compared with £518 million in 2015; RBSI adjusted operating expenses, which exclude restructuring costs of £5 million (2015 - £4 million) was £169 million compared with £156 million in 2015), reflecting an intangible asset write down and increased investment spend.

Impairment losses of £213 million increased £131 million compared with 2015 (Commercial Banking impairment losses of £206 million increased by £137 million compared with 2015; Private Banking impairment releases were £3 million compared with impairment losses of £13 million in 2015; and RBSI impairment losses were £10 million (2015 – nil), largely reflecting a single name charge taken in respect of the oil and gas portfolio.

### Note:

(1) The business transfers included impact of: total income of £218 million (2015 - £79 million); operating expenses of £109 million (2015 - £25 million) and impairment losses of £50 million (2015 - £1 million releases; 2014 - nil).

### Case Study - The shipping news

The Port of Dover is Europe's busiest ferry port. It's a vital international gateway for the movement of passengers and trade, handling up to £119 billion of UK trade each year.

The Dover Western Docks Revival is the port's biggest ever single investment. RBS acted as financial advisor in raising a £200 million package of funding and provided a £35 million revolving credit facility.

This funding will support improvements to the port, transform Dover's waterfront and create up to 600 new jobs.



**Business review****Performance highlights**

	2016				2015			
	Commercial Banking	Private Banking	RBSI	CPB	Commercial Banking	Private Banking	RBSI	CPB
Return on equity (%)	4.1	5.6	13.8	5.2	9.8	(27.7)	18.5	5.8
Net interest margin (%)	1.76	2.66	1.36	1.80	1.88	2.75	1.48	1.92
Cost:income ratio (%)	72	84	47	72	59	171	44	75
Net loans and advances to customers (£bn)	100.1	12.2	8.8	121.1	91.3	11.2	7.3	109.8
Customer deposits (£bn)	97.9	26.6	25.2	149.7	88.9	23.1	21.3	133.3
Loan:deposit ratio (%)	102	46	35	81	103	48	35	82
Risk-weighted assets (£bn)	78.5	8.6	9.5	96.6	72.3	8.7	8.3	89.3
Operating profit (£m)	742	111	190	1,043	1,264	(470)	207	1,001
Operating expenses (£m)	(2,467)	(549)	(174)	(3,190)	(1,921)	(1,101)	(160)	(3,182)
Restructuring costs (£m)	(108)	(37)	(5)	(150)	(69)	(73)	(4)	(146)
Litigation and conduct costs (£m)	(423)	(1)	-	(424)	(51)	(12)	-	(63)
Write down of goodwill (£m)	-	-	-	-	-	(498)	-	(498)
Operating profit excluding restructuring, litigation and conduct costs	1,273	149	195	1,617	1,384	113	211	1,708

and write  
down of  
goodwill (£m)

Operating expenses excluding restructuring, litigation and conduct costs and write down of goodwill (£m)	(1,936)	(511)	(169)	(2,616)	(1,801)	(518)	(156)	(2,475)
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## Business review

### Building a better bank that serves customers well

Commercial Banking reported the largest (and only significant) year on year improvement in NPS amongst major UK banks.

Nearly 80% of our commercial customers' interaction with us is via digital channels, with around 270,000 payments processed every day.

Coutts won the best private bank in the UK for the fifth year running, best private bank for philanthropy services and best initiative of the year in client facing technology at the Global Private Banking Awards, and was highly commended for innovation for its 'Coutts Concierge Online'.

Our customers continue to benefit from the synergies between Commercial and Private Banking, with 1,100 referrals between Commercial and Private Banking in 2016.

RBS continues to support UK business growth through the launch of 6 new business accelerator hubs in 2016, bringing the total to 12. In addition, NatWest launched a £1 billion lending fund to support small businesses.

#### Case Study - Bright sparks

Several million homes will be more energy efficient thanks to advice from bank experts on the biggest UK smart metering finance deal to date.

Our Structured Finance team helped Calvin Capital fund its £1 billion 'Project Spark', which will support the installation of smart meters in seven million homes up and down the country.

The project is the largest of its kind in the UK, and represents a major step towards a government target to replace traditional meters in all homes by 2020.





## **Business review**

### **NatWest Markets**

NatWest Markets - Share of non-statutory operating profit, (13%)

## **Chris Marks**

CEO, NatWest Markets

## **NatWest Markets**

NatWest Markets provides financing and risk management solutions and is built around three product lines: Rates, Currencies and Financing. NatWest Markets puts its customers at the centre of the way it does business.

## **Performance overview**

NatWest Markets reported an operating loss of £386 million compared with an operating loss of £837 million in 2015 and included litigation and conduct costs of £528 million. Adjusted operating profit which excludes own credit adjustments of £53 million (2015 - £120 million), restructuring costs of £112 million (2015 - £524 million) and litigation and conduct costs of £528 million (2015 - £378 million), was £201 million compared with a loss of £55 million in 2015. The increase was driven by lower operating expenses, excluding restructuring costs and litigation and conduct costs, and increased income.

Total income increased by £47 million to £1,574 million compared with 2015. Income excluding own credit adjustments of £53 million (2015 - £120 million) increased by £114 million, or 8%, to £1,521 million and included the impact of transfers of £98 million in 2015. The increase was driven by Rates and Currencies, reflecting sustained customer activity throughout the year and favourable market conditions following the EU referendum and subsequent central bank actions.

Operating expenses decreased from £2,369 million to £1,960 million in 2016, driven by lower restructuring costs and lower operating expenses, excluding restructuring costs and litigation and conduct costs. Adjusted operating expenses, which exclude restructuring costs of £112 million (2015 - £524 million) and litigation and conduct costs of £528 million (2015 - £378 million), reduced by £147 million, or 10%, reflecting c.£250 million of cost reductions partially offset by higher investment spend and also included the impact of business transfers of £31 million in 2015.

## Case Study - Simple solutions

After buying mobile phone operator EE, telecoms group BT wanted to convert the bank loan it used for the acquisition into a longer-dated format.

We acted as a lead bond arranger as well as a cross- currency swap market hedge coordinator, and billing and delivery bank on the five-year bond. By focusing on excellent customer service and through our integrated one-team approach, we were able to find the best solution and to make the process as simple as possible.

This helped BT to return to the European bond market for the first time in nearly two years.

## Business review

<b>Performance highlights</b>	<b>2016</b>	<b>2015</b>
Return on equity (%)	(6.6)	(11.1)
Net interest margin (%)	0.84	0.53
Cost:income ratio (%)	125	155
Total assets (£bn)	240.0	215.3
Funded assets (£bn)	100.9	103.3
Risk-weighted assets (£bn)	35.2	33.1

### Building a better bank that serves customers well

The NatWest Markets brand was introduced on 5 December 2016. The new brand is an important step towards our ambition to become No.1 for customers.

NatWest Markets started a Multi-year transformation in February 2015 and real progress is being made towards building a technology-led business with ongoing investment to improve efficiency and reduce costs while sustaining a well-controlled end-to-end model.

The business's progress against its transformation plan is already being recognised externally:

- No.1 for Gilts by Market Share EMEA FIs (Source: Greenwich Associates, European Fixed Income 2016 – Government Bonds)

- No.1 for GBP Options, GBP Inflation and GBP 2Y -10Y IRS (Source: Total Derivatives Dealer Rankings 2016)

- Best bank for FX post-trade services (FX Week Best Bank Awards 2016)

- No.1 for all European Issuers in the private placement market (Source: Dealogic Private Placement Review, Full Year 2016)

- Best for putting corporate client's interest before the bank's (Source: Global Capital Bond Awards 2016)

– NatWest Markets gained or held share in every Rates & FX product category for EMEA and the Americas  
(Source: Coalition Client Analytics Top 500 FI Wallets: G10 Foreign Exchange, G10 Rates)

## **Business review**

## **Capital Resolution**

### **Mark Bailie**

Chief Operating Officer

## **Capital Resolution**

Capital Resolution was established to execute the sale or wind down of most of the global footprint, from 38 countries to 13, and trade finance and cash management outside the UK and Ireland. Additionally non-strategic markets, portfolio and banking assets identified are being sold or wound down.

## **Performance overview**

Risk weighted assets (RWAs) decreased by £14.5 billion to £34.5 billion reflecting disposal activity partially offset by an increase due to the weakening of sterling.

Capital Resolution made an operating loss of £4,870 million, compared with an operating loss of £3,687 million in 2015, including litigation and conduct costs of £3,413 million.

Adjusted operating loss which excludes own credit adjustments of £134 million (2015 - £175 million), restructuring costs £78 million (2015 - £1,307 million) and litigation and conduct costs of £3,413 million

(2015 - £2,105 million, was £1,432 million compared with a loss of £412 million in 2015.

Total income included disposal losses of £572 million, £205 million higher than in 2015.

Operating expenses reduced by £696 million to £4,255 million reflecting a £775 million reduction in operating expenses excluding restructuring costs and litigation and conduct costs, and a £1,229 million reduction in restructuring costs, partially offset by a £1,308 million increase in litigation and conduct costs.

Adjusted operating expenses, which exclude restructuring costs £78 million (2015 - £1,307 million) and litigation and conduct costs of £3,413 million (2015 - £2,105 million) decreased by £775 million, or 50%, to £764 million, principally reflecting a 1,000 reduction in headcount.

A net impairment loss of £253 million compared with a net impairment release of £725 million in 2015 and principally comprised charges relating to a number of shipping assets (£424 million).



## Governance at a Glance

### Board of directors

<u>Chairman</u> Howard Davies	<u>Executive directors</u> Ross McEwan Ewen Stevenson
<u>Non-executive directors</u> Sandy Crombie (Senior Independent Director) Frank Dangeard Alison Davis Morton Friis Robert Gillespie	Penny Hughes Brendan Nelson Baroness Noakes Mike Rogers
<u>Chief Governance Officer and Board Counsel</u> Aileen Taylor (Company Secretary)	

### Our Board

The Board has twelve directors comprising the Chairman, two executive directors and nine independent non-executive directors, one of whom is the Senior Independent Director. Biographies for each director can be found on pages 60 to 65. Mike Rogers was appointed to the Board on 26 January 2016 and Frank Dangeard was appointed to the Board on 16 May 2016.

The Board is collectively responsible for the long-term success of RBS and delivery of sustainable shareholder value. Its role is to provide leadership of RBS within a framework of prudent and effective controls which enables risks to be assessed and managed.

An internal evaluation of the effectiveness of the Board and its committees was conducted in 2016, led by the Chief Governance Officer and Board Counsel.

## **Our Board committees**

In order to provide effective oversight and leadership, the Board has established a number of Board committees with particular responsibilities. The work of the Board committees is discussed in their individual reports. The terms of reference for each of these committees is available on [rbs.com](http://rbs.com).

The full Governance report is on pages 59 to 149 of the 2016 Annual Report on Form 20-F.

### **Group Audit Committee**

Assists the Board in discharging its responsibilities for monitoring the quality of the financial statements of RBS. It reviews the accounting policies, financial reporting and regulatory compliance practices of RBS and RBS's systems and standards of internal controls, and monitors the work of internal audit and external audit.

### **Board Risk Committee**

Provides oversight and advice to the Board on current and potential future risk exposures of RBS and future risk strategy. It reviews RBS's compliance with approved risk appetite and oversees the operation of the RBS Policy Framework and submissions to regulators.

**Sustainable Banking Committee** Provides support to the Board in overseeing actions being taken by management to run a sustainable long term business, with specific focus on culture, people, customer, brand and environmental social and ethical issues.

**Group Performance and Remuneration Committee** Responsible for approving remuneration policy and reviewing the effectiveness of its implementation. It also considers senior executive remuneration and makes recommendations to the Board on the remuneration of executive directors.

### **Group Nominations and Governance Committee**

Assists the Board in the selection and appointment of directors. It reviews the structure, size and composition of the Board, and the membership and chairmanship of Board committees. It considers succession planning taking into account the skills and expertise which will be needed on the Board in future. Its remit also includes governance oversight.

## Governance at a Glance

### Executive Committee

The Board is supported by the Executive Committee comprising the executive directors and other senior executives. It supports the Chief Executive in managing RBS's businesses. It reviews and debates relevant items before consideration by the Board. It is responsible for developing and delivering RBS's strategy and it monitors and manages financial performance, capital allocation, risk strategy and policy, risk management, operational issues and customer issues.

### UK Corporate Governance Code

Throughout the year ended 31 December 2016, RBS has complied with all of the provisions of the UK Corporate Governance Code issued by the Financial Reporting Council dated April 2016 except in relation to provision (D.2.2) that the Group Performance and Remuneration Committee should have delegated responsibility for setting remuneration for the Chairman and executive directors. RBS considers that this is a matter which should rightly be reserved for the Board.

### Case study

#### Free to dream

Through our partnership with Entrepreneurial Spark, we're helping entrepreneurs realise their dreams of owning and running their own business. We provide free facilities; free Wi-Fi, access to the bank's networks and suppliers, and free business advice. They don't need to bank with us and we take no equity; we simply believe it's right to support entrepreneurs and in turn help the economy grow.

Lawyer Sharon Amesu joined our Manchester hub in February 2016. "There was a real buzz and an immediate sense that I could be part of something quite special and significant" she says. "It's been instrumental in helping me grow my mentoring business and also a fantastically creative space to get to know, and network with, other aspirational and passionate people."

Across 12 accelerators throughout the UK, we have supported 1,736 companies with an aggregate turnover of more than £176 million. We've helped secure more than £151 million worth of investment for entrepreneurs in the Entrepreneurial Spark programme, and they in turn have created 3,152 jobs. More than 80% of the participating companies are still operating.



## Our Board

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	<b>Chairman</b>		
	<p><b>Howard Davies (age 66)</b></p> <p><i>Nationality:</i> British</p> <p><i>Date of appointment:</i> 14 July 2015 (Board), 1 September 2015 (Chairman)</p> <p><i>Experience:</i> Howard was Deputy Governor of the Bank of England from 1995 to 1997 and Chairman of the UK Financial Services Authority from 1997 to 2003. Howard was Director of the London School of Economics and Political Science from 2003 until May 2011. He is also Professor of Practice at the</p>	<p><i>External appointment(s):</i></p> <p>Independent director of Prudential plc and chair of the Risk Committee</p> <p>Member of the Regulatory and Compliance Advisory Board of Millennium Management LLC</p> <p>Chair of the International Advisory Council of the China Securities Regulatory Commission</p> <p>Member of the International Advisory Council of the China Banking Regulatory Commission</p> <p>Chairman of the London Library Trustees</p> <p><i>Committee membership(s):</i></p>	

	<p>Paris Institute of Political Science (Sciences Po).</p> <p>Howard was chair of the UK Airports Commission between 2012 and 2015 and is also the author of several books on financial subjects.</p>	<p>Group Nominations and Governance Committee (Chairman)</p>
<b>Executive directors</b>		
<b>Executive</b>	<p><b>Ross McEwan (age 59)</b></p> <p><i>Nationality:</i> New Zealand</p> <p><i>Date of appointment:</i> 1 October 2013</p> <p><b>Chief</b></p> <p><i>Experience:</i> Ross became Chief Executive of The Royal Bank of Scotland Group in October 2013.</p> <p>Between August 2012 and September 2013, he was Chief Executive Officer for UK Retail, joining from Commonwealth Bank of Australia where he was Group Executive for Retail Banking Services for five years. Prior to this he was Executive General Manager with responsibility for the branch network, contact centres and third party mortgage brokers.</p> <p>Ross has more than 25 years experience in the finance, insurance and investment industries. Prior to Commonwealth Bank of Australia, he was Managing Director of First NZ Capital Securities. He was also Chief</p>	<p><i>External appointment(s):</i></p> <p>None</p> <p><i>Committee membership(s):</i></p> <p>Executive Committee (Chairman)</p>

			Executive of National Mutual Life Association of Australasia Ltd/AXA New Zealand Ltd. Ross has an MBA from Harvard.				

## Our Board

### Executive directors Chief Financial Officer

**Ewen Stevenson (age 50)**

*External appointment(s):*

*Nationality:* British/New Zealand

None

*Date of appointment:* 19 May 2014

*Committee membership(s):*

*Experience:* Prior to his current role, Ewen was at Credit Suisse for 25 years where he was latterly co-Head of the EMEA Investment Banking Division and co-Head of the Global Financial Institutions Group. He has over 20 years of experience advising the banking sector while at Credit Suisse.

Executive Committee

US Risk Committee

Ewen has a Bachelor of Commerce and Administration majoring in Accountancy and a Bachelor of Law from Victoria University of Wellington, New Zealand.

### Independent non-executive directors

**Sandy Crombie (age 68)**

*External appointment(s):*

*Nationality:* British

President of the Cockburn Association

*Date of appointment:* 1 June 2009

(Senior Independent Director)

*Committee membership(s):*

*Experience:* Sandy spent his entire full-time career with Standard Life plc, retiring as Group Chief Executive. An actuary, he has served

Group Performance and Remuneration Committee (Chairman)

Group Audit Committee



his profession in a variety of roles and has also served as a director of the Association of British Insurers.

Group Nominations and Governance Committee

GRG Board Oversight Committee

Sandy has had a variety of cultural and community roles, and was previously Chairman of Creative Scotland, Chairman of the Edinburgh World City of Literature Trust and vice-Chairman of the Royal Conservatoire of Scotland.

## Our Board

### Independent non-executive directors

#### Frank Dangeard (age 59)

*Nationality:* French

*Date of appointment:* 16 May 2016

*Experience:* Previously, Frank served as a non-executive director of Crédit Agricole CIB, EDF, Home Credit, Orange, Sonaecom SGPS, and as Deputy Chairman and acting Chairman of Telenor ASA. During his executive career he held various roles at Thomson S.A., including Chairman and Chief Executive Officer, and was Deputy Chief Executive Officer of France Telecom. Prior to that he was Chairman of SG Warburg France and a Managing Director of SG Warburg.

*External appointment(s):*

Non-executive director of the RPX Corporation

Non-executive director of Symantec Corporation

*Committee membership(s):*

Board Risk Committee

Frank is a graduate of HEC and IEP in Paris and of the Harvard Law School in the US.

#### Alison Davis (age 55)

*Nationality:* British/USA

*Date of appointment:* 1 August 2011

*Experience:* Previously, Alison served as a director of City National Bank, First Data Corporation, Xoom, Diamond foods and chair of the board (and as Non-executive director) of LECG Corporation. She has

*External appointment(s):*

Non-executive director and member of the compensation and audit committees of Unisys Corporation

Non-executive director, and member of the audit committee of Fiserv Inc

Non-executive director and chair of the audit committee of Ooma Inc

*Committee membership(s):*

also worked at McKinsey & Company, AT Kearney, as Chief Financial Officer at Barclays Global Investors (now BlackRock) and as managing partner of Belvedere Capital, a private equity firm focused on buy-outs in the financial services sector.	Group Nominations and Governance Committee Group Performance and Remuneration Committee Sustainable Banking Committee
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Alison is a graduate of Cambridge University and Stafford Business School.

## Our Board

### Independent non-executive directors

#### **Morten Friis (age 64)**

*Nationality:* Norwegian

*Date of appointment:* 10 April 2014

*Experience:* Previously, Morten had a 34 year financial services career and held various roles at Royal Bank of Canada and its subsidiaries including Associate Director at Orion Royal Bank, Vice President, Business Banking and Vice President, Financial Institutions. In 1997, he was appointed as Senior Vice President, Group Risk Management and served as the Chief Credit Officer then Chief Risk Officer from 2004 to 2014. He was also previously a Director of RBC Bank (USA), Westbury Life Insurance Company, RBC Life Insurance Company and of RBC Dexia Investor Services Trust Company.

#### *External appointment(s):*

Member of the Board of Directors of The Canadian Institute for Advanced Research

Member of the Board of Directors of the Harvard Business School Club of Toronto

Non-executive director of Jackson National Life Insurance Company

#### *Committee membership(s):*

Group Audit Committee

Board Risk Committee

US Risk Committee (Chairman)

#### **Robert Gillespie (age 61)**

*Nationality:* British

*Date of appointment:* 2 December 2013

*Experience:* Robert began his career with Price Waterhouse (now PricewaterhouseCoopers) where he qualified as a chartered accountant. He then moved into banking joining SG Warburg, specialising in corporate finance, and was appointed as Co-Head and Managing Director of its

#### *External appointment(s):*

Independent board director at Ashurst LLP

Chairman of Council at the University of Durham

Chairman of the Boat Race Company Limited

Director of Social Finance Limited

US investment banking business in 1989. Following the acquisition in 1995 of Warburg by Swiss Bank Corporation (which subsequently merged with UBS), he then held the roles of Head of UK Corporate Finance, Head of European Corporate Finance and Co-Head of its global business and CEO of the EMEA region. He relinquished his management roles at the end of 2005, and was appointed Vice Chairman of UBS Investment Bank. Robert left UBS to join Evercore Partners, from where he was seconded to the UK Panel on Takeovers and Mergers, as Director General, from 2010 to 2013.	<i>Committee membership(s):</i> Group Nominations and Governance Committee Group Performance and Remuneration Committee Sustainable Banking Committee GRG Board Oversight Committee
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## Our Board

### Independent non-executive directors

#### **Penny Hughes, CBE (age 57)**

*Nationality:* British

*Date of appointment:* 1 January 2010

*Experience:* Previously a non-executive director and Chairman of the corporate compliance and responsibility committee of Wm Morrison Supermarkets plc. Other former non-executive directorships include Skandinaviska Enskilda Banken AB, Home Retail Group plc, Vodafone Group plc, Reuters Group PLC, Cable & Wireless Worldwide plc and The Gap Inc. Penny spent the majority of her executive career at Coca-Cola where she held a number of leadership positions, latterly as President, Coca-Cola Great Britain and Ireland.

#### *External appointment(s):*

Non-executive Chairman of The Gym Group plc. Also chair of the nominations and member of the audit, risk and remuneration committees

Non-executive director and member of the audit and nomination committees of SuperGroup plc

#### *Committee membership(s):*

Sustainable Banking Committee (Chairman)

Board Risk Committee

GRG Board Oversight Committee

#### **Brendan Nelson (age 67)**

*Nationality:* British

*Date of appointment:* 1 April 2010

*Experience:* Brendan was global Chairman, financial services for KPMG. He previously held senior leadership roles within KPMG including as a member of the KPMG UK board from 1999 to 2006 and as vice-Chairman

#### *External appointment(s):*

Non-executive director and Chairman of the audit committee of BP plc

Member of the Financial Reporting Review Panel

#### *Committee membership(s):*

Group Audit Committee (Chairman)

Group Nominations and Governance Committee

from 2006 until his retirement in Board Risk Committee  
2010. He was Chairman of the  
Audit Committee of the Institute GRG Board Oversight Committee  
of Chartered Accountants of (Chairman)  
Scotland from 2005 to 2008.  
President of the Institute of  
Chartered Accountants of  
Scotland 2013/14.

## Our Board

### Independent non-executive directors

#### **Baroness Noakes, DBE (age 67)**

*External appointment(s):*

*Nationality:* British

Deputy Chairman, Ofcom

*Date of appointment:* 1 August 2011

*Committee membership(s):*

*Experience:* Baroness Noakes is an experienced director on UK listed company boards with extensive and varied political and public sector experience. A qualified chartered accountant, she previously headed KPMG's European and International Government practices and has been President of the Institute of Chartered Accountants in England and Wales. She was appointed to the House of Lords in 2000 and has served on the Conservative front bench in various roles including as shadow treasury minister between 2003 and May 2010. Previously held non-executive roles on the Court of the Bank of England, Hanson, ICI, Severn Trent, Carpetright, John Laing and SThree.

Board Risk Committee (Chairman)

Group Audit Committee

GRG Board Oversight Committee

US Risk Committee

#### **Mike Rogers (age 52)**

*External appointment(s):*

*Nationality:* British

None

*Date of appointment:* 26 January 2016

*Committee membership(s):*

*Experience:* Mike has extensive experience in retail banking and financial services. Mike joined Barclays in 1986 where he undertook

Group Performance and Remuneration Committee

Sustainable Banking Committee



a variety of roles in the UK and overseas across business banking, wealth management and retail banking. Mike was Managing Director of Small Business, Premier Banking and UK Retail Banking and was latterly Chief Executive of Liverpool Victoria Group for 10 years.

## Our Board

### Chief Governance Officer and Board Counsel

**Aileen Taylor (age 44)**

*Nationality:* British

*Date of appointment:* 1 May 2010

(Company Secretary)

Aileen is a fellow of the Chartered Institute of Bankers in Scotland and a member of the European Corporate Governance Council. She is also a member of the FCA's Listing Authority Advisory Panel.

*Experience:* A qualified solicitor, Aileen joined RBS in 2000. She was appointed Deputy Group Secretary and Head of Group Secretariat in 2007, and prior to that held various legal, secretariat and risk roles including Head of External Risk (Retail), Head of Regulatory Risk (Retail Direct) and Head of Legal and Compliance (Direct Line Financial Services).

## Executive Committee

The Board is supported by the Executive Committee comprising the executive directors and other senior executives. Details of the composition of the Executive Committee and biographies of its members can be found at [rbs.com>about us>board and governance>ceo and board>executive committee](https://www.rbs.com/about-us/board-and-governance/ceo-and-board/executive-committee).

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## Corporate governance

### Chairman's introduction

I am pleased to introduce the corporate governance report. The following report provides an overview of key roles and responsibilities of the Board, and sets out in greater detail how the Board spent its time in 2016. Board effectiveness and performance evaluation are also covered, as well as an overview of how we communicate with shareholders.

As mentioned in my Chairman's Statement on page 7, the Board has considered a number of key strategic, financial, regulatory and litigation matters during 2016.

Understandably, capital strategy and planning remains a priority for the Board. The Board has continued to provide detailed oversight of litigation and conduct matters, particularly the FCA review of the treatment of SME customers, shareholder litigation and RMBS litigation. The divestment of Williams & Glyn; the implications of the EU Referendum result; and the Transformation agenda were all key strategic challenges deliberated by the Board this year. The Board continues to monitor steps being taken to drive cultural change, including risk culture, and ensuring that the right culture and values are embedded throughout the organisation. The Board has considered the preparations for the implementation of ring-fencing and this will be an area of continued focus in 2017.

On 7 March 2016, the PRA and FCA's Senior Managers' Regime came into effect which, alongside the PRA and FCA's new Certification and Conduct Rules regimes, is aimed at strengthening personal accountability and conduct within banking. The Senior Managers' Regime required us to identify those senior executives and board members (referred to as Senior Managers) who would be allocated specific regulatory responsibilities under the Senior Managers' Regime. The Board has received training and ongoing support to ensure that those members who are Senior Managers are able to demonstrate their compliance with the relevant regulatory requirements.

I and my fellow directors are committed to observing high standards of corporate governance, integrity and professionalism. Our statement of compliance with the UK Corporate Governance Code (the Code) can be found on page 150.

I would like to take this opportunity to thank my fellow Directors for their continued commitment and dedication throughout 2016.

Howard Davies, Chairman of the Board

## The Board

The Board has twelve directors comprising the Chairman, two executive directors and nine independent non-executive directors, one of whom is the Senior Independent Director.

Biographies for each director and details of which Board committees they are members of can be found on pages 59 to 65. The Board considers that the Chairman was independent on appointment and that all non-executive directors are independent for the purposes of the Code.

## Corporate governance

### Board changes

Mike Rogers was appointed as a non-executive director on 26 January 2016. Mike was appointed as a member of the Sustainable Banking Committee with effect from 25 April 2016, and a member of the Group Performance and Remuneration Committee with effect from 1 January 2017. Frank Dangeard was appointed as a non-executive director on 16 May 2016 and as a member of the Board Risk Committee on 4 August 2016.

### Roles and responsibilities

#### The Board

The Board is collectively responsible for the long-term success of RBS and delivery of sustainable shareholder value. The Board's terms of reference include a formal schedule of matters specifically reserved for the Board's decision and are reviewed at least annually. The terms of reference are available at [rbs.com>about](http://rbs.com/about).

As mentioned above a number of board members have been designated as "Senior Managers" under the PRA and FCA's Senior Managers' Regime. The role profiles of relevant directors have been updated to reflect their regulatory responsibilities and they receive ongoing support to ensure they can demonstrate the reasonable steps they have taken to meet their responsibilities.

#### Chairman

The role of Chairman is distinct and separate from that of the Chief Executive and there is a clear division of responsibilities with the Chairman leading the Board and the Chief Executive managing RBS business day to day.

#### The Chairman's key responsibilities are to:

- provide strong and effective leadership to the Board;
- ensure the Board is structured effectively, observes the highest standards of integrity and corporate governance, and sets the tone from the top in terms of culture and values;
- build an effective and complementary Board with an appropriate balance of skills and personalities, and as Chairman of the Group Nominations and Governance Committee consider succession planning for

Board appointments;

- manage the business of the Board and set the agenda, style and tone of Board discussions to promote effective decision-making and constructive debate;
- facilitate the effective contribution and encourage active engagement by all members of the Board;
- in conjunction with the Chief Executive and Chief Governance Officer and Board Counsel, ensure that members of the Board receive accurate, timely and clear information to enable the Board to lead RBS, take sound decisions and monitor effectively the performance of executive management;
- ensure that the performance of individual directors and of the Board as a whole and its committees is evaluated regularly; and
- ensure RBS maintains effective communication with shareholders and other stakeholders.

## Corporate governance

### Chief Executive

The Chief Executive has responsibility for all of RBS's business and acts in accordance with the authority delegated by the Board.

#### The Chief Executive's key responsibilities are to:

- exercise executive accountability for the RBS businesses delivering operational management and oversee the full range of activities of the customer businesses and functions;
- develop, drive and deliver the strategy approved by the Board;
- drive and deliver performance against financial plans, acting in accordance with authority delegated by the Board;
- consult regularly with the Chairman and Board on matters which may have a material impact on RBS;
- act as champion of the culture and values of RBS, creating an environment where employees are engaged and committed to good customer outcomes;
- lead, manage and develop RBS's senior leadership team, ensuring professional capability is developed and that succession coverage meets the needs of RBS;
- ensure RBS has effective frameworks and structures to identify, assess and mitigate risks; and
- in conjunction with the Chairman and Chief Governance Officer and Board Counsel, ensure the Board receives accurate, timely and clear information.

### Senior Independent Director

Sandy Crombie, as Senior Independent Director, acts as a sounding board for the Chairman and as an intermediary for other directors when necessary. He is also available to shareholders to discuss any concerns they may have, as appropriate.

### Non-executive directors

Along with the Chairman and executive directors, the non-executive directors are responsible for ensuring the Board fulfils its responsibilities under its terms of reference. The non-executive directors combine broad



business and commercial experience with independent and objective judgement and they provide independent challenge to the executive directors and the leadership team. The balance between non-executive and executive directors enables the Board to provide clear and effective leadership across RBS's business activities.

The standard terms and conditions of appointment of non-executive directors are available on [rbs.com](https://www.rbs.com) or from RBS Corporate Governance and Regulatory Affairs.

### Board Committees

In order to provide effective oversight and leadership, the Board has established a number of Board committees with particular responsibilities. Please see pages 57 and 58 of the Strategic Report for more details. The terms of reference are available on [rbs.com](https://www.rbs.com).

## Corporate governance

The Board Committee established in 2015 in relation to the Financial Conduct Authority review of the treatment of SME customers continued to meet during 2016, to oversee and provide advice to the Board in relation to the review, the external independent review of Global Restructuring Group (GRG) instigated by the Group and other matters generally related to GRG. A new US Risk Committee was established to comply with US enhanced prudential standards and reports key matters discussed to the BRC. The first meeting took place in May 2016.

### Chief Governance Officer and Board Counsel

Aileen Taylor is the Chief Governance Officer and Board Counsel and the Company Secretary. As of 1 January 2017, she also leads the bank's Regulatory Affairs function as part of an extended remit.

The Chief Governance Officer and Board Counsel's key responsibilities include:

- working closely with the Chairman to ensure effective functioning of the Board and appropriate alignment and information flows between the Board and its committees, including the Executive Committee. This includes Board succession planning, induction, and professional development;
- providing support and advice to the Board on a broad range of strategic, governance, legal and regulatory issues;
- executive responsibility for Chairman/non-executive director search and appointment process;
- management of the bank's profile with key stakeholders, including oversight of relations with key influencers, such as regulators;
- defining and delivering the corporate governance and regulatory affairs strategy across RBS; and
- the provision of professional support to the Board and its committees and leading on implementation of recommendations from the annual Board evaluation.

### Conflicts of interests

RBS has procedures in place to ensure that the Board's management of conflicts of interest and its powers for authorising certain conflicts are operating effectively. On appointment, each director is provided with RBS's guidelines for referring conflicts of interest to the Board. Each director is required to notify the Board of any actual or potential situational or transactional conflicts of interest and to update the Board with any changes to the facts and circumstances surrounding such conflicts.

Situational conflicts can be authorised by the Board in accordance with the Companies Act 2006 and the company's Articles of Association. The Board considers each request for authorisation on a case by case basis and has the power to impose conditions or limitations on any authorisation granted as part of the process.

Details of all directors' conflicts of interest are recorded in a register which is maintained by the Chief Governance Officer and Board Counsel and reviewed annually by the Board.

## Corporate governance

### Board meetings

In 2016, nine Board meetings were scheduled and individual attendance by directors at these meetings is shown in the table below.

In addition to the nine scheduled meetings, 11 additional meetings and committees of the Board were held, including meetings to consider and approve financial statements. The Chairman and the non-executive directors meet at least once per year without executive directors present.

	Attended/ scheduled
Howard Davies	9/9
Ross McEwan	9/9
Ewen Stevenson	9/9
Sandy Crombie	9/9
Frank Dangeard (1)	5/5
Alison Davis	9/9
Morten Friis	9/9
Robert Gillespie	9/9
Penny Hughes	9/9
Brendan Nelson	9/9
Baroness Noakes	9/9
Mike Rogers (2)	9/9

Notes:

(1) Appointed to the Board on 16 May 2016.

(2) Appointed to the Board on 26 January 2016.

### Principal areas of Board focus during 2016

In advance of each Board meeting, the directors are provided with comprehensive papers.

At each Board meeting the directors received reports from the Chairman, Chief Executive, Chief Financial Officer, Chief Risk Officer, Chief Conduct and Regulatory Affairs Officer, Franchise CEOs and the Board Committee Chairmen. An overview of the principal areas of Board focus during 2016 is set out below:

## Customer

- customer service
- network distribution
- products and innovation
- branding
- culture
- customer trust and advocacy

## Finance

- annual financial budget and plan
- capital strategy and planning
- Internal Capital Adequacy Assessment Process
- Individual Liquidity Adequacy Assessment
- pension funding
- recovery and resolution planning
- results and analysts' presentations

## Corporate governance

### Strategy

- annual Board strategy offsite
- EU referendum implications
- Ring-fencing, including legal entity restructuring
- transactions updates
- transformation programme
- Williams & Glyn disposal
- technology updates

### Risk & Conduct

- stress testing
- risk appetite governance and framework
- annual review of strategic risk appetite
- Individual Accountability Regime implementation

### Legal & Governance

- Annual Report and Accounts
- AGM arrangements
- board appointments
- board and committee evaluation
- annual PRA and FCA presentation to the Board
- external auditor evaluation
- internal audit evaluation

- legal report, including litigation updates

## Human Resources

- employee survey results
- executive director remuneration proposals
- executive talent session

During 2016 the Board also visited the Ulster Bank business in the Republic of Ireland, spending time on the business, risks and challenges. The directors met with key customers, politicians and senior industry and business representatives.

## Executive Committee

Executive Committee members attend part of each Board meeting to provide an update on the performance of each of the franchises and risk, operational and conduct issues. Other relevant senior executives attend Board meetings to present reports to the Board as appropriate. This provides the Board with an opportunity to engage directly with management on key issues and supports the Board's succession planning activity.

## Board effectiveness

### Skills and experience of the Board

The Board is structured to ensure that the directors provide RBS with the appropriate balance of skills, experience and knowledge as well as independence. Given the nature of RBS's businesses, experience of banking and financial services is clearly of benefit, and we have a number of directors with substantial experience in that area. The Board also benefits from directors with experience in other fields.

## Corporate governance

The table below illustrates the breadth of skills and experience on the Board.

• Retail Banking	• Chief Executive experience
• Broad Financial Services	• Finance & Accountancy
• Markets/Investment Banking	• Risk
• Government & Regulatory	• Technology/Digital
• Mergers & Acquisitions	• Operations
• Corporate Restructuring	• Change Management
• Stakeholder Management	• Consumer Facing

Board committees also comprise directors with a variety of skills and experience so that no undue reliance is placed on any individual.

### Induction and professional development

Each new director receives a formal induction on joining the Board, which is co-ordinated by the Chief Governance Officer and Board Counsel. This includes visits to RBS's major businesses and functions and meetings with directors and senior management. Meetings with external auditors, counsel and stakeholders are also arranged as appropriate. An illustrative list of the meetings arranged during a new director's induction programme is set out below:

Chairman	Director, Finance
Chief Executive	Chief Accountant
Chief Financial Officer	Head of RBS Tax
Senior Independent Director	Chief Human Resources
Other non-executive directors	Officer



Chief Governance Officer and Board Counsel	Chief Administrative Officer
Chief Risk Officer	Head of Investor Relations
Chief Marketing Officer	Head of Public Affairs
Chief Operating Officer	Director of Strategy & Corporate Development
RBS Treasurer	Director of Transformation
Chief Audit Executive	Head of Restructuring
Chief Legal Officer and General Counsel	Chief Economist
Chairmen and CEOs of principal subsidiaries	External Auditors
Franchise Chief Executive Officers	External Counsel
	Regulators
	Institutional Investors
	Business visits (UK and overseas)

The directors have access to a wide range of briefing and training sessions and other professional development opportunities. Internal training relevant to the business of RBS is also provided. Business visits are arranged as part of the Group Audit Committee and Board Risk Committee schedule (details of which can be found on pages 81 and 91) and all non-executive directors are invited to attend. Directors undertake the training they consider necessary to assist them in carrying out their duties and responsibilities as directors. Directors may also request individual in-depth briefings from time to time on areas of particular interest.

## Corporate governance

During 2016, the directors received updates on a range of subjects to enhance their knowledge, including:

- investor and rating agencies views on RBS;
- disruptive technologies;
- Market Abuse Regulations (Inside Information and Persons Discharging Management Responsibility aspects);
- corporate investigations;
- Senior Managers' Regime;
- The Conduct Rules;
- PRA's final Supervisory Statement on corporate governance and board responsibilities;
- Ring-fencing;
- board diversity;
- The UK Government's proposals for corporate governance reform;
- Institute of Directors 2016 good governance report;
- FRC's report on corporate culture and the role of the board; and
- key regulatory & supervisory policy developments.

The Chief Governance Officer and Board Counsel maintains continuing professional development logs. These are reviewed regularly between the Chairman and each director individually, to assist in identifying future training and development opportunities that are specific to the individual director's requirements.

## Information

All directors receive accurate, timely and clear information on all relevant matters and have access to the advice and services of the Chief Governance Officer and Board Counsel. In addition, all directors are able, if necessary, to obtain independent professional advice at the company's expense.

### Time commitment

It is anticipated that non-executive directors will allocate sufficient time to RBS to discharge their responsibilities effectively and will devote such time as is necessary to fulfil their role. Directors have been briefed on the limits on the number of other directorships that they can hold under the requirements of the fourth Capital Requirements Directive (CRD IV). Each director is required to advise RBS as early as possible and to seek the agreement of the Board before accepting additional commitments that might affect the time the director is able to devote to his or her role as a non-executive director of RBS. The Board monitors the other commitments of the Chairman and directors and is satisfied that they are able to allocate sufficient time to enable them to discharge their duties and responsibilities effectively. The time commitment currently required of our non-executive directors continues to be significant.

### Election and re-election of directors

In accordance with the provisions of the Code, all directors stand for election or re-election by shareholders at the company's Annual General Meeting. In accordance with the UK Listing Rules, the election or re-election of independent directors also requires approval by a majority of independent shareholders.

## Corporate governance

### Performance evaluation

In accordance with the Code, an external evaluation of the Board takes place every three years. An internal evaluation takes place in the intervening years.

The 2015 evaluation was conducted externally by a specialist board evaluation consultancy and a number of initiatives were implemented aimed at improving the overall performance and effectiveness of the Board. These included the creation of a Nominations and Governance Committee, adding a governance oversight function and streamlining processes and membership; a range of actions to enhance agenda planning and the Board's overall operating rhythm; and actions to improve alignment between the Board and executives to ensure a consistent "tone from the top". These themes were taken forward during 2016 under an action plan, are being appropriately addressed and will be kept under regular review as a matter of good practice.

In 2016, the Board and committee evaluation process was conducted internally by the Chief Governance Officer and Board Counsel.

### Performance evaluation process

The Chief Governance Officer and Board Counsel undertook a formal and rigorous evaluation by:

- preparing surveys that were completed by each director and holding interviews with each director;
- discussing the key themes and recommendations for action with the Chairman; and
- recommending the key themes and proposed actions to the Board.

### Outcomes of the 2016 performance evaluation

The 2016 performance evaluation concluded that the Board was strong and operated effectively and within its terms of reference.

Key strengths identified included the following:

- The Chairman provides strong leadership to the Board and has settled into the role well.

- The Board works well together to create effective debate and challenge, and provides effective oversight and challenge to management.
- The Board's composition has been strengthened during 2016 by the appointments of Mr Rogers and Mr Dangeard.
- The quality of information received by the Board continues to improve.
- The Board's committees operated effectively within their terms of reference throughout the year, providing valuable support to the Board.

A summary of the key themes arising from the 2016 performance evaluation is set out below, together with an overview of the key actions proposed:

## Key themes

### Board composition and succession planning

The importance of keeping Board and committee composition under regular review was highlighted, in order to ensure diversity and an orderly succession as a number of non-executive directors approach the end of their tenure with RBS.

## Corporate governance

### Quality of information

Paper quality has improved over recent years. There is scope for further enhancement, by continuing to manage paper length and ensuring an appropriate level of detail is shared with the Board. Similar issues were raised during the committee evaluations.

### Focus of agenda

The balance of the Board agenda tends towards legacy and internal issues, which reflects the current climate. However, it is also important to ensure continued focus on forward-looking and strategic discussions.

### Non-executive director time commitment

Non-executive director time commitment remains significant. This is largely due to the number of extraordinary items which require to be considered by the Board in the current environment.

### Customers and culture

The Sustainable Banking Committee has played a key role in customer and culture issues, however the directors would welcome greater Board focus on these priorities.

### Proposed actions

Recommendations arising out of the 2016 evaluation have been carefully considered by the Board. An action plan has been agreed for 2017 and key actions include:

- Ensuring board & committee composition and succession plans are kept under regular review, to be led by the Group Nominations and Governance Committee.
- Refreshing Board and committee paper templates and guidance, to ensure consistency across the Board and committees in relation to paper length and content.
- Ensuring Board time is appropriately allocated in response to evaluation feedback, to facilitate the effective use of non-executive director time.

- Further developing the Board's role on culture, to include consideration of how Board time is spent on actions to drive cultural change.

In addition, a list of 2017 priorities for the Board was prepared following evaluation feedback and has been factored into the 2017 agenda planning process, as appropriate.

#### Individual director and Chairman effectiveness reviews

The Chairman met with each director individually to discuss their own performance and ongoing professional development and also shared peer feedback provided as part of the evaluation process. Separately, the Senior Independent Director sought feedback on the Chairman's performance from the non-executive directors, executive directors and key external stakeholders and discussed it with the Chairman.

## Corporate governance

### Relations with investors

The Chairman is responsible for ensuring effective communication with shareholders. The company communicates with shareholders through the Annual Report on Form 20-F and by providing information in advance of the Annual General Meeting. Individual shareholders can raise matters relating to their shareholdings and the business of RBS at any time throughout the year by letter, telephone or email via [rbs.com/ir](mailto:rbs.com/ir).

Shareholders are given the opportunity to ask questions at the Annual General Meeting and any General Meetings held or can submit written questions in advance. The Senior Independent Director and the chairmen of the Board committees are available to answer questions at the Annual General Meeting.

Communication with the company's largest institutional shareholders is undertaken as part of the Investor Relations programme:

- the Chief Executive and Chief Financial Officer meet regularly with UKFI, the organisation set up to manage the Government's investments in financial institutions, to discuss the strategy and financial performance of the business. The Chief Executive and Chief Financial Officer also undertake an extensive annual programme of meetings with the company's largest institutional shareholders;
- the Chairman independently meets with RBS's largest institutional shareholders annually to hear their feedback on management, strategy, business performance and corporate governance. Additionally, the Chairman, Senior Independent Director and chairmen of the Board committees met with the governance representatives of a number of institutional shareholders during the year;
- the Senior Independent Director is available if any shareholder has concerns that they feel are not being addressed through the normal channels; and
- the Chairman of the Group Performance and Remuneration Committee consults extensively with major shareholders in respect of the Group's remuneration policy.

Throughout the year, the Chairman, Chief Executive, Chief Financial Officer and Chairman of the Group Performance and Remuneration Committee communicate shareholder feedback to the Board. The directors also receive reports reviewing share price movements and performance against the sector. Detailed market and shareholder feedback is provided to the Board after major public announcements such as a results release. The arrangements in place are to ensure that directors develop an understanding of the views of major shareholders and that these are considered as part of the annual Board evaluation.



The Investor Relations programme also includes communications aimed specifically at its fixed income (debt) investors. The Chief Financial Officer and/or the RBS Treasurer give regular presentations to fixed income investors to discuss strategy and financial performance. There is also a separate section on the RBS website for fixed income investors which includes information on credit ratings, securitisation programmes and securities documentation. Further information is available at [rbs.com/ir](http://rbs.com/ir).

## **Report of the Group Nominations and Governance Committee**

### **Letter from Howard Davies**

#### **Chairman of the Group Nominations and Governance Committee**

Dear Shareholder,

As Chairman of the Board and Chairman of the Group Nominations and Governance Committee I am pleased to present our report on the committee's activity during 2016.

### **Role and responsibilities**

The Group Nominations and Governance Committee was constituted in January 2016 and assumed the responsibilities of the previous Group Nominations Committee to review the structure, size and composition of the Board, and membership and chairmanship of Board Committees. In addition, the Committee monitors the Group's governance arrangements to ensure that best corporate governance standards and practices are upheld and considers developments relating to banking reform and analogous issues affecting the Group in the markets where it operates. The Committee makes recommendations to the Board in respect of any consequential amendments to the Group's operating model.

The Committee engages with external consultants, considers potential candidates and recommends appointments of new directors to the Board.

The terms of reference of the Group Nominations and Governance Committee are reviewed annually, approved by the Board and are available at [rbs.com](http://rbs.com).

### Principal activity during 2016

As highlighted in the Board's 2015 performance review, the Committee acknowledges the tenure of a number of the current Board directors and therefore made succession planning a priority in 2016.

		2016
0 - 3 years		40%
3 - 6 years		30%
6 + years		30%
		100%

In addition to recruitment, the Committee assumed oversight of the process to reach agreement with the PRA in respect of a governance model that adheres to ring-fencing legislation. Ring-fencing also gives rise to a requirement to recruit additional non-executive directors to the boards of our material regulated subsidiaries, which the Committee has also been overseeing.

The Committee has spent time considering the Group's arrangements in respect of legal entity governance. This work is ongoing and is complementary to the Group's preparations for the implementation of ring-fencing legislation.

### Membership and meetings

The Group Nominations and Governance Committee is comprised of the Chairman of the Board and four independent non-executive directors, which is consistent with the findings of last year's recommendation. The Committee holds at least four scheduled meetings per year and also meets on an ad hoc basis as

required. In 2016, there were four Group Nominations and Governance Committee meetings and individual attendance by directors at these meetings is shown in the table below.

	Attended/ scheduled
Howard Davies (Chairman)	4/4
Sandy Crombie	4/4
Alison Davis	4/4
Robert Gillespie	4/4
Brendan Nelson	4/4

## Report of the Group Nominations and Governance Committee

### Consideration of new non-executive directors

As previously advised, JCA Group has been engaged to support the search for new non-executive directors. The search and nominations process has been streamlined, including by establishment of this Committee. The Committee has also considered (by reference to peer institutions) the significant time commitment required of the Group's non-executive directors and how this might be reduced to make the position accessible to a larger pool of candidates. JCA group does not provide search services to any other part of RBS. During 2016, the Committee considered a number of potential candidates and in May 2016, Frank Dangeard was appointed to the Board as a non-executive director.

The Committee has overseen the establishment of the Group's Technology Advisory Board, which was constituted on 1 December 2016 with a remit to *provide an external lens to RBS's innovation and technology agenda including consideration of driving a resilient, simple and efficient technology environment.*

In addition to appointments to the Board (and subsidiary appointments being required to specifically comply with ring-fencing legislation), the Committee has also overseen the process for the appointment of a new chairman for Ulster Bank Ireland DAC.

### Tenure of non-executive directors

The tenure of non-executive directors is set out below.

### Board and Committee membership

As previously mentioned, Frank Dangeard joined the Board as a non-executive director on 16 May 2016 and was subsequently appointed to the Board Risk Committee on 4 August 2016. Frank has substantial Board level experience across a number of sectors, including technology, telecom and financial services. His change management and transformation experience are a real asset to the Board.

The Committee recommended in February 2016 that the CIB Board Oversight Committee should be discontinued, due to its remit having been superseded.

### Performance evaluation

The annual review of the effectiveness of the Board and its senior Committees, including the Group Nominations and Governance Committee, was conducted internally in 2016. The Committee has considered and discussed the outcomes of this evaluation and accepts the findings. Overall the review concluded that the Group Nominations and Governance Committee operated effectively. However, certain recommendations for action were recognised including the need to: regularly engage with the external search firm to provide clarity and guidance on RBS's recruitment requirements; and rebalance the agenda of the Committee to ensure greater focus on strategic issues, including director performance and board and senior management succession.

The outcomes of the evaluation have been reported to the Board and the Committee will track progress during the year.

### Boardroom diversity

The Board currently meets the target of 25 per cent female board representation as set out in Lord Davies' 2011 report on women on Boards. We acknowledge the updated targets published in the Hampton Alexander and Parker reports and will continue to consider the implications for RBS during 2017.

The gender diversity of the Board is set out below.

	2016
Female	25%
Male	75%
	100%

The Board operates a boardroom diversity policy and a copy of the Board's diversity statement is available on [rbs.com>about us](http://rbs.com/about-us).

RBS understands the importance of diversity and, with regard to gender diversity, recognises the importance of women having greater representation at key decision making points in organisations. The search for Board candidates will continue to be conducted, and nominations/appointments made, with due regard to the benefits of diversity on the Board. However, all appointments to the Board are ultimately based on merit, measured against objective criteria, and the skills and experience the individual can bring to the Board.

The balance of skills, experience, independence, knowledge and diversity on the Board, and how the Board operates together as a unit is reviewed annually as part of the Board evaluation. Where appropriate, findings from the evaluation will be considered in the search, nomination and appointment process. If appropriate, additional targets on diversity will be developed in due course.

Further details on RBS's approach to diversity can be found on pages 163 and 164.

Howard Davies

Chairman of the Group Nominations and Governance Committee

23 February 2017

**Report of the Group Audit Committee**

**Letter from Brendan Nelson,**

**Chairman of the Group Audit Committee**

***“The first priority of the Group Audit Committee is to ensure the integrity and quality of RBS’s financial statements”***

Dear Shareholder,

Throughout 2016 RBS has continued to progress its plan to build a strong, simple, fair bank for customers and shareholders and the Group Audit Committee (GAC) has supported this through the review and consideration of RBS’s financial reports and disclosures. This report also sets out the key areas of focus for the GAC during 2016. I am pleased to confirm that the GAC operated effectively during 2016, as was confirmed by the annual evaluation process, details of which are also set out below.



## Accounting and financial reporting

The first priority of the GAC is to ensure the integrity and quality of RBS's financial statements, including its quarterly, interim and full year results and its annual report and accounts. During 2016 the GAC spent considerable time reviewing and discussing RBS's financial results in detail, and challenging the material judgements proposed by management, before recommending them to the Board for approval.

In particular, during 2016 the GAC considered judgements relating to the recoverability of deferred tax assets, the carrying value of goodwill, provisions for litigation and conduct charges, loan impairment provisions and the fair value of financial instruments. Additionally, in the stand-alone parent company accounts, the GAC considered judgements relating to the carrying value of RBSG's investment in subsidiaries.

There were also a number of developments during 2016 which required the GAC's scrutiny from a disclosure perspective. The divestment of Williams & Glyn was an important issue during 2016 and the GAC was fully engaged on this issue in order to ensure that all developments and risks were transparently disclosed to the market. RBS also continues to work through a number of litigation and conduct issues which the GAC has carefully considered in order to ensure its disclosures remain accurate and up to date.

The implications of the EU referendum and subsequent developments in the macro economic environment were an important area of focus for RBS in the second half of 2016. The GAC received reports on the implications for the credit environment which it has considered in the context of RBS's disclosures and financial reports. This will remain an area of ongoing focus into 2017.

The Market Abuse Regulation took effect in July 2016. The GAC reviewed and discussed the implications for RBS's disclosures and the processes RBS has implemented to ensure compliance with these regulations.

The GAC also considered significant developments in relation to financial reporting to ensure that RBS is well prepared for legal and regulatory changes which impact its financial results and disclosures. In particular, the GAC has overseen the preparatory work relating to the introduction of IFRS 9 which will take effect on 1 January 2018.

In relation to the Annual Report and Accounts, the GAC carefully considered the viability report and the 'fair, balanced and understandable' statement, including the processes which support them. The directors are required to make these statements in line with the UK Corporate Governance Code.



## Report of the Group Audit Committee

### Systems of internal control

RBS continues to work on the improvement of its control environment, which is key to making RBS a safer and more secure bank. However, the level of change RBS is undergoing presents significant challenges and RBS's operational risk profile remains heightened. The GAC oversees the arrangements for RBS's systems of Internal Control relating to financial reporting. During 2016 the GAC received quarterly updates from Internal Audit detailing Internal Audit's control ratings for RBS's businesses and functions. The GAC also received bi-annual updates on the control environment certification process and the material operational risk events which are notified to RBS's senior management, executives and non-executive directors.

During 2016 RBS made good progress in developing its operational risk management framework with the roll-out of bank-wide risk appetite statements for its most material risks, this included financial reporting risk appetite which was considered by the GAC in August 2016. RBS has also developed end to end risk and control assessment for material processes during 2016, and the resulting actions to improve and enhance controls will be taken forward during 2017; this process will be overseen by the Board Risk Committee with the GAC focusing on those aspects impacting financial reporting. The drive to achieve satisfactory controls will benefit from the bank-wide programme to enhance risk culture, with its focus on encouraging a proactive approach to risk and a more open and challenging environment.

### External audit

A priority for the GAC during 2016 was to oversee a change of the external auditors. Ernst & Young (EY) assumed the role of RBS's new auditors in March 2016, having been successful in the tender process run in 2014.

On behalf of the GAC, I would like to thank the outgoing external auditors, Deloitte LLP, for their hard work over many years and for their professionalism in ensuring an orderly and smooth handover to EY.

The external auditors have attended each meeting of the GAC in 2016 and have provided the GAC with quarterly reports and ad hoc updates on specific topics as required. I am pleased to confirm that the 2016 evaluation of the external auditor found that EY were performing the audit of RBS effectively.

### Key priorities for 2017

Moving into 2017 the GAC will continue its focus on RBS's accounting and financial reporting. The GAC will continue to consider developments in accounting policy and regulations impacting RBS, including IFRS 9 in particular. The impact of developments in the macro economic environment on the credit portfolio and

financial results will also remain a priority, as will the Control Environment and the GAC will continue to monitor these throughout 2017.

Accounting issues and disclosures relating to legacy litigation and conduct issues are also expected to be an important area of attention during 2017 as had been demonstrated by the provision RBS announced on 26 January 2017 in relation to RMBS litigation and investigations.

I would like to take this opportunity to thank my fellow GAC members for their continued support and focus during 2016.

Brendan Nelson

Chairman of the Group Audit Committee

23 February 2017

## Report of the Group Audit Committee

## Report of the Group Audit Committee

### Membership

The Group Audit Committee (GAC) is comprised of the following four independent non-executive directors.

	Attended/ scheduled
Brendan Nelson (Chairman)	7/7
Sandy Crombie	7/7
Morten Friis	7/7
Baroness Noakes	7/7

Brendan Nelson, Morten Friis and Baroness Noakes are also members of the Board Risk Committee. Sandy Crombie is Chairman of the Group Performance and Remuneration Committee. Brendan Nelson and Sandy Crombie are also members of the Group Nominations and Governance Committee. This cross committee membership helps facilitate effective governance across all finance, risk and compensation issues. It also helps to ensure that agendas are aligned and that overlap of responsibilities is avoided where possible.

The members of GAC are selected with a view to the expertise and experience of the GAC as a whole and with proper regard for the key issues and challenges facing RBS.

The Board is satisfied that all GAC members have recent and relevant financial experience and that each member of the GAC is independent as defined in the SEC rules under the US Securities Exchange Act of 1934 (the “Exchange Act”) and related guidance. The Board has further determined that Brendan Nelson, Committee Chairman, and Baroness Noakes are both ‘financial experts’ for the purposes of compliance with the Exchange Act Rules and the requirements of the New York Stock Exchange, and that they have competence in accounting and auditing as required under the Disclosure Guidance and Transparency Rules. Full biographical details of GAC members are set out on pages 59 to 65.

During 2016 GAC meetings were attended by the Chief Executive and Chief Financial Officer; the Group Chairman; the Internal and External Auditors; and Finance, Legal and Risk Management executives. Other executives, subject matter experts and external advisers were also invited to attend, as required, to present and advise on reports commissioned by the GAC. The GAC also met privately with the external auditors and separately with Internal Audit management.

### Purpose of the Group Audit Committee

The GAC's responsibilities are set out in more detail in its terms of reference which are reviewed annually by the Committee and approved by the Board. These are available on rbs.com.

### Meetings and visits

The GAC held seven scheduled meetings during 2016, four of which were held immediately prior to the submission of the quarterly financial statements to the Board. The GAC also convened three ad hoc meetings to consider:

- the trading statement issued in January 2016;
- documentation relating to disclosures in the 2015 Annual Report and Accounts; and
- disclosure issues relating to the H1 2016 results, including the developments on Payment Protection Insurance.

During 2016, in conjunction with members of the Board Risk Committee, members of the GAC took part in an annual programme of visits to businesses and control functions in order to gain a deeper understanding of the risks and issues they face. This programme comprised two visits to Risk and Restructuring; Conduct and Regulatory Affairs and Internal Audit plus visits to: Personal & Business Banking; Commercial & Private Banking; NatWest Markets (formerly CIB); Capital Resolution, Services; and Finance.

## Report of the Group Audit Committee

Allocation of Group Audit Committee agenda time during 2016 was as follows:

Financial affairs of the group	39%
Standards of internal control	21%
Internal audit	13%
External audit	9%
Regulatory relationships and compliance	13%
Governance and procedural	5%
Total	100%

### Performance evaluation

The performance of the GAC is evaluated annually, and at least once every three years is facilitated by an external party. Following an externally facilitated evaluation in 2015, the evaluation of the GAC's performance in 2016 was conducted internally. The evaluation process involved the completion of questionnaires by both GAC members and members of management and follow up interviews to discuss the findings. The Board and the GAC have considered and discussed the outcomes of this evaluation. Overall the review concluded that the GAC continued to operate effectively. A number of recommendations for improvement were made which were approved by the GAC and the Board; progress against these will be tracked in 2017.

## Report of the Group Audit Committee

### Matters considered by the Committee in 2016

Key area		Matters considered and action taken by the Committee
<b>Financial affairs of the Group</b>		
Accounting judgements and reporting issues considered in the preparation of financial reports		<p>The Group Audit Committee focused on a number of salient judgements and reporting issues in the preparation of the financial results throughout 2016, including the quarterly, half year and full year results and the Annual Report and Accounts. In particular, the Committee considered, discussed and, where appropriate, challenged:</p> <ul style="list-style-type: none"> <li>• provision and disclosure for ongoing regulatory and litigation actions including: Payment Protection Insurance claims, RMBS investigations and litigation, UK shareholder actions, the FCA's investigation into RBS's former Global Restructuring Group, the Central Bank of Ireland's review of Irish tracker mortgages and investigations into alleged foreign exchange rate manipulation. During 2016 RBS has recognised £5.9 billion of litigation and conduct provisions;</li> <li>• the adequacy of loan impairment provisions, focusing in particular on judgements and methodology applied to provisions. The Committee was satisfied that the overall loan impairment provisions and underlying assumptions and methodologies were reasonable and applied consistently;</li> <li>• valuation methodologies and assumptions for financial instruments carried at fair value including RBS's credit market exposures and own liabilities assessed at fair value;</li> <li>• judgements made by management in relation to the carrying value of intangible assets. In particular, in light of changes to economic forecasts, the GAC considered whether any adjustments were required to the carrying value of goodwill and of RBS's investment in subsidiaries</li> </ul>



within the stand-alone parent company accounts; in its Q3 2016 results RBSG reduced the carrying value of its investment in subsidiaries by £6.0 billion to £44.7 billion in light of the deterioration in the economic outlook. The GAC also challenged the processes and the models used to assess the value of these assets;

- judgements made by management in assessing the recoverability of deferred tax assets, in light of continued execution of the RBS's strategy and changes to the UK corporate tax system. A £300 million impairment of deferred tax assets was recognised in RBS's Q3 2016 results;

- management's assessment of the adequacy of internal controls over financial reporting, and identified deficiencies. Remediation of identified weaknesses in relation to privileged access controls for certain IT applications and in relation to legal entity recharge accounting for the allocation of ATM fees was monitored and tracked by the GAC during 2016;

- the quality and transparency of financial and risk disclosures;

- the viability statement in the 2016 report and accounts. The GAC considered the process to support the assessment of principal risks; assessed the company's prospects in the light of its current position and the identified principal risks; selected the time period to be covered by the statement; and reviewed the disclosure on behalf of the Board;

- the going concern basis of accounting including consideration of evidence of RBS's capital, liquidity and funding position. The GAC supported the directors' going concern conclusion. Further information is set out on page 164; and

• the comprehensive review process which supports the GAC and the Board in reaching the conclusion that the disclosures in the Annual Report and Accounts, taken as a whole, are fair, balanced and understandable and provided the information necessary for shareholders to assess the company's position and performance, business model and strategy. The review process included: central co-ordination of the annual report and accounts by the Director of Finance with guidance on requirements being provided to individual contributors; review of the annual report and accounts by the Executive Disclosure Committee prior to consideration by the GAC; and a management certification process which required members of the Executive Committee and other senior executives to provide confirmation following their review of the annual report and accounts that they considered them to be fair, balanced and understandable. This process was also undertaken in respect of the half year and quarterly results announcements. The External Auditor also considered the Board's statement as part of its audit requirements.

Having considered the above, the Committee recommended the quarterly, interim and full year results announcements and the Annual Report and Accounts to the Board for approval.

## Report of the Group Audit Committee

Key area		Matters considered and action taken by the Committee
<b>Standards of internal control</b>		
Annual Risk and Control report		The GAC considered the effectiveness of RBS's internal control system, including any significant failings or weaknesses. The Williams & Glyn divestment programme and the NatWest Markets control environment were both identified as weaknesses, these have both been closely monitored and reviewed by the Board Risk Committee and are discussed further in the report of the Board Risk Committee. The GAC also considered RBS's disclosure on internal control matters in conjunction with the related guidance from the Financial Reporting Council.
Control Environment Certification		The GAC considered the outputs of bi-annual self-assessments of the robustness of the internal control environment for RBS's customer-facing businesses, and its support and control functions. This informs the control environment disclosure in the annual report and accounts.
Integrated Risk Assessment Approach		The GAC reviewed work undertaken on the bank's integrated risk assessment approach which is designed to provide a single approach to the assessment of risk mind sets and behaviours and risk capabilities, leading to a more effective and simplified approach to the assessment of risk culture, the three lines of defence and performance assessments.
Whistleblowing		The GAC received updates on whistleblowing activity and the performance of RBS's whistleblowing service. It monitored the effectiveness of the whistleblowing framework and enquired as to any trends or themes. It also received updates on communications and awareness activity relating to whistleblowing and testing of the framework. The GAC was also advised of the actions RBS has taken to ensure compliance with the new FCA and PRA whistleblowing regulations which applied to RBS from 7 September 2016. In March 2016 the GAC Chairman was appointed as Whistleblowing Champion for RBS, in line with the requirements outlined in the PRA and FCA regulations; this role carries the responsibility for ensuring and overseeing the integrity, independence and effectiveness of the firm's whistleblowing arrangements.

Ledger Transformation Programme		The GAC received updates in relation to the delivery of the new general ledger, the introduction of which has been overseen by the GAC. The new ledger replaces previous legacy systems and supports new functionality such as discrete legal entity views and multi-currency accounting on a single ledger platform. The GAC was provided with updates on the recommended actions and plans to deliver the programme and the key risks and challenges it presented.
Taxation		The GAC reviewed RBS's tax position, including a deep dive on Tax in October 2016 which covered; the structure of the Tax team, Tax Risk within the Risk Management Framework, material tax risks and disputes, UK Corporate tax compliance, deferred tax assets, VAT risks and challenges, external tax developments and the key projects on which the tax team are engaged.
Litigation and Regulation		The GAC considered regular reports on most significant legal risks and developments affecting RBS, including relevant updates on ongoing major litigation and investigations, privacy and competition issues, legal risks within structural reform and recovery and resolution planning, as well as material emerging legal risks and/or changes in law or regulation and any recent provisions and settlements or recoveries. Key themes and observations from RBS's Sensitive Investigations Unit were also highlighted to the GAC.
Notifiable Event Process		The GAC received bi-annual reports on control breaches which are captured by RBS's notifiable event process. Process-related errors were the main root cause of Major notifiable events escalated in 2016. Throughout 2016 senior management has actively promoted an open culture around raising GNEPs and regularly reinforced that these are integral in helping the bank's employees learn from their mistakes. Under this process all Board directors were alerted to the most significant breaches.
Fraud		The GAC reviewed management's processes for identifying and responding to the risk of fraud.
Sarbanes-Oxley Act of 2002		The GAC considered RBS's compliance with the requirements of the Sarbanes-Oxley Act of 2002, and was satisfied in this respect. RBS had no Material Weaknesses as at 31 December 2016, however Significant Deficiencies were identified relating to legal entity recharge arrangements and action is being taken by Management to improve these processes. The GAC has also overseen RBS's drive to continue to improve its SOX processes.

## Report of the Group Audit Committee

Key area		Matters considered and action taken by the Committee
<b>Systems of internal control</b>		
Market Abuse Regulation		The GAC considered the impact of the Market Abuse Regulation which took effect in July 2016. The GAC noted the main changes to disclosure requirements and the processes implemented by RBS to address these. This included the establishment of a sub-committee of the executive disclosure committee to consider potential instances of inside information, including whether there are any grounds for delaying disclosure under the Market Abuse Regulation, and escalate these as required to the GAC and Board.
<b>Internal audit</b>		
Reports and Opinions		The GAC received quarterly reports and opinions from Internal Audit throughout 2016. These reports and opinions updated the GAC on the effectiveness of the governance, risk management and internal control framework, ongoing issues and the adequacy of remediation activity. The full year and half year reports included Internal Audit's opinion in relation to RBS's Risk & Control Environment and its Risk & Control Awareness. Internal Audit are now using the new simplified bank-wide risk and control rating metrics, which came into effect on 1 January 2016. The new metrics align the way RBS assesses its risks and controls across the first, second and third lines of defence. The GAC received updates on management's response to Internal Audit's findings and challenged management as to progress on remediating such findings.
Annual Plan and Budget		The GAC considered and approved Internal Audit's plan for 2017, which is focused on the highest risks faced by RBS. The GAC also considered Internal Audit's budget and was satisfied that this was sufficient to allow Internal Audit to deliver the plan.
Internal Audit Charter		Updates to Internal Audit's charter, to reflect changes in reporting structures and amendments to the Institute of Internal Auditors

		International Standards, were approved by the GAC and the GAC confirmed the independence of Internal Audit.
Visits		During two visits to Internal Audit in 2016, the GAC received updates on a variety of issues impacting the internal audit function, including; resourcing, bench strength, risk mindset and behaviours, strategic priorities, use of data analytics and internal quality assurance.
Chief Audit Executive		The Chief Audit Executive continued to report to the Chairman of the GAC, with a secondary reporting line to the Chief Executive for administrative purposes. The GAC assessed the annual performance (including risk performance) of the Chief Audit Executive.
Annual Evaluation		The annual review of effectiveness of Internal Audit was undertaken internally in 2016. Under the evaluation process feedback on Internal Audit was provided by GAC members and attendees (including the external auditors), chairmen of subsidiary audit committees, key members of business risk committees and other key members of management. The evaluation concluded that Internal Audit had operated effectively during the year. Certain recommendations were made to aid continuous improvement within the function; these will be implemented during 2017 and progress will be tracked by the GAC.
<b>Relationship with regulators</b>		
Regulatory Relationships, Risk of Enforcement and Upstream Risk		The GAC received a report on the status of RBS's relationships with its key regulators, the status of regulatory reviews, including any reviews at risk of potential enforcement action in 2016, and key upstream risk developments. The GAC Chairman also attended continuous assessment meetings with the PRA and FCA, meetings with the Bank of England and other audit committee chairmen and trilateral meetings with the PRA and external auditor.
	<b>External audit</b>	
Transition of auditors		The GAC supervised the transition of the external auditor from Deloitte to EY during 2016 with EY assuming the role of external auditor for RBS at the end of March 2016. The Board will recommend the appointment of EY as external auditor to shareholders for approval at the Annual General Meeting.
External Audit Reports		Jon Bourne has been EY's lead audit partner for RBS since EY assumed the role of external auditor in March 2016. Jon Bourne attends each meeting of the GAC and reports to the GAC on the external auditor's observations and conclusions from the year-end audit and half-year review of The Royal Bank of Scotland Group plc, The Royal Bank of Scotland plc and National Westminster Bank Plc, work in connection with the Q1 and Q3 financial results and any recommendations for enhancements to RBS's reporting and controls.
Audit Plan and fees		The GAC received updates in relation to the external auditor's 2016 plan and approved the 2016 audit fees including the fee for the 2016 interim results. The GAC was authorised by shareholders at the Annual General Meeting to fix the remuneration of the external auditors.



## Report of the Group Audit Committee

Key area		Matters considered and action taken by the Committee
<b>External audit</b>		
Annual Evaluation		The GAC conducted an internal evaluation to assess the independence and objectivity of the external auditor during 2016. This review included an evaluation of the effectiveness of the audit process and sought the views of the GAC members, attendees and other key members of management. Regard was had to the external auditor's mindset and culture, skills, character and knowledge, quality control and judgement. The evaluation concluded that the external auditor was operating effectively. A number of recommendations for continuous improvement were identified which the external auditor has agreed to take forward during 2017. Following the evaluation the GAC recommended that the Board seek the reappointment of EY as external auditor at the next annual general meeting.
CASS Opinions		At the GAC's request the external auditor presented the results of its assurance procedures on compliance with the FCA's Client Asset Rules for RBS's regulated legal entities for the year ended 31 December 2015. The GAC also considered the CASS Audit plan for 2017, the findings of which will be reported to the GAC once the audit is complete.
External Audit Report to the PRA		The GAC considered the 'dry run' report to the PRA by the external auditor for the 2015 year end. The report responded to specific questions posed by the PRA. This report was produced in preparation for implementation of auditor reporting for the largest UK banks which is required for 2016 year ends, in line with the proposals set out in PRA consultation paper CP8/15.
<b>Audit and non-audit services</b>		
Non-audit services policy		To help safeguard the objectivity and independence of the external auditor, the GAC maintains a policy that sets out the circumstances in which the external auditor is permitted to supply audit and non-audit services. EY were appointed RBS's external auditors in March 2016 but they have been subject to the policy since becoming independent from RBS in 2015 in the lead up to their appointment.



The GAC reviews the non-audit services policy at least annually to ensure it remains fit for purpose. During 2016 the GAC approved a number of amendments to the policy to ensure it met the requirements of the EU Audit Regulation and also to streamline to operation of the policy.

In accordance with the policy, all audit services and permitted non-audit services are approved in advance.

Under the policy certain services are classed as Audit-Related Services and these may be approved by the Director of Finance, on behalf of the GAC, up to a limit of £100,000 each financial quarter. Engagements for Audit-Related Services in excess of this quarterly limit require the approval of the GAC Chairman. All Audit-Related Services are reported to the GAC quarterly.

The GAC has also delegated authority to the Director of Finance to approve the provision of services by the external auditor to non-consolidated subsidiaries of RBS within an annual cap and to approve engagements with the external auditor where RBS has limited or no influence in the selection process. All such engagements are reported to the GAC each quarter.

For all other permitted non-audit service engagements, where the fee is below £5,000 approval by the Director of Finance is required. Where the fee is above £5,000 but below £100,000 approval by the GAC Chairman is required. For engagements where the fee is expected to exceed £100,000 a competitive tender process must be held and approval of the full GAC is required. In addition all engagements must be approved by the Director of Finance and by Supply Chain Services. All such ad hoc approvals of non-audit services are ratified by the GAC each quarter.

## Report of the Group Audit Committee

	Key area	Matters considered and action taken by the Committee
	<b>Audit and non-audit services</b>	
	Non-audit Services Policy	<p>During 2016, the current and previous external auditors were approved to undertake the significant engagements set out below whilst in the role of external auditor:</p> <ul style="list-style-type: none"> <li>• Deloitte were engaged to prepare an audit opinion, required by the PRA confirming the level of asset run down in RBS Capital Resolution, taking into accounting outstanding liabilities/indemnities to any disposed asset; details of any residual assets and how these will be managed following the closure of RBS Capital Resolution; and details of any ongoing obligations RBS will have to any disposed assets;</li> <li>• Deloitte's role as Reporting Accountant for Williams &amp; Glyn was extended, to permit them to prepare a financial 'fact pack' to support the trade sale marketing of Williams &amp; Glyn;</li> <li>• Deloitte were engaged to support Williams &amp; Glyn with validation, review, quality assurance and documentation activities in relation to Williams and Glyn's capital stress plan;</li> <li>• Deloitte were engaged to support the first phase of a Central Bank of Ireland mandated investigation into tracker mortgages in Ulster Bank Rol. This first phase comprised the development and submission of a detailed plan for conducting the investigation and ensuring that appropriate governance was in place;</li> <li>• EY were engaged to review historical and prospective financial information for certain parts of the business;</li> <li>• EY were engaged to provide an assurance opinion for an information request from the European Commission in connections with its competition</li> </ul>

investigation into pre-2012 FX currency trading; and

- EY were engaged to audit the control environment and control objectives for RBS and Ulster Bank's internal reporting procedures relating to the Scottish & Northern Ireland Banknote Rules 2011 and the Note Circulation Scheme Rules, as required by the Bank of England.

The decision to approve the engagement of the external auditor for the services noted above was due to factors including synergies and efficiencies relating to the audit work, their existing knowledge of RBS which allowed work to commence quickly and with minimal disruption and the benefits in maintaining consistency between similar engagements. In each case the GAC was satisfied that the engagement did not impact the external auditor's independence.

Although RBS's previous external auditors are no longer subject to independence requirements, they do have an ongoing role to consent to the release of its prior period audit opinions for US reporting purposes (statutory and comfort letter related). Given any requirement to perform additional audit work for historic periods would require previous external auditors to re-establish independence, a number of safeguards relating to their appointment remain in place under the policy, including the requirement for engagements with Deloitte to be approved by the GAC or on its behalf by the Director of Finance (depending on the value of the engagement. Since Deloitte have been removed from independence requirements with these safeguards in place they have been engaged as follows:

- to provide additional quality assurance over management's assessment of the adequacy of SOX 404 control design and management's testing of the effective operation of SOX 404 controls;
- as the skilled person to support the Bank's ring-fencing programme;
- in relation to the remediation of the tracker mortgage book in Ulster Bank;

		<ul style="list-style-type: none"><li>• to provide resource support to help technology teams to implement and embed a new Technology delivery framework and;</li><li>• to support the second phase of the Central Bank of Ireland mandated investigation into tracker mortgages in Ulster Bank. This second phase of work involves a review of Ulster Bank Ireland DAC's 2001-2015 mortgage loan book in line with the Central Bank of Ireland 'Framework for Conducting the Tracker Mortgage Examination'.</li></ul> <p>Further details of the non-audit services that are prohibited and permitted under the policy can be found on rbs.com. Information on fees paid in respect of audit and non-audit services carried out by the external auditor can be found in Note 5 on the consolidated accounts on page 412.</p>
<p>Brendan Nelson Chairman of the Group Audit Committee</p>		

**Report of the Board Risk Committee**

**Letter from Baroness Noakes**

**Chairman of the Board Risk Committee**

**“RBS as a whole is on a journey towards a robust, well managed control environment”**

Dear Shareholder,

Executive Committee

The Committee had a challenging programme of risk issues to consider in 2016 and the report that follows provides details of the topics reviewed and debated by the Committee during the year. The Committee reviewed and provided oversight of the risk profile of the bank relative to the bank's strategy and risk appetite against the backdrop of an economic environment which is challenging for the bank and which was made more uncertain following the outcome of the EU referendum.

### Strategic Risk and Transformation

The Committee continued to devote considerable attention to the demanding bank-wide transformation programme in 2016. In particular, it considered execution and delivery risk on behalf of the Board and monitored the amount of change risk faced by the business. We focused on the impact of transformation plans on the bank's control environment and on the control transformation workstream which is a key part of the overall programme. End to end risk and control assessments for material processes were carried out during 2016 and in 2017 we will be overseeing the improvement actions which are needed. The broader cost and control objectives of the transformation programme will continue to be a key priority in 2017 and future years.

Delivery of the Williams & Glyn separation programme remained a significant area of focus of the Committee in the first half of the year. In light of the delivery challenges, the Board decided to change its strategic direction and the committee subsequently focused on the wind-down of the programme.

As the year progressed, increasing agenda time was devoted to the implementation of the bank's ring-fencing programme as the programme moved from the design phase into the execution phase. The Committee reviewed the revised baseline plan before submission to the regulator and oversaw the development of an integrated assurance programme for the project involving Risk, Internal Audit and external third party assurance.

### Control Environment

RBS as a whole is on a journey towards a robust, well-managed control environment and the Committee reviews the control ratings of significant business areas twice a year. Challenges are greatest within the bank's NatWest Markets (formerly CIB) franchise and we reviewed management's plans to strengthen substantively its control environment and address known weaknesses. We will oversee the effective delivery of those plans, relying in particular on more detailed challenge in the second line of defence.

## Report of the Board Risk Committee

### Risk Appetite

The bank's risk appetite framework provides a structured approach to risk taking and the committee reviewed proposed enhancements to the framework prior to Board approval. We have extended our detailed examination beyond the suite of strategic risks to all material risk categories via a series of in depth reviews of the individual risk appetite statements and related metrics. These sessions enabled essential preparatory work to be undertaken prior to transitioning to a Board approval framework for these material risks in 2017. We will continue to supervise closely the maturing risk appetite framework, including remediation where breaches of material risk appetite are identified, in the year ahead.

### Stress Testing

The bank conducted a number of stress tests in 2016 including the European Banking Authority and Bank of England stress tests in addition to its own internal stress tests. The Committee played a vital role in reviewing the scenarios and assumptions deployed and in ensuring that the outputs of the tests were subjected to a high degree of scrutiny and challenge. The Committee also oversaw enhancements to the bank's stress testing capability and this will remain a priority in 2017.

### Other

Other material areas of Committee focus during the year have included:

- conduct risk and the oversight of on-going regulatory investigations and remediation;
- the capital and liquidity position of RBS and related regulatory submissions;
- cyber security including the outcome of RBS's participation in a cyber testing initiative led by the Bank of England (CBEST);
- risk culture, the three lines of defence model and risk performance assessments, now being combined into an integrated risk assessment process; and
- continued refinements to risk reporting.

### Key priorities for 2017

The bank has made significant advances this year towards its goal of becoming a stronger, simpler and fairer bank. However, while progress has been made, more work is required before the bank will be operating fully within risk appetite and the Committee will keep this under review in 2017. In the coming year the Committee will also continue to oversee the work being carried out under the bank's significant change programmes and the impact of those initiatives on the risk profile of the bank. Other areas of focus of the Committee will include cyber risk, IT resilience and assessing the impact of external factors on the

bank's risk profile.

I would like to conclude by welcoming Frank Dageard to the Committee and by thanking my fellow Committee members for their continued support and diligence throughout the year. I would also like to extend my gratitude to Robert Gillespie, who stood down as a member in August, for his valuable contribution.

Baroness Noakes

Chairman of the Board Risk Committee

23 February 2017



## Report of the Board Risk Committee

### Report of the Board Risk Committee

#### The role and responsibilities of the Board Risk Committee

The Board Risk Committee (BRC) assumes responsibility on behalf of the Board to provide oversight of current and potential risk exposures and future risk strategy, including the determination of risk appetite and tolerance, and to promote a culture of risk awareness within RBS.

The BRC's responsibilities are set out in more detail in its terms of reference which are reviewed annually by the BRC and approved by the Board. These are available on RBS's website: [rbs.com](http://rbs.com).

#### Membership

The Board Risk Committee comprises independent non-executive directors. Details of the skills and experience of each of the BRC members are set out in their biographies on pages

55 to 57.

		Attended/ scheduled
Baroness Noakes (Chairman)	9/9	
Frank Dangeard (1)	3/3	
Morten Friis	9/9	
Penny Hughes	9/9	
Brendan Nelson	9/9	
Former Members		
Robert Gillespie(2)	6/6	

Notes:

(1) Appointed to the committee on 4 August 2016.

(2) Stood down from the committee on 4 August 2016.

Brendan Nelson is chairman of the Group Audit Committee of which Baroness Noakes and Morten Friis are also members. Penny Hughes is chairman of the Sustainable Banking Committee. This common membership across Committees helps to ensure effective governance across the committees.

BRC meetings are also attended by the RBS Chairman, relevant executives, including the Chief Executive, Chief Financial Officer, Chief Risk Officer, Chief Conduct & Regulatory Affairs Officer, Chief Legal Officer and General Counsel and Chief Audit Executive, and the lead partner of the External Auditor. External advice is sought by the BRC, where appropriate.

## Report of the Board Risk Committee

### Meetings and visits

Nine scheduled meetings and six ad hoc meetings were held in 2016. The ad hoc meetings were required to consider: the results of various phases of internal and external stress tests; the Ring-Fencing Revised Baseline Plan; and the draft budgets and related stress test outputs.

In 2016, members of the BRC, in conjunction with members of the Group Audit Committee, undertook a programme of visits to focus on various businesses and control functions including bi-annual visits to Risk and C&RA. The purpose and scope of this programme is discussed in detail in the Report of the Group Audit Committee above.

The BRC also held in-depth sessions on risk reporting and the legal entity framework and associated capital requirements.

### Performance Evaluation

The annual review of the effectiveness of the Board and its senior Committees, including the Board Risk Committee, was conducted internally in 2016. The BRC has considered and discussed the outcomes of this evaluation and accepts the findings. Overall the review concluded that the Board Risk Committee continued to operate effectively. However, certain recommendations for action were recognised including the need to: rebalance the agenda of the BRC to ensure sufficient focus on the most pertinent risks and reduce the length of meetings; place more reliance on executive committees to reduce pressure on the BRC' agenda; and hold Executives to account for sign-posting key issues and escalating a unified position from all three lines of defence.

The review included a small number of general recommendations which are relevant for both the Board and its senior committees. Key themes and actions arising from these general recommendations are set out in the Board report on page 74 and will be considered, and addressed as appropriate, at Board level.

The outcomes of the evaluation have been reported to the Board and the BRC will track progress on its 2017 priorities during the year.

### Allocation of Board Risk Committee agenda time:

Current risk profile and issues	26%
Change agenda and large projects	10%
Process, policies and risk appetite	15%
Regulatory returns and stress testing	15%
Accountability and remuneration	6%
Risk, conduct and regulatory affairs focus sessions	13%
Franchise and function focus sessions	15%
Total	100%

## Report of the Board Risk Committee

### Matters considered by the Committee in 2016

Key area	Issues considered and Action taken by the BRC
<b>Risk Profile</b>	
Reporting	<ul style="list-style-type: none"> <li>• Provided oversight of RBS's risk profile relative to RBS's strategy and risk appetite through the review of emerging risks and changes in RBS's most significant portfolios and operations, as presented within the comprehensive Risk Management Report. In order to focus on changes in the RBS's risk profile and to highlight trends, the BRC transitioned during the year to taking this report on a quarterly basis. A short form risk report was considered at all other meetings.</li> <li>• Received oral updates from the Chief Risk Officer and Chief Conduct and Regulatory Affairs Officer on the most current and material risks at each meeting. This enabled the BRC to discuss RBS's top risks and whether these were being managed effectively; whether RBS was operating within risk appetite; and whether business change was being managed effectively.</li> <li>• Held an in-depth session on risk reporting in October 2016 which led to additional recommendations for refinements to the form and content of reporting. Management will progress these improvements during 2017.</li> </ul>
External developments	<ul style="list-style-type: none"> <li>• Received reports from the Chief Risk Officer at each meeting highlighting external developments with the potential to affect RBS's ability to meet its strategic objectives or continue its operations. This included updates on the global economic environment, including developments in the US, Europe and China and associated impacts on financial markets; regulatory proposals for potential future capital requirements; and preparation for, and the impact of, the EU referendum result.</li> </ul>
General Counsel's report	<ul style="list-style-type: none"> <li>• The General Counsel reported to the BRC at each meeting on current and emerging key legal developments and risk and significant litigation risks affecting RBS.</li> </ul>
US Risk Committee	<ul style="list-style-type: none"> <li>• Received quarterly reports from the Chairman of the US Risk Committee on the key matters discussed at that forum. The US Risk Committee was established in May 2016 in response to US regulatory requirements and comprises Morten Friis as Chairman, the Chairman of the Board Risk Committee and the RBS Chief Financial Officer. It provides oversight of the risk management framework of RBS's combined US operations, including the review and approval of US risk management policies and material submissions to US regulators.</li> </ul>
<b>Strategic Risk</b>	

Transformation	<ul style="list-style-type: none"> <li>• Kept the execution risk of the RBS-wide transformation programme under review, receiving regular updates from the transformation team on progress, including independent opinions from Risk, C&amp;RA and Internal Audit.</li> <li>• Considered progress against plan and reviewed interdependencies with other significant change programmes and key threats to delivery. In particular, the impact of the Williams &amp; Glyn programme on transformation was monitored. Reviewed the impact of 2016 cost reductions and the 2017 budget restrictions on the programme.</li> <li>• Requested focus sessions on the controls transformation workstream, in particular the prioritisation and completion of the Risk and Control Assessments planned in 2016. A report was received from Internal Audit on the robustness of the assessments and the BRC will oversee management's plans to enhance processes and to remediate control weaknesses identified through completion of the exercise.</li> </ul>
Williams & Glyn	<ul style="list-style-type: none"> <li>• In Q1 2016, exercised oversight of the risks and challenges to the planned physical separation of assets in advance of the divestment of Williams &amp; Glyn, confirming appropriate governance and assurance processes were in place for the programme.</li> <li>• Received independent reports on progress from Risk and Internal Audit, supplemented by independent third party assurance on progress.</li> <li>• Received updates on the wind-down of the separation programme after the decision of the Board not to proceed with this method of divestment and considered the impact of the decision upon people, costs, records management and security. Reviewed the impact of the change in strategic direction upon other key deliverables.</li> </ul>
Ring-fencing Implementation plan	<ul style="list-style-type: none"> <li>• Considered the key risks of the implementation of the ring-fencing programme as it moved from the design phase into execution in H2 2016, including reviewing the revised baseline plan and endorsing its submission to the PRA.</li> <li>• Oversaw the development of an integrated assurance programme involving Risk, Internal Audit and external third party assurance.</li> </ul>

## Report of the Board Risk Committee

Key area	Matters considered and action taken by the BRC
<b>Strategic Risk</b>	
Change Risk	<ul style="list-style-type: none"> <li>Discussed the change risk profile of RBS and the prioritisation and impact of mandatory change programmes and considered the agreed risk appetite statement and measures used to assess change risk across RBS. Suggested refinements to the processes for assessing change risk and the acceptable volume of change.</li> </ul>
Client Pricing for Assets and Liabilities	<ul style="list-style-type: none"> <li>Reviewed the client pricing process against regulatory requirements to ensure that the pricing of liabilities and assets takes into account RBS's business model and risk strategy. The BRC noted that additional testing would be undertaken and enhancements made to the process. An annual review will be undertaken in future years.</li> </ul>
<b>Enterprise Wide Risk</b>	
Risk appetite	<ul style="list-style-type: none"> <li>Reviewed the risk appetite governance framework for 2016; provided feedback on the mechanism for managing and escalating breaches of risk appetite; and made suggestions in relation to simplification of the framework, before recommending this to the Board for approval.</li> <li>Reviewed risk appetite for strategic risks (earnings volatility, RBS-wide and functions, funding and equity investors) and subject to suggested refinements, recommended this to the Board for approval.</li> <li>Refreshed governance arrangements for material risks and put in place plans to transition to a Board approval framework for the most significant risks in 2017. This involved a number of in depth reviews of risk appetite throughout the year in relation to the following risk areas: tax, pensions, records management, payment processing, IT stability &amp; resilience, people, reputational, traded market risk, non-traded market risk, business risk, financial reporting, legal entity risk, operational risk, information and cyber security, retail credit, mortgage risk, wholesale credit, commercial real estate, acquisition risk, settlement risk and conduct risk.</li> <li>Reviewed the cascade of RBS-wide risk appetite to franchises and functions and the alignment between strategic and material risk appetite statements.</li> <li>Considered the use of risk capacity (being the parameters within which risk appetite is set) and agreed risk capacity limits for strategic risks.</li> </ul>
Stress testing	

	<ul style="list-style-type: none"> <li>• In Q1 2016, the BRC considered the results of the 2015 budget and forecast stress testing and reviewed Internal Audit's planned activity for assessing stress testing in 2016.</li> <li>• During the year, the BRC considered the underlying assumptions and scenario selection for the external Bank of England stress test, including Internal Audit's opinion, making recommendations to the Board as appropriate.</li> <li>• Provided challenge and scrutiny to the results of the three phases of the 2016 EBA stress test and the results of the 2016 Bank of England stress test.</li> <li>• Reviewed the results of the reverse stress test and made recommendations to the Board in this regard.</li> <li>• In H2 2016, the BRC considered the 2016 budget and forecast base and stress scenarios together with opinions from the three lines of defence and draft outputs and made recommendations to the Board in this regard.</li> <li>• Oversaw enhancements to RBS's stress testing capability, in particular the remediation actions taken in response to the PRA review of stress testing capability.</li> </ul>
Model risk framework	<ul style="list-style-type: none"> <li>• Oversaw the development of a new model risk framework designed to deliver improvements in the management of model risk. This included reviewing progress in remediating areas of identified weaknesses such as model validation and the restructure of model risk management team.</li> </ul>
Integrated risk assessment process	<ul style="list-style-type: none"> <li>• Reviewed work undertaken by RBS to understand its risk culture and approaches to its assessment against a clearly articulated target culture. Considered the proposed Integrated Risk Assessment approach which was designed to provide a single approach to the assessment of risk mindsets and behaviours and risk capabilities leading to a more effective and simplified approach to the assessment of risk culture, the three lines of defence and performance assessments.</li> <li>• The BRC reviewed the output of the pilot of the revised approach within certain functions and franchises and Risk.</li> </ul>
RDAR	<ul style="list-style-type: none"> <li>• Monitored progress towards full compliance with the Basel Principles on Effective Risk Data Aggregation and Reporting (RDAR). Received a report from Internal Audit on material compliance with RDAR principles and oversaw communications with the PRA in this regard. The BRC will continue to ensure that areas requiring additional improvement are remediated in 2017 alongside plans to achieve full compliance.</li> </ul>





## Report of the Board Risk Committee

Key area	Matters considered and Action taken by the BRC
<b>Enterprise Wide Risk</b>	
Risk Assurance	<ul style="list-style-type: none"> <li>Received quarterly reports on issues highlighted by reviews conducted in each of the three franchises by Credit Quality Assurance, Market Quality Assurance, Control Assurance and a newly created Stress Testing Assurance team.</li> </ul>
<b>Market, Credit and Operational Risk</b>	
Credit, Market and Operational risk MI	<ul style="list-style-type: none"> <li>Reviewed RBS's risk profile relative to credit, market and operational risk, and examined detailed management information (MI) within the Risk Management report in this regard.</li> </ul>
Control Environment Certification	<ul style="list-style-type: none"> <li>Received bi-annual reports on the Control Environment of the franchises and functions and sought management's assurance that appropriate measures were in place to ensure that the businesses could continue to operate safely, where control weaknesses had been identified.</li> </ul>
NatWest Markets (formerly CIB) Control Environment Remediation	<ul style="list-style-type: none"> <li>Reviewed and challenged management plans to remediate and strengthen the conduct and control environment across the NatWest Markets franchise. Received reports on specific remediation issues and control issues including, Trade and Transaction Reporting; Collateral Management Algorithmic Trading and Intra-Day Risk; IMA waiver and capital implications; and surveillance measures and potential enhancements.</li> <li>Reviewed management's transformation plans for the business, including how these would impact remediation, mandatory change and the control environment.</li> <li>Received reports following challenge by the second line of defence and the Technical Executive Risk Forum of management's views of progress against expected outcomes.</li> </ul>
Payments	<ul style="list-style-type: none"> <li>Received progress reports in relation to the payments transformation programme, designed to remediate weaknesses in the payments infrastructure and provide a platform to support mandatory change.</li> <li>Requested updates on compliance with the Payment Card Industry Data Security Standards and Wire Transfer Regulations (WTR) and considered an Internal Audit report on WTR compliance.</li> </ul>
Resilience, security and cyber risk	<ul style="list-style-type: none"> <li>The BRC received bi-annual reports on security and resilience and requested a separate update on cyber security. This included a report on the controls and defences in place, an update on improvements identified via RBS's participation in CBEST (a cyber testing initiative led by the Bank of England), and a summary of the alignment of the RBS's security policy with</li> </ul>

	the ISO standards.
Material credit exposures	<ul style="list-style-type: none"> <li>• Oversaw the Executive Credit Group (ECG) receiving a summary of the decisions made by the ECG in the period. Reviewed the most material credit decisions made in 2015 and examined trends in the market.</li> <li>• Approved a revised governance for large credit exposure decisions, designed to enhance the level of BRC and Board oversight.</li> </ul>
Other operational risks	<p>The BRC also reviewed reports in relation to:</p> <ul style="list-style-type: none"> <li>• the potential risks posed by end of life software;</li> <li>• simplification of the RBS Policy Framework. The BRC requested that greater analysis of the volume of exceptions to policy be undertaken; and</li> <li>• data quality. Following review of progress against a detailed plan, the BRC was pleased to note significant progress in this area.</li> </ul>
<b>Capital and Liquidity Risk</b>	
ICAAP and ILAAP	<ul style="list-style-type: none"> <li>• In Q2 2016 the BRC reviewed the draft Internal Capital Adequacy Assessment process (ICAAP) along with an Internal Audit review and recommended the document to the Board for approval subject to certain enhancements.</li> <li>• In Q3 2016 the BRC reviewed both the scenarios assumptions for the 2016 Internal Liquidity Adequacy Assessment Process (ILAAP) and the final ILAAP submission and, after due consideration, recommended them to the Board.</li> </ul>
Recovery and Resolution planning	<ul style="list-style-type: none"> <li>• Oversaw the first part of a two year remediation process in designed to deliver a recovery plan in line with industry best practice.</li> <li>• Examined and commented upon the draft 2016 recovery plan and resolution pack and recommended them to the Board for approval. Approved the final version of the recovery plan under delegated authority from the Board.</li> </ul>
Capital Management	<ul style="list-style-type: none"> <li>• Reviewed the progress of the capital management capability enhancement programme.</li> <li>• Received an update on proposed regulatory changes to capital requirements and noted the areas most likely to be impacted and the likely implementation timescales.</li> </ul>

## Report of the Board Risk Committee

Key area	Matters considered and Action taken by the BRC
<b>Capital and Liquidity Risk</b>	
Legal entity control & risk framework	<ul style="list-style-type: none"> <li>Held a detailed session on the internal finance and risk processes relating to subsidiary legal entities in June 2016 and considered an update on the legal entity operating model later in the year, with a particular focus on specific enhancements being developed to improve the robustness of the legal entity control and risk framework. Supported management's plans to create an RBS-wide programme to build legal entity capability and deliver a coordinated framework focusing on specific legal entity control and assurance requirements.</li> </ul>
<b>Conduct, Regulatory and Remediation</b>	
Representations to Regulators	<ul style="list-style-type: none"> <li>Reviewed the assurance and governance in place to support representations to regulators.</li> <li>Reviewed attestations requiring Board level approval, including a US Volcker Rule attestation and representations relating to controls in place within the FX business.</li> </ul>
Financial Crime	<ul style="list-style-type: none"> <li>Discussed the Group Money Laundering Reporting Officer's (MLRO) Annual Report 2015 and recommended it to the Board.</li> </ul>
Other conduct risks	<p>The BRC also reviewed reports in relation to:</p> <ul style="list-style-type: none"> <li>the European Markets Infrastructure and Markets in Financial Instruments regulations;</li> <li>progress to meet the requirements of the European Deposit Guarantee Scheme;</li> <li>RBS's and NatWest's compliance with the FCA client assets rules (CASS) and recommended the reports to the Board for approval;</li> <li>the New Product Risk Assessment (NPRA) process;</li> <li>complaints performance improvement; and</li> <li>individual regulatory investigations and remediation.</li> </ul>
<b>Risk and Conduct &amp; Regulatory Affairs</b>	
	<ul style="list-style-type: none"> <li>Oversaw the performance and the independence of the Risk and Compliance functions, through undertaking bi-annual visits to Risk and Conduct &amp; Regulatory Affairs during which the BRC considered people and succession planning, budget and the resource capability of both functions. Received quarterly dashboards of key management information covering headcount, comparisons to budget, high performing staff turnover and</li> </ul>

	<p>outputs of staff surveys.</p> <ul style="list-style-type: none"> <li>Assessed the performance of the Chief Risk Officer and Chief Conduct &amp; Regulatory Affairs Officer.</li> </ul>
<p><b>Accountability and Remuneration</b></p>	
	<p>Continued to provide oversight over the risk dimension of performance and remuneration arrangements, working closely with the Group Performance and Remuneration Committee. The Report of the Group Performance and Remuneration Committee on pages 101 to 149 includes further detail on how risk is taken into account in remuneration decisions. Key matters considered by the BRC included:</p> <ul style="list-style-type: none"> <li>accountability recommendations in respect of significant material events;</li> <li>the risk and control objectives of members and attendees of the RBS's Executive Committee, with additional focus on underlying objectives for the Chief Risk Officer and the Chief Conduct &amp; Regulatory Affairs Officer;</li> <li>an assessment of the risk/conduct performance of members and attendees of RBS's Executive Committee, with recommendations made to the Group Performance and Remuneration Committee as appropriate to inform its decision on pay and awards;</li> <li>an assessment of the risk/conduct performance of the RBS and its businesses, with recommendations made to the Group Performance and Remuneration Committee to inform its decision on adjustments to the annual bonus pools;</li> <li>performance conditions for the RBS's Long Term Incentive Plans and assessment of proposed vesting levels to ensure risk management/conduct performance is fairly reflected in vesting outcomes; and</li> <li>the proposed Executive Director Future Remuneration Policy as detailed on pages 113 to 119 from a risk and control perspective.</li> </ul>

Baroness Noakes  
 Chairman of the Board Risk Committee

**Report of the Sustainable Banking Committee**

**Letter from Penny Hughes**

**Chairman of the Sustainable Banking Committee**

*“Our brand strategy reflects our drive to build a customer focused bank which our people can be proud of and our customers trust”*

Dear Shareholder,

The Sustainable Banking Committee (SBC) is primarily concerned with overseeing, supporting and challenging actions taken by management to promote RBS as a sustainable business, capable of generating long term value for its stakeholders.

Despite a challenging year for the Bank in general, we have made progress on our agenda to build a more sustainable bank. The SBC continues to focus on culture, customers, people, brand & communications and environmental, social and ethical (ESE) issues. Engagement with management continues to be good and we have listened, learnt and acted on challenges and ideas from stakeholders we have spoken to throughout the year.

Our ambition to be number one for customer service, trust and advocacy in each of our chosen business areas remains unchanged. Delivering this ambition depends on our ability to demonstrate beyond question that we are a responsible company, that has learnt from the past, doing business in a sustainable way.

We will earn trust by putting customers first, making RBS a great place to work, supporting our communities, and being mindful of environmental impacts.

## Report of the Sustainable Banking Committee

Progress made in 2016 includes:

- furthering the integration of sustainable banking into our core businesses and increasing transparency of this with the integration of our previously separate Sustainability Report into the main Annual Report;
- encouraging the development of the sustainable banking strategy, meeting the needs of all our stakeholders whilst aligning with RBS's overall strategy;
- overseeing how management is embedding culture and Determined to lead standards within our employee value proposition;
- overseeing the brand strategy to reposition Royal Bank of Scotland, NatWest and Ulster Bank for customers;
- posing and addressing key challenges with management such as the provision of free banking, supporting enterprise and supporting companies or individuals to seek alternative finance when RBS is unable to help;
- challenging management's efforts on meeting the needs of particular customer groups such as high net worth individuals and small and medium sized enterprises;
- ongoing commitment to both internal and external stakeholder engagement through face to face sessions and visits to customer facing businesses;
- reviewing our progress on environmental targets; and
- reviewing complaint handling and the strategy to identify root cause and resolution.

The efforts to build a responsible and sustainable business are being recognised through independent and external measures. We retained our place in the Dow Jones World Sustainability Index with our highest score to date (84) and achieved a leadership category listing in the Carbon Disclosure Project Index (A-).

We are also increasingly being recognised as an attractive employer. RBS was shortlisted at the 2016 National Diversity Awards as well as being shortlisted for Outstanding Employee Network Group of the Year in the European Diversity Awards. We recently came 13<sup>th</sup> in Stonewall's top 100 employers, up from 32<sup>nd</sup> last year.





## Report of the Sustainable Banking Committee

The SBC has also seen tangible evidence of good customer outcomes. RBS is the largest lender to small and medium sized business in the UK and gross lending to our Personal and Business Banking customers is up 29% year on year. Building financial capability remains a focus for RBS with financial health checks available to Personal and Business Banking customers. MoneySense, our flagship financial education programme for

5 –18 year-olds, also continues to grow. Raising awareness of the importance of financial education was supported by a NatWest national advertising campaign last year, along with a new commitment to reach another one million young people with MoneySense by the end of 2018.

The repositioning of our primary customer brands was a significant moment for RBS. The SBC played a role in overseeing and challenging the brand strategy which plays an important role in building a customer focused bank which our people can be proud of and our customers trust.

Over a number of years RBS has experienced a shift by setting out a clear and simple purpose and defining our Values. We have restructured our business, made progress on our service proposition but acknowledge there is more to do, introduced the YES Check and made changes to the way we do some of the fundamentals of banking. The SBC will continue to operate at a strategic level to support management on its journey to reaching our ambition to becoming a more sustainable and truly customer focused bank.

My thanks go to the SBC members and attendees for their contribution and support through another challenging year.

Penny Hughes

Chairman of the Sustainable Banking Committee

23 February 2017

## Report of the Sustainable Banking Committee

## Report of the Sustainable Banking Committee

### Meetings

The Sustainable Banking Committee held six scheduled Committee meetings in 2016 which were attended by the Chief Executive, Chairman, senior representatives from the customer-facing franchises as well as Human Resources, Sustainability, Risk, Conduct & Regulatory Affairs, Communications & Marketing, and Strategy.

### Stakeholder engagement sessions

In addition to ongoing engagement which takes place across our business each day, the Committee has run a proactive engagement programme since 2011 to which we invite external stakeholders to meet with, and challenge, the most senior decision makers in RBS.

We have met with over 50 different groups of NGOs, civil society groups, government bodies, consumer groups and investors in this way and the purpose is to listen and understand where RBS could do more. These discussions help shape future policies, influence strategic priorities and inform decision making across RBS on our journey to becoming a customer focused bank.

In 2016 we held four such stakeholder engagement sessions covering the following topics:

- how to serve and support scale-up, high growth customers beyond start up stage;
- defining the vision of sustainable banking for RBS and taking a bolder, more integrated approach to delivering it;
- financial capability and the key concerns and challenges faced by Irish consumers in relation to their personal finances; and
- what does sustainable banking mean for our culture, our behaviour, our people and our customers?

Following the sessions we identify opportunities for follow up and further engagement. In December, we welcomed back a number of our past guests to share the progress made and invited further challenge and alternative perspectives.

As part of its programme of stakeholder engagement, members of the SBC undertook a visit to Personal and Business Banking which provided valuable insight to the SBC. There are plans for more frontline customer engagement in 2017.

## Membership

The Sustainable Banking Committee comprises four independent non-executive directors. The Chairman and members of the SBC, together with their attendance at meetings, are shown below.

	Attended/ scheduled
Penny Hughes (Chairman)	6/6
Alison Davis	6/6
Robert Gillespie	6/6
Mike Rogers (1)	5/5

Note:

(1) Appointed to the committee on 25 April 2016

## Report of the Sustainable Banking Committee

### Performance evaluation

The annual review of the effectiveness of the Board and its senior Committees, including the Sustainable Banking Committee, was conducted internally in 2016. The Committee has considered and discussed the outcomes of this evaluation and accepts the findings. Overall the review concluded that the Sustainable Banking Committee continued to operate effectively.

In particular, during 2016 the Committee focused on being more forward looking and strategic with its time, focusing on priorities of culture, people, customer, brand & communications and ESE issues. The stakeholder engagement sessions are regarded as a valuable opportunity to learn how well RBS is aligned to external sustainability priorities. During 2017, the Committee will continue to focus on these priorities, and ensure it undertakes a proactive programme of stakeholder engagement.

The outcomes of the evaluation have been reported to the Board and the Committee will track progress during the year.

### Role and responsibilities of the Sustainable Banking Committee

Authority is delegated to the Sustainable Banking Committee by the Board and the SBC reports and makes recommendations to the Board as required. The terms of reference of the SBC are available on rbs.com and these are reviewed annually and approved by the Board. A report on the activities of the SBC in fulfilling its responsibilities is provided to the Board following each meeting. The principal responsibilities of the SBC are shown below:

#### Culture

- receive updates on actions to drive the Board approved culture;
- oversee progress on standards, competence and capability;

#### People

- oversee the Employee Value Proposition and initiatives to ensure a diverse workforce which feels clear, capable and motivated;

## Customer

- oversee customer centricity priorities and how RBS is supporting and engaging with key customer segments;
- oversee progress being made to achieve the long term target of being number one for customer service, trust and advocacy in each of our chosen businesses;

## Brand & Communications

- oversee the brand strategy in moving to a bank of brands approach focusing on building equity in our customer brands;
- oversee actions being taken by management to manage RBS's reputation;

## ESE Issues

- receive reports on managing ESE risk;
- consider RBS's environmental footprint and how RBS is operating in its communities; and
- consider activities being undertaken to support the "green" economy

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**Directors' remuneration report**

**Annual statement from Sandy Crombie  
Chairman of the Group Performance and Remuneration Committee**

*“the focus is on meaningful, long-term shareholding as the mechanism for achieving alignment with shareholders”*

Dear Shareholder,

I am pleased to set out the Directors' Remuneration Report for 2016. This report describes the pay decisions that we took for the last financial year and the new remuneration policy that is being proposed to shareholders for approval at the forthcoming AGM.



## Policy developments in 2016

I know that views on executive pay are continuing to evolve. The government is consulting on areas of reform aimed at strengthening the UK's corporate governance arrangements. A separate industry-led Executive Remuneration Working Group has also set out areas where it is believed that improvement is needed to restore trust in current remuneration practices. RBS continues to contribute to consultations aimed at strengthening governance and pay arrangements.

It is clear many shareholders value simple remuneration structures. The Committee spent a great deal of time considering alternative constructs and how these would align to RBS's cultural aims on pay. The proposed new policy represents a significant change and has two principal aims: to produce greater alignment with shareholders and to discourage the potential for excessive risk taking.

The design focuses on creating alignment by ensuring executives build up larger shareholdings and retain them for longer. This intent is being reinforced by a significant increase in shareholding requirements from 250% to 400% of salary for the Chief Executive and from 125% to 250% for the Chief Financial Officer. The new policy also encourages sustainable long-term performance by having a lower maximum long-term incentive award level, but with performance assessed on factors that the executive would reasonably be expected to achieve, creating a less leveraged construct and encouraging safe and secure growth. The maximum potential long-term incentive award is being reduced by around 40% for the Chief Executive and by around 30% for the Chief Financial Officer.

## Directors' remuneration report

It is also proposed that pro rating of long-term incentive awards will not apply for good leavers under the new policy. The Committee recognises that time pro rating is a common preference for some investors and its removal has only been included after considerable thought, and after consulting with a number of shareholders. The intention is to create high levels of shareholding that persist for a period after leaving and pro rating of awards reduces this alignment. RBS is unusual in having no annual bonus element of pay for executive directors and bonus awards would typically not be subject to pro rating. Furthermore, the policy aims broadly to maintain the expected value of pay to executive directors over their typical tenure in role. This aim is achieved through a combination of reduced award levels, performance factors that are designed to be more within the control of management and the removal of pro rating for good leavers. The circumstances that would be considered for good leaver treatment are set out in more detail in this report.

No change is proposed to the quantum of fixed pay, although fixed share allowances will be released over three, rather than five years to create a more even release of value across fixed and variable pay. A further development is that the pension allowance under the recruitment policy for new executive directors will be reduced from 35% to 25%, bringing the rate closer to that of the wider employee population.

In summary, the focus is on meaningful long-term shareholding as the mechanism for achieving alignment with shareholders. To date, the proposed remuneration policy has been well received in discussions with our largest shareholders.

## Considerations for other employees

The Committee recognises that RBS will only achieve its ambitions if all employees are engaged, motivated and supported by appropriate remuneration structures. Average salaries for our UK employees have increased by 7.5% over the last three years while executive directors' salaries have been static. Our rates of pay continue to exceed the living wage and we have removed sales incentives for front line retail staff and increased fixed pay so that they can concentrate on providing great customer service.

## Financial performance in 2016

Some important milestones were met in 2016. RBS was able to retire the Dividend Access Share in March and this was a key part in normalising RBS's capital structure. Good progress has also been made in resolving a number of major legacy and conduct issues although these continue to affect financial results. Variable pay across RBS is subject to a robust performance assessment process which allows outcomes to be adjusted if risk management or conduct has fallen short of the required standard.

The restructuring of the business has continued during 2016 but there is a strong business at the heart of RBS, capable of delivering sustainable returns for shareholders. The franchises have performed well with adjusted operating profits of £4,249 million for 2016. The Committee's decisions aim to strike a balance in rewarding employees for good performance but recognising RBS is not yet in the position that it needs to be.

## Directors' remuneration report

### Pay decisions for 2016

The Group bonus pool has fallen from £373 million in 2015 to £343 million in 2016, a reduction of 8%. Over 93% of this pool will be paid to those below the executive level. Where employees do receive a bonus, the average amounts remain relatively modest with 50% of employees receiving £2,000 or less and a further 23% receiving less than £5,000. The amount of any immediate cash bonuses continues to be limited to £2,000.

The report sets out further information and I hope shareholders will support the resolutions on remuneration arrangements at the forthcoming AGM. I am very grateful for the guidance and support provided by my fellow Committee members as well as those who assist the Committee over the year. I would also like to thank shareholders for their constructive input as we discussed how best to shape the remuneration policy for the years ahead.

Sandy Crombie

Chairman of the Group Performance and Remuneration Committee

23 February 2017

## Directors' remuneration report

### Key features of the new remuneration policy for executive directors

<b>Key features</b>	<p>The new policy is focused on the long term, aimed at attracting and keeping the right people for RBS.</p> <p>The intent is a policy that aligns executives with shareholders predominantly through holding shares rather than formulaic and unpredictable performance conditions.</p> <p>As a result, shareholding requirements will be significantly increased under the new policy and performance testing of LTI awards will be based on factors that executive directors would reasonably be expected to achieve, encouraging executives to operate within risk appetite.</p> <p>The maximum quantum will be reduced in line with a growing consensus on the need to restrain executive pay.</p> <p>The intention is to create a construct that is more highly valued by executives, by assessing performance on factors considered to be more within the control of management and therefore providing greater certainty of outcomes.</p> <p>Combined with the removal of pro rating for good leavers, the expected value of remuneration delivered to executive directors over time is broadly maintained.</p> <p>Longer vesting and retention periods will apply to LTI awards, with the release of shares over an eight year period, helping to ensure decisions and outcomes reflect a truly long-term timeframe and are even further aligned with the experience of shareholders.</p>
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### How will performance assessment work under the proposed LTI construct?

For each of the core performance areas of Finance, Risk & Operations, Customers and our People, the Committee will consider whether the executive director has over the relevant period achieved what would

reasonably have been expected in the circumstances. The Committee will review performance against factors (examples are set out below) relevant to RBS's strategic objectives in each area, but will apply its judgement without reference to formulaic targets. Performance will be assessed taking into account circumstances applying over the period of assessment which may have affected the achievability of performance objectives. The majority of the performance variation will take place under a pre-grant test, with a pre-vest assessment representing a final check that, taking all circumstances into account, overall performance has been satisfactory. The achievement of reasonable or 'target' performance expectations will deliver full, or nearly full, payout of the LTI awards, reflecting the significantly reduced level of awards.

## **Directors' remuneration report**

Each year, the performance factors will be determined in light of RBS's priorities for that year. The first awards will not be made under the proposed LTI construct until early 2018 and further details will be disclosed in the 2017 annual remuneration report.

The pre-grant test will constitute a collective and individual view of performance over the prior year. No deduction will be made for target performance. Prior to vesting, a pre-vest test will be based on an assessment of collective performance for the year for which the award was made, knowing 'what we know now', and taking into account all circumstances. This is intended to carry a high degree of certainty, and to vest as long as a threshold level of sustainable performance has been delivered.

The aim is to reward sustained performance and, following the application of both the pre-grant and pre-vest assessment, executive directors should expect to receive 80% of the award on average over time provided that they deliver on the performance factors as determined by the Committee. Awards may be reduced, potentially down to zero, further to the application of either the pre-grant or pre-vest tests where there has been significant underperformance or risk management failings.



## Directors' remuneration report

### Comparison of the current and new remuneration policy for executive directors

#### Fixed remuneration - overall, no change in quantum at this time

*Current policy* – **Salary** £1,000,000 for the Chief Executive £800,000 for the Chief Financial Officer **Fixed share allowance** 100% of salary, delivered in shares released over a five year retention period. **Pension allowance** 35% of salary, delivered in cash. **Standard benefit funding**

£26,250

*New policy* - No changes to salary levels are proposed at this time. No change to the fixed share allowance amount but shares will be released over a three year retention period, to create a more even release structure between fixed and variable pay. No change to pension allowance for current executive directors. Policy for new executive directors to be reduced to 25% of salary. No changes to standard benefit funding level.

#### Variable remuneration –significant reduction in maximum potential

*Current policy* - **Long-term incentive award** Underlying award of 400% of salary but with pay-out capped by regulatory maximum which for performance year 2016 equates to 287% of salary. Pre-vest performance measures based on four categories: Economic Profit, Relative TSR, Safe & Secure Bank and Customers & People together with a risk and conduct underpin. A three year performance period and the award vests in equal amounts in years four and five. A six month retention period applies after vesting and the clawback period is seven years from the date of grant.

*New policy* - 175% of salary for the current Chief Executive (currently £1.75 million) and 200% of salary for the current Chief Financial Officer (currently £1.6 million). Pre-grant and pre-vest tests, to consider performance in the round, against what would reasonably have been expected in the areas of Finance, Risk & Operations, Customers and our People. Risk & Control and Stakeholder Perception underpins will apply. Extension of the deferral period with vesting taking place in equal amounts over years three to seven. A 12 month retention period applies after vesting. The clawback period is extended to ten years from grant if events are under investigation at the end of the seven year period.

#### Other elements - better alignment with shareholders

*Current policy* - **Shareholding requirement** 250% of salary for the Chief Executive 125% of salary for the Chief Financial Officer A period of five years is allowed in which to build up shareholdings to the required level. Any unvested share awards are excluded from the calculation. **Leaver treatment** LTI awards held by

good leavers are normally pro rated based on time served during the performance period

*New policy* - 400% of salary for the Chief Executive Unvested LTI awards will count towards the requirement once any pre-vest performance has been assessed, three years after grant. The number of unvested shares that count will be reduced to reflect the estimated tax liability arising on vesting. Once shares are free from their respective retention periods, executive directors will be permitted to sell a maximum of 25% of such shares until the requirement is met. It is estimated that it would take a new Chief Executive five years to meet the 400% shareholding requirement. Executive directors will continue to hold significant shareholdings after leaving and a post-employment shareholding requirement is therefore not considered necessary. Depending on leaver circumstances, it would take between three and eight years for an executive director to fully dispose of RBS shares due to the long vesting and retention periods.

Future LTI awards held by good leavers will not be subject to pro rating for time. Removal of pro rating is a key part of the construct in order to achieve the reduction in maximum opportunity while broadly maintaining expected value to executive directors over their typical tenure in role. It also helps to ensure that individuals retain an appropriate long-term focus right up to the point of departure, as well as providing greater shareholder alignment post employment.

Further details on the new remuneration policy and arrangements for the year ahead can be found in the relevant sections of this report.

**Directors' remuneration report**

**Change in maximum remuneration opportunity**

### Expected target value of remuneration

The new remuneration policy promotes sustainable long-term performance by having a lower maximum LTI award level and performance tests that encourage individuals to operate within risk appetite. The release of shares will extend over an eight year period (vesting over seven years and one year post-vesting retention period), following a year of pre-grant assessment to determine the size of the award.

While the maximum and expected value of pay from a single year's remuneration is being reduced, the policy aims broadly to maintain the expected value of pay to executive directors over their typical tenure in role. The combination of reduced LTI award levels, offset by performance based on factors that the executive would reasonably be expected to achieve and the removal of pro rating for good leavers ensures this aim is achieved.

### Timing of remuneration payments – based on the Chief Executive for the 2017 performance year





## Directors' remuneration report

### Questions and answers on the new remuneration policy

#### Why are changes being made to the policy at this time?

The current remuneration policy was approved by shareholders at the 2014 AGM for a period of three years and is therefore due for renewal at the 2017 AGM. During 2016, the Committee took the opportunity to assess how the remuneration policy could best fit with RBS's culture and pay philosophy for employees.

#### What options did the Committee consider?

During 2016, the Committee reviewed the current policy against a range of factors including the latest guidance from shareholders, regulatory requirements, the external environment and wider social considerations in determining executive pay.

Two main options were identified following the review:

- Adopting an alternative LTI construct to replace the current structure, based on reduced maximum quantum but with performance assessed on factors that the executive would reasonably be expected to achieve; or
- Keeping the current construct with changes limited to those required to comply with regulatory requirements.

After consultation with major shareholders, the Committee believes that the alternative LTI construct provides the best fit with RBS's ambitions as well as being strongly aligned to the creation of long-term shareholder value.

#### What material factors are taken into account when setting remuneration policy?

The intention is to create a remuneration policy that is specific to RBS and its particular circumstances rather than looking to follow standard market practice. The policy aims to reinforce our values and support the delivery of RBS's strategy. The views of shareholders are key in shaping the remuneration policy along with the need to comply with evolving regulatory requirements. The Committee also looks to ensure consistency, where possible, between the executive director policy and pay proposals for the broader employee population. This includes less reliance on variable pay and the use of deferral in shares, malus and clawback to ensure that any variable pay that is awarded is aligned with long-term performance.

### What are the key features of the new policy?

RBS-driven features:

- Maximum potential LTI awards will be reduced;
- Performance assessment is based on factors considered to be more within the control of management;
- The policy encourages executive directors to operate within risk appetite and deliver safe and secure growth;
- Shareholding requirements will be increased;
- Fixed share allowances will be released over a three year rather than a five year retention period, in recognition of the impact of the extended deferral period for LTI awards;
- LTI awards held by executive directors who leave in 'good leaver' circumstances will not be subject to time pro rating, helping to maintain expected value and increasing post employment shareholder alignment; and
- The pension allowance under the recruitment policy for new executive directors will be reduced from 35% to 25% of salary, with a corresponding increase to other elements of fixed pay.



## Directors' remuneration report

Regulatory-driven features:

- Pre-grant performance tests will be introduced;
- The pre-grant performance test has the effect of preventing the grant of an LTI award in the year of joining;
- The deferral period will be extended with awards vesting between years three to seven from the date of grant;
- The retention period that applies after the vesting date will be increased from six months to twelve months; and
- The clawback period is extended to ten years from grant if events are still under investigation after seven years.

### Why will future LTI awards not be subject to pro rating?

The new policy takes into account the significant reduction in maximum opportunity and the regulatory restriction which has the effect of preventing the granting of LTI awards in the first year of employment. The Committee believes that removal of time pro rating for good leavers is fair in order to broadly maintain the expected value of pay over time and is appropriate in RBS's particular circumstances.

RBS is unusual in having no annual bonus element of pay and bonus awards would typically not be subject to pro rating. Under an LTI only construct, removal of pro rating helps to ensure that executive directors are motivated and retain an appropriate long-term focus right up to the point of departure, and also provides greater shareholder alignment and continued accountability for decisions post employment. The departing good leaver retains exposure to RBS shares for up to eight years post leaving due to the long vesting and retention periods that continue to apply.

The removal of pro rating places additional focus on good leaver definitions and further details on the circumstances that will qualify for good leaver treatment are set out on page 120.



## Directors' remuneration report

### When will the new policy be implemented?

Subject to approval from shareholders, the new policy will be effective from the date of the AGM. The changes will be implemented in a transitional period from 2017 to 2018. The fixed share allowance for 2017 will be awarded after the AGM, to be released over a three year retention period, and the first LTI awards under the new policy will be made in early 2018.

### How will LTI awards be made in 2017?

The LTI award to be made in March 2017, for the 2016 performance year, will be the last award made under the existing remuneration policy. This award will include a longer deferral period, with 50% of the award vesting after four years and the remaining 50% vesting in years five to seven, along with an extended clawback period in line with regulatory requirements. Further details for 2017 can be found on page 122 and a summary of the transitional arrangements is set out below.

Awarded in 2017	Awarded in 2018
2017 salary	2018 salary
2017 pension	2018 pension
2017 fixed share allowance (released over 2018-2020)	2018 fixed share allowance (released over 2019-2021)
Current policy LTI for 2016 performance year (vests 50% in 2021, 50% split over 2022-2024)	New policy LTI for 2017 performance year (vests pro-rata over 2021-2025)

### Wider employee considerations

To provide the best possible customer service, RBS is building a strong, simple and fair bank. Performance and pay management is part of that process.

### RBS needs to build an engaged and inclusive workforce, capable of providing excellent customer service.

- Senior leaders are subject to individual and collective performance assessment based on factors which include financial strength and customer service.

- RBS has set a target for each Executive Committee member to have at least 30% women in senior roles (the top three leadership layers) by 2020.
- Gender targets are one of three People measures, together with engagement and leadership, which are considered when assessing performance for some of our senior leaders.
- Employees are motivated by good leadership and almost 16,000 employees undertook our 'Determined to Lead' leadership programme in 2016.
- We have now trained over 60% of employees at all levels of RBS to tackle unconscious bias, helping to remove bias in our recruitment processes, build more inclusive teams, make well informed decisions and better understand and serve our customers.
- In October 2016 we launched Service Excellence, our new customer service programme with over 34,000 employees receiving training so far.
- Professional Standards Frameworks set out the relevant knowledge, skills, and behaviours expected of RBS employees to embed good conduct.
- While employee engagement has been impacted during 2016 by the ongoing restructuring of the business, it remains higher than when we set out our strategic plan in 2014.

## Directors' remuneration report

### RBS is simplifying how employees get paid.

- In Personal & Business Banking, pay for frontline roles is linked to supporting customers, rather than short-term incentive schemes, and this was extended to employees in Ulster Bank with effect from 1 January 2017.
- Our clerical population in the UK and Republic of Ireland now receives only fixed pay, making pay arrangements easier to understand.
- Salary ranges have been updated to reflect the external market and to ensure that people doing the same or similar roles are paid more consistently.

### The Committee must ensure that good behaviours are encouraged and that conduct issues are accounted for.

- The policy aims to pay people appropriately for their work and commitment to serve customers well.
- RBS continues to operate as a fully accredited living wage employer.
- If conduct falls short of the standard expected, the Committee can adjust variable pay awards through malus (reduction or cancellation of awards prior to payment) or clawback (recovering awards that have already been paid).
- Further information on the accountability review process under which malus and clawback can be applied is set out later in this report.
- The Committee aims to strike a fair balance between adjustments to variable pay as a targeted measure to change behaviour whilst not disproportionately penalising employees who are not directly responsible for events.
- As set out below, bonuses have continued to shrink at RBS, aligned with the restructuring that has taken place and the actions taken by the Committee.
- Pay levels reflect the progress made in 2016 and the bank that RBS is becoming, while ensuring our people are fairly and appropriately rewarded for the work they do.

### Bonus pool reduced steadily from 2010 to 2016





## Directors' Remuneration Policy

### Directors' Remuneration Policy

A new Directors' Remuneration Policy is being proposed to shareholders at the forthcoming Annual General Meeting (AGM). Subject to approval being received, the policy will be effective from the date of the 2017 AGM. The policy will apply for three years, until the AGM in 2020, unless changes are required in which case a revised policy will be submitted to shareholders for approval. The objective of the policy is to support the business strategy and promote the long-term success of RBS.

### Fixed pay elements for current executive directors

Fixed pay elements are intended to provide a level of competitive remuneration for performing the role. The intention is to have less reliance on variable pay and thus discourage excessive risk-taking.

#### Purpose and link to strategy

- **Salary** To aid recruitment and retention of high performing individuals whilst paying no more than is necessary. To provide a competitive level of fixed cash remuneration, reflecting the skills and experience required.
- **Fixed share allowance** To provide fixed pay that reflects the skills and experience required and responsibilities for the role. This will be delivered in shares subject to a retention period.
- **Benefits** To provide a range of flexible and market competitive benefits that are valued and assist key individuals in carrying out their duties effectively.
- **Pension** To encourage planning for retirement and long-term savings.

#### Operation

- **Salary** Paid monthly and reviewed annually. The rates for 2017 are unchanged: Chief Executive - £1,000,000 Chief Financial Officer - £800,000

Further details on remuneration arrangements for the year ahead are set out in the annual report on remuneration.

- **Fixed share allowance** A fixed allowance paid entirely in shares. Individuals receive shares that vest immediately subject to any deductions required for tax purposes and a retention period will apply. Shares will be released from the retention period in equal tranches over a three year period. The fixed share allowance will broadly be paid in arrears, currently in two instalments per year(1). The fixed share allowance is not pensionable.



- **Benefits** A set level of funding is provided and executive directors can select from a range of standard benefits including, but not limited to: company car, private medical cover, life assurance, critical illness insurance.

In addition, executive directors are entitled to travel assistance in connection with company business including the use of a car and driver. RBS will meet the cost of any tax due on the benefit. On rare occasions where they are accompanied by their spouse / partner to business events, RBS may also meet the costs and any associated tax liability. Executive directors are also entitled to holiday and sick pay.

Further benefits including, but not limited to, relocation costs (e.g. tax advice, shipment and storage facilities, housing and flight allowances and payment of legal fees) may be offered in line with market practice. RBS may also put in place certain security arrangements for executive directors where that is deemed appropriate.

- **Pension** Provision of a monthly cash pension allowance based on a percentage of salary. Opportunity to use the cash to participate in a defined contribution pension scheme.

### Maximum potential value

- **Salary** Determined annually. Any future salary increases will be considered against peer companies and will not normally be greater than the average salary increase for RBS employees over the period of the policy. Other than in exceptional circumstances, the salary will not increase by more than 15% over the course of this policy.
- **Fixed share allowance** An award of shares with an annual value of up to 100% of salary at the time of award, or such higher amount which represents such value rounded up to the nearest whole share.
- **Benefits** Set level of funding for standard benefits (currently £26,250) which is subject to review.

The total value of benefits provided is disclosed each year in the annual report on remuneration.

The maximum potential value of benefits will depend on the type of benefit and cost of its provision, which will vary according to market rates

- **Pension** Pension allowance for current executive directors of 35% of salary.

Note:

(1) The company believes that delivery in shares is the most appropriate construct for a fixed allowance to executive directors, qualifying as fixed remuneration for regulatory requirements. If regulatory requirements emerge that prohibit allowances being delivered in shares, or deem that such allowances will not qualify as fixed remuneration, then RBS reserves the right to provide the value of the allowance in cash instead in order to comply with the requirements.

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## Directors' Remuneration Policy

### Variable pay

Variable pay is intended to incentivise the delivery of sustainable long-term performance, with rewards aligned to shareholders' interests and adjusted for risk. The first awards under the new policy will be made in early 2018.

### Element of pay Variable pay award (long-term incentive)

**Purpose and link to strategy** To support a culture where individuals are rewarded for the delivery of sustained, target performance, taking into account RBS's strategic objectives.

Performance will include a range of financial and non-financial factors to encourage long-term value creation for shareholders.

Delivery in shares with the ability to apply malus adjustments and clawback further supports longer-term alignment with shareholders' interests.

**Operation** Any variable pay awarded will be delivered as a long-term incentive, paid in shares and subject to performance assessment and employment conditions.

Awards will be subject to deferral, malus, clawback, post-vesting retention periods and any other terms as required by regulators.

A one year pre-grant performance period will apply and awards will also be subject to a pre-vest performance assessment at the end of a three year period, with vesting taking place from years three to seven after grant.

Awards are subject to malus prior to vesting and clawback post vesting. Clawback applies for seven years from the date of award, extended to ten years if events are under investigation at the end of the normal seven-year clawback period. The post-vesting retention period will be 12 months.

The award will be delivered under the RBS 2014 Employee Share Plan, as approved by shareholders at the 2014 AGM.

**Maximum potential value** The maximum award for current directors is 175% of salary for the Chief Executive and 200% of salary for the Chief Financial Officer, or such higher amount which represents such value rounded up to the nearest whole share.

Awards are also subject to the regulatory requirement that limits variable pay to the level of fixed pay and can be valued in line with EBA rules, including any available discount for long-term deferral.

The regulatory limit is currently higher than the level under the proposed new policy.

Prior performance will be taken into account when determining the value of the award at the time of grant.

The vesting level of the award can vary between 0% and 100% dependent on the assessment of performance.

**Performance assessment** Performance will be assessed in the areas of Finance, Risk & Operations, Customers and our People to determine whether the executive has achieved what would reasonably have been expected in the circumstances.

The Committee will consider relevant factors (e.g. CET1 ratio under the Finance heading and others relating to progress in the areas of Risk & Operations, Customers and People objectives) that are relevant to RBS's strategic aims but will apply its judgement for the most part without reference to formulaic targets.

Risk & Control and Stakeholder Perception underpins will apply which may lead to downwards adjustment.

Performance will be assessed in the round. The majority of the performance variation is expected to take place under the pre-grant test, with the pre-vest assessment representing a final check that, taking all circumstances into account, overall performance has been satisfactory.

The Committee has discretion to vary the performance factors in appropriate circumstances.

Further details on the performance factors and assessment will be set out in the annual remuneration report for the relevant

### Notes to policy table

- The performance factors for variable pay awards have been chosen to reward sustained performance and are complemented by increased long-term shareholding requirements. Any targets will be set in line with RBS's strategic priorities.
- The fixed share allowance is part of fixed remuneration and is therefore not subject to any performance adjustment.
- Changes have been made under the proposed policy to lower the maximum quantum of LTI awards combined with performance factors considered to be more within the control of management and increased shareholding requirements. Further details on the changes can be found on page 105 to 112.
- Remuneration for executive directors broadly follows the policy for all employees but generally with a higher element of variable pay and greater delivery in shares, held for the long term to ensure appropriate alignment with the interests of shareholders.
- Further details on the remuneration policy for all employees, including details on how malus and clawback can be applied, can be found on pages 144 to 146.

## Directors' Remuneration Policy

### Other pay elements

#### Element of pay Shareholding requirements

**Purpose and link to strategy** To ensure executive directors build and continue to hold a significant shareholding to align with the interests of shareholders

**Operation** Executive directors are required to build up a shareholding equivalent to a percentage of salary. Unvested shares from LTI awards will count on a net of tax basis towards meeting the shareholding requirement once the pre-vest performance assessment has taken place, at the end of the three year period.

Once the respective retention periods have passed, directors are permitted to dispose of up to 25% of the net of tax shares received until the shareholding requirement is met. Any shares purchased voluntarily will be excluded from this sale restriction.

**Maximum potential value** Chief Executive 400% of salary Chief Financial Officer 250% of salary Requirements may be reviewed in future but are not expected to be reduced

#### Element of pay All-employee share plans

**Purpose and link to strategy** An opportunity to acquire RBS shares.

**Operation** Opportunity to elect to contribute from salary and acquire shares under any of the company's all-employee share plans in operation from time to time, such as the RBS Sharesave and Buy As You Earn Plan. These plans are not subject to performance conditions.

**Maximum potential value** Statutory limits imposed by HMRC or the applicable limits under the relevant plans.

#### Element of pay All-employee share plans

**Purpose and link to strategy** To ensure RBS can continue to honour payments due to executive directors.

**Operation** In approving this policy, authority is given to honour any previous commitments or arrangements entered into with current or former directors, including share awards granted under the 2014 Employee Share Plan. LTI awards under the existing policy will normally vest over a three to seven year period subject to the achievement of relevant performance conditions, based on Economic Profit, Relative Total Shareholder Return, Safe & Secure Bank and Customers & People measures. Six month post-vesting

retention periods and service requirements also apply. Further details of the value and terms of the awards can be found in the annual remuneration reports for the relevant years. Authority is also given to honour arrangements agreed for an employee prior to appointment as an executive director that may have different terms or performance conditions.

**Maximum potential value** In line with existing commitments and arrangements.

**Directors' Remuneration Policy**

**Remuneration scenarios for current executive directors under the new remuneration policy**

Notes:

(1) The charts above are for illustration only and do not take into account any share price movement over the period.

(2) The benefits figure includes standard benefit funding as outlined in the policy but excludes exceptional or business related items such as relocation allowances and travel assistance in connection with company business, the value of which will be disclosed in the total remuneration table each year.

(3) Subject to the performance assessment, LTI awards will vest between years three to seven from award and be subject to a 12 month retention period post vesting.

(4) The total maximum opportunity represents a 20% reduction for the Chief Executive and a 17% reduction for the Chief Financial Officer from that available under the current policy. The variable pay element is approximately 40% lower for the Chief Executive and 30% lower for the Chief Financial Officer than the current policy.

(5) The relatively minor difference between expected and maximum shown above is the consequence of a deliberate move to a less leveraged remuneration construct. The expected value has been calculated at 80% of maximum. The policy has a strong focus on long-term shareholding to create alignment with shareholders along with LTI awards assessed on factors that executive directors would reasonably be expected to achieve, encouraging performance within risk appetite.



**Directors' Remuneration Policy****Remuneration for the Chairman and non-executive directors**

<b>Element of pay</b>	<b>Purpose and link to strategy</b>	<b>Operation</b>	<b>Maximum potential value</b>
Fees	To provide a competitive level of fixed remuneration that reflects the skills, experience and time commitment required for the role.	<p>Fees are paid monthly in cash. The Board retains discretion to pay fees in shares as well as cash.</p> <p>The level of remuneration reflects the responsibility and time commitment required and the level of fees paid to directors of comparable major UK companies.</p> <p>Fees are reviewed regularly. Additional fees may be paid for new Board Committees provided these are not greater than fees payable for the existing Board Committees as detailed in the annual report on remuneration.</p> <p>No variable pay is provided so that the Chairman and non-executive directors can maintain appropriate independence, focus on long-term decision making and constructively challenge performance of the executive directors.</p>	<p>Following a review of the size of the Board against comparable companies and the relative time commitment for individual non-executive directors at RBS, it is proposed to increase the basic Board fee for non-executive directors in 2017 from the date of the AGM. This would be the first change in the basic Board fee since the policy was last approved in 2014. There is no change at this time to the Chairman's composite fee.</p> <p>The rates for the year ahead are set out in the annual report on remuneration.</p> <p>Any future increases to fees will be considered against fees paid to directors of comparable companies and will not normally be greater than the average inflation rate over the period under review, taking into account that any change in responsibilities, role or time commitment may merit a larger increase. Other than in exceptional circumstances, fees will not increase by more than 15% over the course of this policy.</p>

Benefits	To provide a level of benefits in line with market practice.	<p>Reimbursement of reasonable out-of-pocket expenses incurred in connection with the performance of duties.</p> <p>The Chairman and non-executive directors are entitled to travel assistance in connection with company business including the use of a car and driver. RBS will meet the cost of any tax due on the benefit. On rare occasions where they are accompanied by their spouse / partner to business events, RBS may also meet the costs and any associated tax liability. Other benefits may be offered in line with market practice.</p> <p>The Chairman also receives private medical cover.</p>	The value of the private medical cover provided to the Chairman and any other benefits will be in line with market rates and disclosed in the annual report on remuneration.
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## Discretion

The Committee has certain discretionary powers under the company's employee share plan rules. For example, the Committee has discretion to determine whether an individual would qualify as a good leaver on departure and also to decide that awards held by good leavers should vest earlier than the normal vesting date. Such discretions would only be used to ensure a fair outcome for the director and for shareholders, taking into account the circumstances of departure, the performance of the director and the need for an orderly transition. If discretion is applied in these circumstances then it will be disclosed.

Further discretions include the ability to: treat LTI awards in a range of ways in the event of a change of control, including the ability for LTI awards to be exchanged for new awards; change any performance measures, targets, and to adjust such awards if major events occur (for example transaction and capital raisings); and make administrative changes to the plan rules. In addition, the Committee retains discretion to apply malus and clawback to LTI awards. When assessing performance, the Committee can also adjust the number of shares that are received under LTI awards through the application of underpins in appropriate circumstances.

The Committee also retains the discretion to make reasonable and proportionate changes to the Directors' Remuneration Policy in order to respond to changing legal or regulatory requirements or guidelines (including but not limited to any PRA or FCA revisions to their remuneration rules and the EBA

remuneration guidelines). Where proposed changes are considered to be material, the Committee will consult with RBS's major shareholders.

## Directors' Remuneration Policy

### Recruitment remuneration policy

- RBS considers both internal and external candidates and assesses the skills and experience required for each role. Pay is generally set at no more than is required to attract the most suitable candidate for the role;
- The policy on the recruitment of new directors aims to be competitive and to structure pay in line with the framework applicable to current directors, based on the elements of pay detailed in the policy table, recognising that some adjustment to quantum within that framework may be necessary to secure the preferred candidate;
- The pension allowance for new executive directors will be reduced from 35% to 25% of salary, to bring the rate more in line with that of other employees, with a corresponding increase to other elements of fixed pay;
- Consideration will be given to the skills and experience held by the individual being recruited, as well as the incumbent's position;
- In the event of an internal promotion, existing contractual commitments can continue to be honoured;
- A buy-out policy exists to replace awards forfeited or payments foregone. The buy-out policy is in line with regulatory requirements, including the PRA rules that apply to buy-outs concluded on or after 1 January 2017;
- The Committee will minimise buy-outs wherever possible and ensure they are no more generous than, and on substantially similar terms to, the original awards or payments they are replacing. No sign-on awards or other payments will be offered on joining;
- Any awards granted following the recruitment of a candidate may be made under the company's employee share plans from time to time or under the relevant provisions in the Listing Rules and will need to comply with regulatory requirements. Full details will be disclosed in the next remuneration report following recruitment; and
- The maximum level of variable pay which may be granted to new executive directors will be guided by, but not limited to, arrangements for existing executive directors and in any event will not be more than one times the level of fixed pay, valued according to EBA rules. The maximum level excludes any buy-out arrangements.

### Other directorships

Agreement from the Board must be sought before directors accept any additional roles outside of RBS. Procedures are in place to make sure that regulatory limits on the number of directorships held are complied with. The Board would also consider whether it was appropriate for executive directors to retain any remuneration receivable in respect of any external directorships, taking into account the nature of the

appointment. Neither of the current executive directors holds a non-executive director role at any other company at this time. Details of the directorships held by other directors can be found in the biographies section of the corporate governance report.

## **Directors' Remuneration Policy**

### **Consideration of employment conditions elsewhere in the company**

The Committee retains oversight of the remuneration policy for all employees to ensure there is a fair and consistent approach throughout the organisation. The policy uses deferral, malus and clawback to promote effective risk management and alignment with shareholders' interests.

Consultation on remuneration generally takes place with our social partners, including representatives from UNITE. RBS is a fully accredited Living Wage employer and we set our minimum pay (including benefit funding) above the level that is required to meet this.

An annual employee opinion survey takes place which includes a number of questions on pay and culture. This includes questions on employees' understanding of how pay is determined and whether employees believe they are paid fairly for the work they do.

While employees are not directly consulted on the directors' remuneration policy, around 24,000 of our employees are shareholders through the company's employee share plans and have the ability to express their views through voting on the Directors' Remuneration Report.

### **Consideration of shareholders' views**

An extensive consultation is undertaken every year with major shareholders, including UKFI and other stakeholders, on our proposed remuneration approach. The consultation process typically involves inviting our largest shareholders to attend either one-to-one meetings or roundtable discussions.

A range of topics are discussed including the remuneration policy for the year ahead and any significant changes. The process takes place in sufficient time for shareholders' views to be considered prior to the Committee making any final decisions on remuneration and variable pay awards.

In late 2016, meetings took place involving a number of institutional shareholders and shareholder bodies representing a substantial portion of the non-UKFI shareholding. The reaction to the consultation process was positive and allowed the Committee to gain valuable insight into any areas of concern. Shareholders and other stakeholders indicated they were supportive of the new remuneration construct, highlighting the reduction in maximum potential variable pay and increased shareholding requirements as favourable features.

Shareholders asked wide-ranging questions including how the performance tests would work and the rationale for removing pro rating for good leavers. The Committee Chairman explained how the expected value of pay would be broadly maintained over time under the new policy, provided that pro rating for good leavers did not apply, and that there were merits in assessing executive directors against factors considered to be more within their control and which they could reasonably be expected to achieve.

Shareholders continue to play a vital role in developing remuneration practices that support the long-term interests of the business and the Committee is grateful and greatly encouraged by their involvement in the process.

**Directors' Remuneration Policy****Service contracts and policy on payments for loss of office – directors**

Provision	Policy details for executive directors
Notice period	RBS or the executive director is required to give 12 months' notice to the other party to terminate the executive director's employment.
Payments for loss of office	There are no pre-determined provisions for compensation on termination. There is discretion for RBS to make a payment in lieu of notice (based on salary only) which is released in monthly instalments. The executive director must take all reasonable steps to find alternative work and any remaining instalments will be reduced as appropriate to offset income from any such work.
Treatment of outstanding employee share plan awards on termination	<p>Any shares awarded under the fixed share allowance and LTI awards will be treated in accordance with the relevant plan rules as approved by shareholders.</p> <p><b>Fixed share allowances</b></p> <p>Shares will continue to be released over the applicable retention period helping to ensure that former executive directors maintain an appropriate interest in RBS shares. In all leaver circumstances, executive directors will continue to be eligible to receive a pro-rated fixed share allowance to reflect the period up to the termination date.</p> <p><b>LTI awards made under the existing remuneration policy (approved at the 2014 AGM)</b></p> <p>LTI awards normally lapse on leaving unless the termination is for one of a limited number of specified 'good leaver' reasons or the Committee exercises its discretion to prevent lapsing. LTI awards held by good leavers will continue to be subject to pro rating, to reflect the proportion of the performance period that has elapsed at the date of termination, unless the Committee exercises its discretion to determine otherwise. LTI awards held by good leavers will normally vest on the original vesting dates, subject to the performance conditions being met.</p> <p><b>Changes for LTI awards made under the new remuneration policy</b></p> <p>Under the policy being proposed to the 2017 AGM, LTI awards made in future will not be subject to pro rating for time in good leaver circumstances, for the reasons outlined earlier in</p>



this report. Awards will also generally be made to good leavers in respect of the final year of employment.

#### Good leaver definition for LTI awards

This definition applies to all LTI awards that the executive director holds. Individuals will qualify for good leaver treatment if they leave due to ill-health, injury, disability, death, retirement, redundancy, the employing company ceasing to be a member of the Group, transfer of the employing business, or any other reason if and to the extent the Committee decides in any particular case.

With respect to the 'retirement' category above, and recognising the typical length of tenure for executive director roles, retirement good leaver treatment for executive directors will typically be considered taking all circumstances into account. Factors the Committee would expect to be present before agreeing to good leaver treatment under retirement include: whether the individual has been in role for at least five years, or otherwise qualifies for retirement criteria under RBS's policy, has demonstrated satisfactory performance, is not leaving to work in a capacity considered to be competing directly and materially with RBS, and is leaving at a time and in a manner that is agreed with the Board.

**Directors' Remuneration Policy**

Provision	Policy details for the Chairman and non-executive directors
Other provisions	Contracts include standard clauses covering remuneration arrangements and discretionary incentive plans (as set out in this report), reimbursement of reasonable out-of-pocket expenses incurred in performance of duties, redundancy terms and sickness absence, the performance review process, the disciplinary procedure and terms for dismissal in the event of personal underperformance or breaches of RBS policies. The Committee retains the discretion to make payments (including but not limited to professional and outplacement fees) to facilitate smooth handovers, mitigate against legal claims and/or procure reasonable assistance with investigations or claims, subject to any payments being made pursuant to a settlement or release agreement.
Notice and termination provisions	The Chairman and the non-executive directors have letters of appointment reflecting their responsibilities and time commitments. They do not have notice periods and no compensation would be paid to the Chairman or non-executive directors in the event of termination of appointment, other than standard payments payable for the period served up to the termination date.

**Election or re-election of directors**

In accordance with the provisions of the UK Corporate Governance Code, all directors of the company stand for election or re-election annually by shareholders at the company's AGM.

**Annual report on remuneration****Annual report on remuneration**

The sections audited by the company's auditors, Ernst and Young LLP, are as indicated.

**Implementation of remuneration policy in 2017**

Details of remuneration to be awarded in 2017 to executive directors are set out below. The long-term incentive (LTI) award is the grant due to be made in March 2017 for the 2016 performance year and the structure reflects the longer deferral period under PRA requirements. Subject to the performance conditions being met, vesting will take place between years four to seven (with 50% of any vesting in year four and 50% split over years five to seven). This will be the last LTI award under the current remuneration policy with any subsequent awards being made under the proposed new remuneration policy set out on page 113. The fixed share allowance for 2017 will be granted after the 2017 AGM and, subject to shareholder approval of the proposed policy, will be released over a three year retention period.

**Executive directors' remuneration to be awarded in 2017**

	Salary	Standard benefits	Pension 35% of salary	Fixed share allowance 100% of salary (1)	LTI award calculated in line with regulatory cap (2)
Chief Executive	£1,000,000	£26,250 (3)	£350,000	£1,000,000	£2,870,000
Chief Financial Officer	£800,000	£26,250	£280,000	£800,000	£2,305,000

## Notes:

(1) Fixed share allowance will be payable broadly in arrears, currently in two instalments per year, and the shares will be released in equal tranches over a three year period.

(2) The LTI that can be awarded in 2017 is limited to the level of fixed remuneration, taking into account the EBA discount rules for long-term deferral. The discount factor is a mechanism to take account of opportunity costs and inflation risk for the value being provided over time and can be applied if the deferral period is at least five years. By incorporating the current discount factor, LTI awards can be granted in March 2017 with a face value of approximately 121% of fixed remuneration. For example, the Chief Executive received fixed remuneration of £2,376,250 in 2016 (based on standard benefits only) which allows an LTI award to be made at £2,870,000. Performance measures and targets are set out on page 128.

(3) Amount shown relates to standard benefit funding. Executive directors are also entitled to benefits in

line with the stated policy including travel assistance and the Chief Executive is entitled to a flight allowance as part of his relocation arrangements. The value of benefits will be disclosed each year in the total remuneration table.

## Annual report on remuneration

### Chairman and non-executive directors' fees for 2017

The basic Board fee for non-executive directors has been unchanged since the current remuneration policy was approved by shareholders in 2014. During 2016, the Group's Nominations and Governance Committee considered how Board fees for non-executive directors compared to peer companies. RBS has a smaller number of Board members than most, meaning that the relative time commitment for individual non-executive directors is likely to be greater. Non-executive directors have also absorbed a number of incremental responsibilities arising out of matters considered to be unique to RBS. It is proposed that the basic Board fee is increased from £72,500 to £80,000 per annum and, subject to shareholder approval being obtained, the change will take effect from the date of the AGM. A summary of the proposed annual fees payable is set out below.

Chairman (composite fee)		£750,000
Non-executive director basic fee (for period pre AGM)		£72,500
Non-executive director basic fee (for period post AGM)		£80,000
Senior Independent Director		£30,000
Group Audit Committee (GAC), Group Performance and Remuneration Committee (RemCo),	Member	£30,000
Board Risk Committee (BRC) and Sustainable Banking Committee (SBC)	Chairman	£60,000
Board Oversight Committee (BOC) for GRG, US Risk Committee	Member	£15,000
	Chairman	£30,000
NatWest Markets (formerly CIB) advisory role		£30,000
Group Nominations and Governance Committee	Member	£15,000

The CIB BOC was disbanded at the end of February 2016. However, the Board agreed that Robert Gillespie, the former CIB BOC Chairman, should continue in an advisory role, supporting the NatWest Markets (formerly CIB) CEO and senior management team during a transitional period for the business for which he receives fees of £30,000 per annum.

**Annual report on remuneration****Total remuneration paid to executive directors for 2016 (audited)**

	Ross McEwan		Ewen Stevenson	
	2016	2015	2016	2015
	£000	£000	£000	£000
Salary	1,000	1,000	800	800
Fixed share allowance (1)	1,000	1,000	800	800
Benefits (2)	113	149	26	26
Pension	350	350	280	280
Total fixed remuneration (3)	2,463	2,499	1,906	1,906
Annual bonus	n/a	n/a	n/a	n/a
Long-term incentive award (4)	1,030	993	—	—
Total remuneration	3,493	3,492	1,906	1,906

## Notes:

(1) The value of the fixed share allowance is based on 100% of salary and, as part of fixed remuneration, it is not subject to any performance conditions. It is delivered in shares and released over a retention period.

(2) Includes standard benefit funding of £26,250 per annum with the remainder being travel assistance in connection with company business (£74,621) and relocation expenses (£11,801) provided to Ross McEwan. The 2015 benefits figure for Ross McEwan has been restated to include a value for travel assistance during that year.

(3) The total fixed remuneration at £2,463,000 is higher than the £2,376,250 fixed remuneration in the implementation of policy section as the lower figure includes standard benefits only.

(4) The 2016 value for Ross McEwan relates to an LTI award granted in 2014 that is due to vest in March 2017. The performance conditions ended on 31 December 2016 and have been assessed as set out below together with an estimate of the vesting value. The value for 2015 has been amended from the estimated value of £1,347,000 provided in the 2015 report to reflect the actual value on the vesting date in March 2016.

**Annual report on remuneration****2014 LTI – final assessment of performance measures (audited)**

An assessment of performance of each relevant element was provided by internal control functions and PwC assessed relative Total Shareholder Return (TSR) performance against a peer group of comparator banks.

Performance Measures (and weightings)	Performance for minimum vesting	Vesting at minimum	Performance for maximum (100%) vesting	Actual Performance	Vesting outcome	Weighted Vesting %
Economic Profit (25%)	(£1 billion)	25%	£0	(£0.4 billion)	82%	20%
Relative TSR (25%)	TSR at median	20%	TSR at upper quartile	18 <sup>th</sup> percentile ranking	0%	0%
Safe & Secure Bank (25% split across two measures)	Vesting between 0% - 100% qualified by Committee discretion CET1 ratio target: >=12% Cost:income ratio target: 59%			CET1 ratio: 13.4%  Cost:income ratio of 61%	88%	22%
Customers & People (25% split across two measures)	Vesting between 0% - 100% qualified by Committee discretion Net Promoter Score target: Gap to number 1 of 8.7 Engagement Index (EI) target: EI within 3 points of Global Financial Services (GFS) norm			Gap to number 1 of 13.4  EI: 6 points behind GFS norm	0%	0%
Overall vesting outcome (1)						42%

Note:

(1) The Economic Profit outcome was determined according to the vesting scale where target performance of (£0.77 billion) would result in 62.5% vesting.

The vesting within the Safe & Secure Bank and Customers & People categories has been qualified by Committee discretion, taking into account the margin by which targets have been missed or exceeded and any other relevant factors. The CET1 ratio target was exceeded and the cost:income ratio was deemed to have been substantially met, reflecting the significant progress from the 2013 base year of 69% and

recognising the significant headwinds in the external environment since that time. This resulted in 100% and 75% vesting respectively for these elements and a combined vesting outcome under the Safe & Secure category of 88%.

On the Customers measure, whilst absolute performance on the customer position had improved over the period, the target on closing the gap had been missed and in the circumstances the Committee concluded performance was not sufficient in order to justify vesting. On the People measure, the Committee recognised that engagement scores had been impacted by a number of unforeseen factors and difficult decisions required by management during the year but again it was felt that the level of vesting for this element should be nil.

The Committee also received input from the BRC. In making its final judgement, the Committee considered the overall context of performance including a number of factors such as the Williams & Glyn transaction. The Committee believed such factors were already adequately reflected across the performance categories and that the overall vesting outcome above was fair and appropriate.



**Annual report on remuneration****2014 LTI vesting amount included in the total remuneration table (audited)**

Ross McEwan was granted an LTI award in March 2014. The performance conditions as set out on the previous page ended on 31 December 2016 and the award is due to vest in March 2017. The average share price over the last three months of the financial year has been used to estimate the vesting value.

	Ross McEwan			
Performance category	% vesting	Maximum RBS shares (1)	Vested RBS shares	Value (2)
Economic Profit	82%	305,064	244,052	
Relative TSR	0%	305,064	—	
Safe & Secure Bank	88%	305,064	268,457	
Customers & People	0%	305,064	—	
Overall vesting outcome based on above	42%		512,509	£1,030,143
<i>Maximum capped shares available to vest</i>			<i>915,193</i>	

## Notes:

(1) The maximum number of shares is calculated in line with the underlying award structure where each of the four performance categories could give rise to shares worth 100% of salary at grant but with the overall maximum capped at 300% of salary at grant. The percentage vesting under the Economic Profit category has been rounded from 82% to 80% when calculating the number of vested shares in order to maintain the overall weighted vesting outcome at 42%.

(2) Based on a RBS share price of £2.01, the average over the three month period from October to December 2016.

## Annual report on remuneration

### 2015 and 2016 LTI awards to executive directors – current assessment (audited)

The table represents an early indication of potential vesting outcomes only based on the position at 31 December 2016. Subject to the assessment of performance conditions over a three year period, these LTI awards will vest in years four and five from the date of grant. Details of the final performance assessment and any use of discretion will be disclosed in the remuneration report for the relevant year.

Performance measure	Weighting	Performance for minimum vesting	Vesting at minimum	Performance for maximum vesting	Vesting at maximum	2015 current assessment	2016 current assessment
Economic Profit	25%	Minimum economic profit targets	25%	Performance ahead of the Strategic Plan	100%	Good progress and currently favourable to target set	Currently tracking behind target range
Relative TSR	25%	TSR at median of comparator group	20%	TSR at upper quartile of comparator group	100%	Below median performance for vesting	Below median performance for vesting
Safe & Secure Bank	25%	Target ranges set for: CET1 ratio and Cost:income ratio	Vesting between 0% – 100% qualified by Committee discretion taking into account the margin by which targets have been missed or exceeded			CET1 ratio is in range for vesting.	CET1 ratio is in range for vesting.
Customers & People	25%	Target ranges set for: Net Promoter Score, Net Trust Score and Employee Engagement				Cost:income ratio is broadly in line with target	Cost:income ratio currently tracking behind target range
						Customer & People measures currently tracking behind target range	Customer & People measures currently tracking behind target range



**Annual report on remuneration**

<b>LTI awards granted during 2016 (audited)</b>					
	Grant date	Face value of award (£000s)	Number of shares awarded (1)	% vesting at minimum and maximum	Performance Requirements (2)
Ross McEwan	8 March 2016	2,680	1,187,207	Between 0% - 100% with minimum vesting as set out above	Conditional share awards subject to performance conditions, as set out above, measured over the three year period from 1 January 2016 to 31 December 2018
Ewen Stevenson	8 March 2016	2,150	952,424		

## Notes:

(1) The number of shares awarded was calculated in line with the regulatory cap that limits variable pay to the level of fixed pay and for this award equated to 268% of salary, The award price of £2.2574 was calculated based on the average share price over five business days prior to the grant date.

(2) The awards are eligible to vest in equal tranches in 2020 and 2021, subject to the achievement of performance conditions. Malus provisions will apply up until vesting and clawback provisions will also apply for a period of seven years from the date of grant.

**Performance conditions for LTI awards to be granted to executive directors in 2017, for the 2016 performance year**

This will be the last LTI award under the current remuneration policy, with any subsequent awards being made under the new remuneration policy, subject to shareholder approval at the 2017 AGM. A three year performance period will apply until 31 December 2019. Subject to the achievement of the performance conditions, shares will vest 50% four years from the date of grant with the remaining 50% vesting pro rata between years five to seven from grant. Any awards that vest will be subject to a six month retention period.

Awards granted to executive directors in March 2017 will be subject to four equally weighted performance categories, each able to vest up to 100% of base salary, subject to the maximum award that is possible under the policy and the regulatory cap. Details of the performance measures and the Committee's rationale for selecting them are set out below.



## Annual report on remuneration

### Economic Profit (25%)

**Reason:** Economic Profit, being a risk-adjusted financial measure, is consistent with regulatory requirements and provides a balance between measuring growth and the cost of capital employed in delivering that growth.

**Measure:** Economic Profit for RBS defined as profit after tax less preference share charges less tangible net asset value multiplied by the cost of equity.

### Performance target and weightings

Weighting	Performance target	Vesting range
25%	Target consistent with the achievement of RBS's strategic long term return on equity target	25% - 100%

### Relative Total Shareholder Return (25%)

**Reason:** Relative TSR provides a direct connection between executive directors' awards and relative returns delivered to shareholders.

**Measure:** The measure compares performance against a group of comparator banks. The TSR comparator group was updated for awards made in 2016 to more accurately reflect the business strategy with reduced focus on investment banking. No changes have been made for the awards to be granted in March 2017.

### Relative TSR Comparator Group

1 Barclays

2 Lloyds Banking Group

3 HSBC

4 to 13 BBVA, BNP Paribas, Credit Agricole, ING, Intesa San Paolo, Nordea, Santander, Societe Generale, Standard

### Performance target and weightings

Weighting	Performance target	Vesting range
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25%	TSR between median and upper quartile	20% - 100%
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## Annual report on remuneration

### Safe & Secure Bank (25%)

**Reason:** The Safe & Secure Bank measures have a particular focus on risk reduction and the building of a safe, sustainable business.

**Measure:** The key measures in this category are the achievement of pre-determined Common Equity Tier 1 (CET1) and Cost:income (C:I) ratios.

### Performance target and weightings

Category	Metrics and weighting	Performance target
Safe & Secure Bank	CET1 ratio (12.5%)	CET1 ratio target of $\geq 13\%$
	C:I ratio (12.5%)	C:I ratio target of 56%

### Customers & People (25%)

**Reason:** These measures reward management for building a customer-focused business with engaged employees.

**Measure:** Net Promoter Scores (NPS) and Net Trust Scores (NTS) will be used. Employee engagement will be measured against the Global Financial Services (GFS) norm.

### Performance target and weightings

Category	Metrics and weighting	Performance target
Customers & People	Advocacy (7.5%)	Significant progress on NPS and NTS scores
	Trust (5%)	



Engagement (12.5%)	Employee Engagement Index one point above GFS norm
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The overall vesting under the Safe & Secure Bank and Customers & People categories will be qualified by the Committee's discretion taking into account changes in circumstances over the performance period, the margin by which individual targets have been missed or exceeded, and any other relevant factors.

## **Annual report on remuneration**

In line with previous practice, the Economic Profit is considered to be commercially sensitive. Within the Customers category, new metrics are being developed which will target trust and advocacy, specific to customers on a segmental basis, and will be consistent with RBS's long-term ambition. Further information on the trust and advocacy targets will be disclosed in the 2017 Directors' Remuneration Report, to the extent permitted by commercial sensitivity. Details of all targets and performance against these will be disclosed retrospectively after any vesting has been determined, in the annual report on remuneration for 2019.

### **Underpin**

The Committee will also review financial and operational performance against the business strategy and the risk environment prior to agreeing vesting of awards. In assessing the risk considerations, the Committee will be advised independently by the BRC. If the Committee considers that the vesting outcome calibrated in line with the performance conditions outlined above does not reflect underlying financial results, or if the Committee is not satisfied that conduct and risk management during the performance period has been effective, then the terms of the awards allow for an underpin to be used to reduce vesting or lapse the award.

### **Payments for loss of office (audited)**

No remuneration payment or payment for loss of office was made to directors during 2016.

### **Payments to past directors (audited)**

Stephen Hester and Bruce Van Saun received shares in March 2016 on the vesting of the LTI award granted in 2013 as set out below. The assessment of RBS-wide performance measures is detailed on page 79 of the 2015 Annual Report on Form 20-F.

## Annual report on remuneration

### Value of payments on vesting (audited)

Performance category	% vesting	Stephen Hester		Bruce Van Saun		Value (3)
		Maximum RBS shares (2)	Vested RBS shares	Maximum CFG shares (2)	Vested CFG shares	
Economic Profit	62%	107,805	66,839	65,656	40,706	
Relative TSR	0%	107,805	0	65,656	0	
Balance Sheet & Risk	90%	107,805	97,025	65,656	59,090	
Strategic Scorecard	72%	107,805	77,620	65,656	47,272	
Initial vesting outcome based on above					147,068	
					131,377	
Final outcome post application of underpin (1)	56%		241,484			
	50%		215,718	£496,799		\$2,828,547
<i>Maximum capped number of shares available to vest</i>			323,415		196,967	

#### Notes:

(1) The Committee also considered recommendations from the BRC and concluded it would be appropriate to apply the risk and financial performance underpin in respect of the above awards. This resulted in downward discretion being applied to reduce the final vesting outcome from 56% to 50%.

(2) The maximum number of shares is calculated in line with the underlying award structure where each of the four performance categories could give rise to shares worth 100% of salary at grant but with the overall maximum capped at 300% of salary. The number has been reduced on a pro rata basis to reflect time served by Stephen Hester. The interests for Bruce Van Saun's award were converted to shares in Citizens Financial Group, Inc. as part of the IPO of that business.

(3) Based on a RBS share price of £2.303 and Citizens Financial Group, Inc. share price of \$21.53 on the date of vesting.



(1) Howard Davies joined the Board on 14 July 2015 and became Chairman with effect from 1 September 2015. The Benefits column includes private medical cover.

(2) In line with market practice, non-executive directors are reimbursed expenses incurred in connection with their attendance at Board meetings. To the extent that HMRC determines that any amounts are taxable, RBS will settle the associated tax liability on behalf of the non-executive director.

(3) Under the 'Other' column, Sandy Crombie received fees as the Senior Independent Director and Morten Friis received fees for his work on the US steering group until April 2016. The US Risk Committee was established with Morten Friis and Baroness Noakes receiving fees as Chairman and member of the Committee respectively. Robert Gillespie received fees for his role as an advisor to the NatWest Markets (formerly CIB) CEO and senior management.

(4) Frank Dangeard and Mike Rogers joined the Board on 16 May 2016 and 26 January 2016 respectively.

Key to table:

Noms & Gov	Group Nominations and Governance Committee
GAC	Group Audit Committee
RemCo	Group Performance and Remuneration Committee
BRC	Board Risk Committee
SBC	Sustainable Banking Committee
BOC	Board Oversight Committee for the RCR, NatWest Markets (formerly CIB) and GRG business areas

## **Annual report on remuneration**

### **Directors' interests in shares and shareholding requirements (audited)**

The current shareholding requirement is to hold shares to the value of 250% of salary for the Chief Executive and 125% of salary for the Chief Financial Officer. Under the proposed new policy, the requirement will be increased to 400% of salary for the Chief Executive and 250% of salary for the Chief Financial Officer, as detailed in the remuneration policy section of this report.

### **Shareholding requirements for executive directors**

Notes:

- (1) Ross McEwan holds 259,455 shares from his 2015 and 2016 fixed share allowances that are included in the total shares beneficially owned below but these have been excluded from the shareholding requirements calculation as he will transfer these shares to charity at the end of the retention period.
- (2) Value of shares held is based on the share price of £2.246 as at 31 December 2016. During the year ended 31 December 2016, the share price ranged from £1.489 to £3.02.

## Annual report on remuneration

### Share interests held by directors

	Shares owned at 31 December 2016  (or date of cessation if earlier)	% of issued share capital	Value (£)  (1,2)	% of shareholding requirement met (3)	Unvested Long-term incentive awards	Unvested Deferral Plan awards
Ross McEwan	1,645,498	0.013918	£3,113,053	124.5%	2,519,886	—
Ewen Stevenson	766,499	0.006483	£1,721,557	172.2%	1,818,809	—
Howard Davies	41,000	0.000347				
Sandy Crombie	20,000	0.000169				
Frank Dangeard	—	—				
Alison Davis	20,000	0.000169				
Morten Friis	20,000	0.000169				
Robert Gillespie	25,000	0.000211				
Penny Hughes	562	0.000005				
Brendan Nelson	12,001	0.000102				
Baroness Noakes	41,000	0.000347				
Mike Rogers	—	—				

#### Notes:

(1) Ross McEwan holds 259,455 shares from his 2015 and 2016 fixed share allowances that are included in the total shares beneficially owned but these have been excluded from the shareholding requirements calculation as he will transfer these shares to charity at the end of the retention period.

(2) Value of shares held is based on the share price of £2.246 as at 31 December 2016. During the year ended 31 December 2016, the share price ranged from £1.489 to £3.02.

(3) The current shareholding requirement is to hold shares to the value of 250% of salary for the Chief Executive and 125% of salary for the Chief Financial Officer. Under the proposed new policy, the requirement will be increased to 400% of salary for the Chief Executive and 250% of salary for the Chief Financial Officer.

(4) Interest is 10,000 American Depository Receipts representing 20,000 ordinary shares.



No other director had an interest in the company's ordinary shares during the year or held a non-beneficial interest in the shares of the company at 31 December 2016, at 1 January 2016 or date of appointment if later. The interests shown above include shares held by persons closely associated with the directors. As at 23 February 2017, there were no changes to the directors' interests in shares shown in the table above.

## Annual report on remuneration

## Directors' interests under the company's share plans (audited)

## Long-term incentive awards

	Awards held at 1 January 2016	Awards granted in 2016	Award price £ in 2016	Awards vested in 2016	Market price on vesting £	Value on vesting £	Awards lapsed in 2016	Awards held at 31 December 2016	Expected vesting date
Ross McEwan	696,152		3.09	431,614	2.30	992,712	264,538	915,193	—
	915,193		3.28					915,193	07.03.17
	417,486		3.74					417,486	06.03.19 – 06.03.20
		1,187,207	2.26					1,187,207	08.03.20 – 08.03.21
	2,028,831	1,187,207		431,614			264,538	2,519,886	
Ewen Stevenson	435,611	(1)		147,354	2.30	338,914		288,257	07.03.17
	578,128		3.27					578,128	06.03.19 – 06.03.20
			3.74					578,128	06.03.20 – 08.03.20 –
		952,424	2.26					952,424	08.03.21
	1,013,739	952,424		147,354				1,818,809	

## Deferred awards

	Awards held at 1 January 2016	Awards granted in 2016	Award price £	Awards vested in 2016	Market price on vesting £	Value on vesting £	Awards lapsed in 2016	Awards held at 31 December 2016	Expected vesting date
Ross McEwan	18,797		3.09	18,797	2.30	43,233			—

Note:

(1) Award granted to Ewen Stevenson on appointment in May 2014 to replace awards forfeited on leaving Credit Suisse.



## Annual report on remuneration

### Total Shareholder Return (TSR) performance

The graph below shows the performance of RBS over the past eight years in terms of TSR compared with that of the companies comprising the FTSE 100 Index. This index has been selected because it represents a cross-section of leading UK companies. The TSR for FTSE UK banks for the same period has been added for comparison.  
*Source: Datastream*

**Chief Executive pay over same period**

	2009	2010	2011	2012	2013 (1) 393 (RM)	2014	2015	2016
Total remuneration (£000s)						1,878	3,492	3,493
Annual bonus against maximum opportunity	1,647 0%	3,687 85%	1,646 0%	1,646 0%	1,235 (SH) 0%	n/a	n/a	n/a
LTI vesting rates against maximum opportunity	0%	0%	0%	0%	0%	72.85%	62%	56%

## Notes:

(1) 2013 remuneration includes Stephen Hester (SH) as CEO for the period to 30 September and Ross McEwan (RM) for the period from 1 October to 31 December 2013.

(2) Figures have been amended where appropriate to reflect any restatement of prior year amounts, for example, to reflect the actual rather than estimated value of LTI vestings as part of the total remuneration figure and any revisions to the value of benefits provided.



## Annual report on remuneration

### Change in Chief Executive pay compared with employees

The table below shows the percentage change in remuneration for the Chief Executive between 2015 and 2016 compared with the percentage change in the average remuneration of RBS employees based in the UK. In each case, remuneration is based on salary, benefits and annual bonus.

	Salary 2015 to 2016 change	Benefits 2015 to 2016 change	Annual Bonus 2015 to 2016 change
Chief Executive (1)	0%	0%	n/a
UK employees (2)	4.51%	4.18%	(4.86%)

#### Notes:

(1) Executive directors are not eligible for an annual bonus. Standard benefit funding for executive directors remained unchanged between 2015 and 2016. The benefits for the Chief Executive excludes other benefits such as travel assistance in connection with company business and relocation benefits, the value of which is disclosed each year in the total remuneration table. In 2016, Ross McEwan also received a fixed share allowance as part of his fixed pay.

(2) The size of the percentage increase for fixed pay elements to 2016 is partly due to the one-off impact of removing incentives for certain frontline roles. The data represents full year salary costs of the UK based employee population, which covers the majority of RBS employees and is considered to be the most representative comparator group.

## Annual report on remuneration

### Relative importance of spend on pay

The table below shows a comparison of remuneration expenditure against other distributions and charges.

	2016	2015 (1)	
	£m	£m	change
Remuneration paid to all employees (2)	4,670	5,208	(10.3%)
Distributions to holders of ordinary shares	—	—	
Distributions to holders of preference shares and paid-in equity (3)	1,697	385	341%
Taxation and other charges recognised in the income statement:			
- Social security, Bank levy and Corporation tax	747	597	25.1%
- Irrecoverable VAT and other indirect taxes incurred by RBS (4)	697	691	0.9%

Notes:

- (1) Numbers exclude discontinued operations, principally CFG in 2015.
- (2) Remuneration paid to all employees represents total staff expenses per Note 3 to the Financial Statements, exclusive of social security and other staff costs.
- (3) Includes final payment relating to the Dividend Access Share of £1,193 million in 2016.
- (4) Input VAT and other indirect taxes not recoverable by RBS due to it being partially exempt.

The items above have been included as they reflect the key stakeholders for RBS and the major categories of distributions and charges made by RBS.

### Consideration of matters relating to directors' remuneration Membership of the Group Performance and Remuneration Committee

All members of the Committee are independent non-executive directors. The Committee held seven scheduled meetings in 2016 and a further two ad hoc meetings.

Attended/



	scheduled
Sandy Crombie (Chairman)	7/7
Alison Davis	7/7
Robert Gillespie	7/7

Mike Rogers was appointed as a new member of the Committee with effect from 1 January 2017.

### The role and responsibilities of the Committee

The Committee is responsible for:

- approving the remuneration policy for all employees and reviewing the effectiveness of its implementation;
- reviewing performance and making recommendations to the Board on remuneration arrangements for executive directors;
- approving remuneration arrangements for members and formal attendees of the Executive Committee and employees with total annual compensation which exceeds an amount determined by the Committee, currently £1 million; and
- setting the remuneration framework and principles for employees identified as Material Risk Takers falling within the scope of UK regulatory requirements.

In mitigating potential conflicts of interest, directors are not involved in decisions regarding their own remuneration and remuneration advisers are appointed by the Committee rather than management. The terms of reference of the Committee are reviewed annually and available on [rbs.com](http://rbs.com).

## Annual report on remuneration

### Summary of the principal activity of the Committee in 2016

The new executive director remuneration policy and any issues arising under the accountability review process were considered at the majority of meetings. Set out below is a summary of other key activities considered by the Committee.

#### First quarter

- 2015 performance reviews and remuneration arrangements for members and attendees of the Executive Committee and high earners.
- Approval of variable pay pools and the 2015 Directors' Remuneration Report.
- Assessment of the performance of LTI awards granted in prior years and performance targets for 2016 awards.
- Executive Committee members' 2016 objectives.

#### Second quarter

- Key external trends and regulatory updates.
- Annual review of external advisers to the Committee.
- Remuneration governance across legal entities and the impact of the Senior Managers Regime.
- Annual review of remuneration policy for all employees.

#### Third quarter

- 2016 half-year performance reviews for members and attendees of the Executive Committee and high earners.
- Considering the future pay construct for all employees.
- Interim business performance assessment.
- Divestment principles update.

- External stakeholder engagement plan.

#### Fourth quarter

- Review of the implementation of the remuneration policy.
- 2016 preliminary pay elements including bonus pool, deferral and LTI awards.
- Executive Committee members' annual objectives for 2017.
- Update on regulatory requirements.
- Stakeholder engagement and feedback on new remuneration policy for executive directors.
- Review of draft Directors' Remuneration Report for 2016.

## **Annual report on remuneration**

### **Performance evaluation process**

The Committee has considered the findings of the annual review of the effectiveness of the Committee which was conducted internally by the Chief Governance Officer and Board Counsel.

Positive comments were received on moving to a reduced number of meetings with appropriate use of delegation, giving time to focus on important issues such as the future pay construct. There was good evidence of challenge on key points of principle during debates and overall it was felt that the dynamic of the Committee worked well. The Masterclass sessions, where in-depth consideration is given to specific matters, continued to be well received by members.

On areas for development, the importance of papers containing all the relevant information was highlighted and there was still scope to further improve the articulation of how reward links to strategy. There was also a suggestion that it would be helpful for the Committee to have another member. Subsequently, the Board agreed that Mike Rogers would be appointed to the Committee with effect from 1 January 2017.

Potential areas were identified for future focus by the Committee including absolute pay levels, competitiveness and internal fairness.

### **Advisers to the Committee**

The Committee reviews its selection of advisers annually. PricewaterhouseCoopers LLP (PwC) was appointed as the Committee's remuneration advisers on 14 September 2010 following a review of potential advisers, and the appointment was reconfirmed by the Committee in May 2016 after an annual review of the quality of the advice received and fees charged. PwC is a signatory to the voluntary code of conduct in relation to remuneration consulting in the UK.

PwC also provide professional services in the ordinary course of business including assurance, advisory, tax and legal advice to RBS subsidiaries. There are processes in place to ensure the advice received by the Committee is independent of any support provided to management. As well as receiving advice from PwC in 2016, the Committee took account at meetings of the views of the Chairman; Chief Executive; Chief Financial Officer; Chief HR Officer; the Director of Organisation and Performance; the Chief Governance Officer and Board Counsel; the Chief Risk Officer; and the Chief Conduct and Regulatory Affairs Officer. The fees paid to PwC for advising the Committee in relation to directors' remuneration are charged on a

time/cost basis and in 2016 amounted to £214,706 excluding VAT (2015 - £121,358). The increase in fees is a result of additional work undertaken during 2016 in developing the new directors' remuneration policy.

## Annual report on remuneration

### Statement of shareholding voting

The tables below set out the voting by shareholders on the resolution to approve the Annual Report on Remuneration at the AGM held in May 2016 and the resolution at the AGM in June 2014 when the Directors' Remuneration Policy was last approved.

#### Annual Report on Remuneration – 2016 AGM

For	Against	Total votes cast	Withheld
42,686,046,288	188,029,796	42,874,076,084	6,603,412
(99.56%)	(0.44%)		

#### Directors' Remuneration Policy – 2014 AGM

For	Against	Total votes cast	Withheld
20,893,215,888	70,382,756	20,963,598,644	170,307,216
(99.66%)	(0.34%)		

### Shareholder dilution

During the ten year period to 31 December 2016, awards made that could require new issue shares to be used in connection with the company's employee share plans represented 5.4% of the company's issued ordinary share capital, leaving an available dilution headroom of 4.6%. The company meets its employee share plan obligations through a combination of new issue shares and market purchase shares.

Sandy Crombie

Chairman of the Group Performance and Remuneration Committee

23 February 2017

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**Other Remuneration Disclosures****Remuneration of eight highest paid senior executives below Board (1)**

	Executive 1	Executive 2	Executive 3	Executive 4	Executive 5	Executive 6	Executive 7	Executive 8
	£000	£000	£000	£000	£000	£000	£000	£000
Fixed pay (cash)	800	800	675	688	588	638	575	450
Fixed allowances	800	800	675	688	588	638	288	225
Annual bonus	—	—	—	—	—	—	—	—
Long-term incentive awards (vested value)	175	175	412	261	167	—	250	—
Total remuneration (2)	1,775	1,775	1,762	1,637	1,343	1,276	1,113	675

Notes:

- (1) Remuneration earned in 2016 for eight members of the Executive Committee.
- (2) Disclosure includes prior year long-term incentive awards which vested during 2016. The amounts shown reflect the value of vested awards using the share price on the day the awards vested.

**How risk is reflected in our remuneration process**

The RBS remuneration policy explicitly aligns remuneration with effective risk management. Focus on risk is achieved through clear risk input into objectives, performance reviews, the determination of variable pay pools and incentive plan design as well as the application of malus and clawback. The Committee is supported in this by the BRC and the RBS Risk function.

A robust process is used to assess risk performance. A range of measures are considered, specifically the overall Risk Profile; Credit, Regulatory and Conduct Risk; Operational Risk; Enterprise Risk; and Market Risk. The steps we take to ensure appropriate and thorough risk adjustment are also fully disclosed and discussed with the PRA and the FCA.



## Other Remuneration Disclosures

### Variable pay pool determination

For the 2016 performance year, RBS has operated a multi-step process which is a control function led assessment to determine performance and therefore the appropriate bonus pool by franchise and function.

The process considers a balanced scorecard of performance assessments at the level of each franchise or support function. The assessments are made across financial, customer and people measures. Risk and conduct assessments at the same franchise or functional level are then undertaken to ensure that performance achieved without the appropriate risk and conduct controls and culture is not inappropriately rewarded.

BRC will then review any material risk and conduct events and if appropriate an underpin may be applied to the individual business and function bonus pools and where appropriate to the overall RBS bonus pool. BRC may recommend reduction of a bonus pool if it considers that risk and conduct performance is unacceptable or that the impact of poor risk management has yet to be fully reflected in the respective inputs.

Following further review against overall performance and conduct, the Chief Executive will make a final recommendation to the Committee, informed by all the previous steps in the process and his strategic view of the business. The Committee will then make an independent decision on the final bonus pool taking all of these earlier steps into account.

### Accountability review process and malus/clawback

An accountability review process is operated that allows RBS to respond in instances where new information would change the variable pay decisions made in previous years and/or the decisions to be made in the current year. Under the accountability review process, RBS can apply malus and clawback.

- Malus can be applied to reduce (if appropriate to zero) the amount of any variable pay awards prior to payment taking place.
- Clawback provisions can also be applied to recover awards that have vested.

Any variable pay awarded to Material Risk Takers from 1 January 2015 onwards is subject to clawback for seven years from the date of grant. For awards made in respect of the 2016 performance year onwards, this period has been extended to ten years for executive directors and other Senior Managers under the Senior Managers Regime where there are outstanding internal or regulatory investigations at the end of the normal seven-year clawback period. Malus and clawback can be applied to current and former employees.

## Other Remuneration Disclosures

There are a number of trigger events under which malus and clawback will be considered including:

- the individual participating in or being responsible for conduct which results in significant losses for RBS;
- the individual failing to meet appropriate standards of fitness and propriety;
- reasonable evidence of an individual's misbehaviour or material error;
- RBS or the individual's relevant business unit suffering a material failure of risk management; and
- in the case of malus only, circumstances where there has been a material downturn in financial performance.

### How have we applied this in practice?

During 2016 a number of issues and events were considered under the accountability review framework. The outcomes covered a range of actions including: reduction and forfeiture of unvested awards through malus; reduction of current year variable pay awards; dismissal with forfeiture of unvested awards; and suspension of awards pending further investigation.

## Other Remuneration Disclosures

### Our remuneration policy for all employees

The remuneration policy supports the business strategy and is designed to promote the long-term success of RBS. It aims to reward employees for delivering good performance against targets provided this is achieved in a manner consistent with our values and within acceptable risk parameters. The remuneration policy applies the same principles to all employees including Material Risk Takers (MRTs) subject to UK regulatory requirements (1). The current key elements underpinning the remuneration policy are set out below.

Element of pay	Objective	Operation
Base salary	To aid recruitment and retention of high performing individuals whilst paying no more than is necessary. To provide a competitive level of fixed cash remuneration, reflecting the skills and experience required, and to discourage excessive risk taking.	Base salaries are reviewed annually and should reflect the talents, skills and competencies that the individual brings to the business.
Role-based allowance	To provide fixed pay that reflects the skills and experience required for the role.	Allowances are provided to certain employees in key roles in line with market practice and qualify as fixed remuneration for regulatory requirements. They are delivered in cash and/or shares depending on the level of the allowance and the seniority of the recipient. Shares are subject to an appropriate retention period, not less than six months.
Benefits (including pension)	To provide a range of flexible and market competitive benefits. To encourage planning for retirement and long-term savings.	In most jurisdictions, employee benefits or a cash equivalent are provided from a flexible benefits account.
Annual bonus	To support a culture where employees recognise the importance of serving customers well and are rewarded for superior performance.	The annual bonus pool is based on a balanced scorecard of measures including Customer, Financial, Risk and People measures. Allocation from the pool depends on performance of the franchise or function and the individual. Individual performance assessment is supported by a structured performance management framework.  Immediate cash awards are limited to a maximum of £2,000. Under the deferral arrangements a significant proportion of

		<p>annual bonus awards for our more senior employees are deferred over a three to seven year period. Awards are subject to malus and clawback provisions. For MRTs, a minimum of 50% of any annual bonus is delivered in shares and subject to a minimum six month retention period post vesting in line with regulatory requirements.</p> <p>Guaranteed awards are only used in very limited circumstances in accordance with regulatory requirements.</p>
Long-term incentive awards	To support a culture where good performance against a full range of measures will be rewarded. To encourage the creation of value over the long term and to align further the rewards of the participants with the returns to shareholders.	<p>RBS provides certain employees in senior roles with long-term incentive awards. Awards are structured as performance-vesting shares. Performance is typically measured over a three year period. For awards made in respect of the 2016 performance year, vesting will take place over a three to seven year period.</p> <p>The amount of the award that vests may vary between 0% -100% depending on the performance achieved. Awards are subject to malus and clawback provisions and a minimum six month retention period applies to MRTs post vesting.</p>
Other share plans	To offer employees in certain jurisdictions the opportunity to acquire shares.	Employees in certain countries are eligible to contribute to share plans which are not subject to performance conditions.

Note:

(1) The EBA has issued criteria for identifying MRT roles i.e. staff whose professional activities have a material influence over RBS's performance or risk profile. The criteria for identifying MRTs are both qualitative (based on the nature of the role) and quantitative (i.e. those who exceed the stipulated total remuneration threshold based on the previous year's total remuneration).

The qualitative criteria can be summarised as: staff within the management body; senior management; other staff with key functional or managerial responsibilities; staff, individually or as part of a Committee, with authority to approve new business products or to commit to credit risk exposures and market risk transactions above certain levels.

The quantitative criteria are: individuals earning €500,000 or more in the previous year; individuals in the top 0.3% of earners in the previous year; individuals who earned more than the lowest paid identified staff per the qualitative criteria, subject to specific exceptions in the criteria.

## Other Remuneration Disclosures

In accordance with UK regulatory requirements and internal dealing rules that apply to employees, the conditions attached to discretionary share-based awards prohibit the use of any personal hedging strategies to lessen the impact of a reduction in value of such awards. These conditions are explicitly acknowledged and accepted by employees when any share-based awards are granted.

### Remuneration of MRTs

The quantitative disclosures below are made in accordance with Article 450 of the EU Capital Requirements Regulation in relation to 665 employees who have been identified as MRTs.

#### 1. Aggregate remuneration expenditure

Aggregate remuneration expenditure in respect of 2016 performance was as follows:

	Franchises		Total
	PBB, CPB and NatWest Markets (formerly CIB)	Rest of RBS	
	£m	£m	£m
	211.6	143.5	355.1

#### 2. Amounts and form of fixed and variable remuneration

##### Fixed remuneration for 2016

Consisted of salaries, allowances, pensions and benefits.

	Senior management	Other MRTs	Total
Number of beneficiaries	11	654	665
Total fixed remuneration	£m 17.4	£m 205.7	£m 223.1
			147
Executive Committee			310



## Other Remuneration Disclosures

### Variable remuneration awarded for 2016 performance

Variable remuneration consisted of a combination of annual bonus and long-term incentive awards, deferred over a three to seven year period in accordance with regulatory requirements. Under the RBS bonus deferral structure, cash awards are limited to £2,000 per employee.

	Senior		
	management	Other MRTs	Total
<b>Annual bonus awards</b>			
Number of beneficiaries	—	510	510
	£m	£m	£m
Variable remuneration (cash)	—	1.2	1.2
Deferred remuneration (bonds)	—	11.3	11.3
Deferred remuneration (shares)	—	86.3	86.3

Long-term incentive awards vest subject to the extent to which performance conditions are met and can result in zero payment.

	Senior		
	management	Other MRTs	Total
<b>Long-term incentive awards</b>			
Number of beneficiaries	10	98	108
	£m	£m	£m
Long-term incentive awards	17.2	16.2	33.4

The variable component of total remuneration for MRTs at RBS shall not exceed 100% of the fixed component. Based on the information disclosed above, the average ratio between fixed and variable remuneration for 2016 is approximately 1 to 0.6.

### 3. Outstanding deferred remuneration through 2016

The table below includes deferred remuneration awarded or paid out in 2016 in respect of prior performance years. Deferred remuneration reduced during the year relates to long-term incentives lapsed when performance conditions are not met, long-term incentives and deferred awards forfeited on leaving



and malus adjustments of prior year deferred awards and long-term incentives.

	Senior management	Other MRTs
Category of deferred remuneration	£m	£m
Unvested from prior year	34.2	200.8
Awarded during the financial year	17.5	129.4
Paid out	7.4	113.0
Reduced from prior years	1.9	21.8
Unvested at year end	42.4	195.5

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## Other Remuneration Disclosures

### 4. Sign-on and severance payments

RBS does not operate 'Sign-on awards'. Guaranteed variable remuneration may be used for new hires in compensation for awards foregone in their previous company. Three such payments totalling £442,695 are included in the tables above. This relates to commitments made on recruitment in respect of three new employees. These awards are still subject to deferral.

No severance payments were made during the financial year in excess of contractual payments, local policies, standards or statutory amounts, other than one payment of £219,500 made in commercial settlement of legal proceedings related to the early termination of a contract of employment.

### All staff total remuneration

- The average salary for all employees is £32,620.
- 13,664 employees earn between £50,000 and £100,000.
- 5,545 employees earn between £100,000 and £250,000.
- 1,025 employees earn total remuneration over £250,000.

Total remuneration by band for all employees earning >€1 million	Number of employees	
	2016	2015
€1.0m - €1.5m	48	53
€1.5m - €2.0m	20	24
€2.0m - €2.5m	10	11
€2.5m - €3.0m	5	7
€3.0m - €3.5m	0	2
€3.5m - €4.0m	0	2
€4.0m - €4.5m	3	0
€4.5m - €5.0m	0	1
€5.0m - €6.0m	1	0
€6.0m - €7.0m	0	1
Total	87	101

Notes:

(1) Total remuneration in the table above includes fixed pay, pension and benefit funding and variable pay (including actual value of LTI vesting in 2016) after the application of malus.

(2) Executive directors are not included. The table is based on an exchange rate where applicable of €1.224 to £1 as at 31 December 2016 and amounts disclosed for 2015 have been restated using the same exchange rate so that comparison can be made on a like for like basis.

Employees that earned total remuneration of over €1 million in 2016 represent just 0.1% of our employees. This number reduces to 72 employees if we exclude pension and benefit funding. These employees include those who manage major businesses and functions with responsibility for significant assets, earnings or areas of strategic activity and can be grouped as follows:

- The CEOs responsible for each area and their direct reports.
- Employees managing large businesses within a franchise.
- Income generators responsible for high levels of income including those involved in managing trading activity and supporting clients with more complex financial transactions, including financial restructuring.
- Those responsible for managing our balance sheet and liquidity and funding positions across the business.
- Employees managing the successful disposal of assets in Capital Resolution and reducing RBS's capital requirements.

## Compliance report

### Statement of compliance

RBS is committed to high standards of corporate governance, business integrity and professionalism in all its activities.

Throughout the year ended 31 December 2016, RBS has complied with all of the provisions of the UK Corporate Governance Code issued by the Financial Reporting Council dated April 2016 (the “Code”) except in relation to provision (D.2.2) that the Group Performance and Remuneration Committee should have delegated responsibility for setting remuneration for the Chairman and executive directors. RBS considers that this is a matter which should rightly be reserved for the Board and this is an approach RBS has adopted for a number of years. Remuneration for the executive directors is first considered by the Group Performance and Remuneration Committee which then makes recommendations to the Board for consideration. This approach allows all non-executive directors, and not just those who are members of the Group Performance and Remuneration Committee, to participate in decisions on the executive directors’ and the Chairman’s remuneration and also allows the executive directors to input to the decision on the Chairman’s remuneration. The Board believes this approach is very much in line with the spirit of the Code and no director is involved in decisions regarding his or her own remuneration. We do not anticipate any changes to our approach on this aspect of the Code. Information on how RBS has applied the main principles of the Code can be found in the Corporate governance report on pages 59 to 149. A copy of the Code can be found at [www.frc.org.uk](http://www.frc.org.uk).

RBS has also implemented the recommendations arising from the Walker Review and complied in all material respects with the Financial Reporting Council Guidance on Audit Committees issued in September 2012 and April 2016.

Under the US Sarbanes-Oxley Act of 2002, specific standards of corporate governance and business and financial disclosures and controls apply to companies with securities registered in the US. RBS complies with all applicable sections of the US Sarbanes-Oxley Act of 2002, subject to a number of exceptions available to foreign private issuers.

### Internal control

Management of The Royal Bank of Scotland Group plc is responsible for the system of internal controls that is designed to maintain effective and efficient operations, compliant with applicable laws and regulations. The system of internal controls is designed to manage, or mitigate, risk to an acceptable residual level rather than eliminate it entirely. Systems of internal control can only provide reasonable and not absolute assurance against material misstatement, fraud or loss.



## Compliance report

### Management's report on internal control over financial reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting for RBS.

RBS's internal control over financial reporting is a component of an overall system of internal control and is designed to provide reasonable assurance regarding the preparation, reliability and fair presentation of financial statements for external purposes in accordance with International Financial Reporting Standards (IFRS) and includes:

- Policies and procedures that relate to the maintenance of records that, in reasonable detail, fairly and accurately reflect the transactions and disposition of assets.
- Controls providing reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in accordance with IFRS, and that receipts and expenditures are being made only as authorised by management.
- Controls providing reasonable assurance regarding the prevention or timely detection of unauthorised acquisition, use or disposition of assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. In addition, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions or because the degree of compliance with policies or procedures may deteriorate.

Management assessed the effectiveness of RBS's internal control over financial reporting as of 31 December 2016 based on the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in the 2013 publication of 'Internal Control - Integrated Framework'.

Based on its assessment, management believes that, as of 31 December 2016, RBS's internal control over financial reporting is effective.

The effectiveness of RBS's internal control over financial reporting as of 31 December 2016 has been audited by Ernst & Young LLP, RBS's independent registered public accounting firm. The report of the independent registered public accounting firm to the directors of the Royal Bank of Scotland Group plc expresses an unqualified opinion and have given an unqualified opinion on RBS's internal control over financial reporting as of 31 December 2016.



## Compliance report

### Report of Independent Registered Public Accounting Firm

#### Members of The Royal Bank of Scotland Group plc

We have audited The Royal Bank of Scotland Group plc and subsidiaries' (together, the "Group") internal control over financial reporting as of 31 December 2016 based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework) (the COSO criteria). The Group's management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Group's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorisations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorised acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.



## Compliance report

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Group maintained, in all material respects, effective internal control over financial reporting as of 31 December 2016 based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of the Group as of 31 December 2016, and the related consolidated statements of income, comprehensive income, changes in equity and cash flows for the year then ended and our report dated 23 February 2017 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP  
London, United Kingdom  
23 February 2017

## Compliance report

### Disclosure controls and procedures

Management, including RBS's Chief Executive and Chief Financial Officer have conducted an evaluation of the effectiveness and design of RBS's disclosure controls and procedures (as such term is defined in Exchange Act Rule 13a-15(e)). Based on this evaluation, RBS's Chief Executive and Chief Financial Officer concluded that RBS's disclosure controls and procedures were effective as of the end of the period covered by this annual report.

### Changes in internal control

There was no change in RBS's internal control over financial reporting that occurred during the period covered by this report that has materially affected, or is reasonably likely to materially affect, RBS's internal control over financial reporting.

### The New York Stock Exchange

As a foreign private issuer with American Depository Shares representing ordinary shares, preference shares and debt securities listed on the New York Stock Exchange (the "NYSE"), RBS is not required to comply with all of the NYSE standards applicable to US domestic companies (the "NYSE Standards") provided that it follows home country practice in lieu of the NYSE Standards and discloses any significant ways in which its corporate governance practices differ from the NYSE Standards. RBS is also required to provide an Annual Written Affirmation to the NYSE of its compliance with the mandatory applicable NYSE Standards.

The Group Audit Committee fully complies with the mandatory provisions of the NYSE Standards (including by reference to the rules of the Exchange Act) that relate to the composition, responsibilities and operation of audit committees. In March 2016 RBS submitted its required annual written affirmation to the NYSE confirming its full compliance with those and other applicable provisions. More detailed information about the Group Audit Committee and its work during 2016 is set out in the Group Audit Committee report on pages 79 to 87.

RBS has reviewed its corporate governance arrangements and is satisfied that these are consistent with the NYSE Standards, subject to the following departures: (i) NYSE Standards require the majority of the Board to be independent. The NYSE Standards contain different tests from the Code for determining whether a director is independent. RBS follows the Code's requirements in determining the independence of its directors and currently has 9 independent non-executive directors, one of whom is the senior independent director (ii) The NYSE Standards require non-management directors to hold regular sessions without management present and that independent directors meet at least once a year. The Code requires the Chairman to hold meetings with non-executive directors without the executives present and non-executive directors are to meet without the Chairman present at least once a year to appraise the

Chairman's performance and RBS complies with the requirements of the Code. (iii) The NYSE Standards require that the nominating/corporate governance committee of a listed company be composed entirely of independent directors.

## Compliance report

The Chairman of the Board is also the Chairman of the Group Nominations and Governance Committee, which is permitted under the Code (since the Chairman was considered independent on appointment). The terms of reference of the Group Nominations and Governance Committee differ in certain limited respects from the requirements set out in the NYSE Standards, including because the Group Nominations and Governance Committee does not have responsibility for overseeing the evaluation of management (iv) The NYSE standards require that the compensation committee of a listed company be composed of entirely of independent directors. Although the members of the Group Performance and Remuneration Committee are deemed independent in compliance with the provisions of the Code, the Board has not assessed the independence of the members of the Group Performance and Remuneration Committee and the Group Performance and Remuneration Committee has not assessed the independence of any compensation consultant, legal counsel or other adviser, in each case, in accordance with the independence tests prescribed by the NYSE Standards.

The NYSE Standards require that the compensation committee must have direct responsibility to review and approve the Chief Executive's remuneration. As stated at the start of this Compliance Report, in the case of RBS, the Board, rather than the Group Performance and Remuneration Committee, reserves the authority to make the final determination of the remuneration of the Chief Executive (v) The NYSE Standards require listed companies to adopt and disclose corporate governance guidelines. Throughout the year ended 31 December 2016, RBS has complied with all of the provisions of the Code (subject to the exception described above) and the Code does not require RBS to disclose the full range of corporate governance guidelines with which it complies (vi) The NYSE Standards require listed companies to adopt and disclose a code of business conduct and ethics for directors, officers and employees, and promptly disclose any waivers of the code for directors or executive officers. RBS has adopted a code of conduct which applies to all directors, officers and employees and is supplemented by a number of key policies and guidance dealing with matters including , among others, anti-bribery and corruption, anti-money laundering, sanctions, confidentiality, inside information, health, safety and environment, conflicts of interest, market conduct and management records. The Code of Conduct is available to view on RBS's website at [rbs.com](http://rbs.com) .

This Compliance report forms part of the Corporate governance report and the Report of the directors.

## Report of the directors

The directors present their report together with the audited accounts for the year ended 31 December 2016.

## Group structure

The company is a holding company owning the entire issued ordinary share capital of The Royal Bank of Scotland plc, the principal direct operating subsidiary undertaking of the company.

Following placing and open offers in December 2008 and in April 2009, HM Treasury (HMT) owned approximately 70.3% of the enlarged ordinary share capital of the company. In December 2009, the company issued a further £25.5 billion of new capital to HMT in the form of B shares. HMT sold 630 million of its holding of the company's ordinary shares in August 2015. In October 2015 HMT converted its entire holding of 51 billion B shares into 5.1 billion new ordinary shares of £1 each in the company.

The final dividend payment on the Dividend Access Share (DAS) owned by HMT of £1.2 billion was paid in March 2016, effecting the immediate retirement of the DAS which was redesignated as a single B share and subsequently cancelled.

At 31 December 2016, HMT's holding in the company's ordinary shares was 71.3%.

## RBS Group ring-fencing

The UK ring-fencing legislation requiring the separation of essential banking services from investment banking services will take effect from 1 January 2019.

To comply with these requirements it is RBS's intention to place the majority of the UK and Western European banking business in ring-fenced banking entities under an intermediate holding company. NatWest Markets will be a separate non ring-fenced bank and The Royal Bank of Scotland International (Holdings) Limited (RBSI Holdings) will also be placed outside the ring-fence, both as direct subsidiaries of RBSG.

The final ring-fenced legal structure and the actions to be taken to achieve it, remain subject to, amongst other factors, additional regulatory, Board and other approvals as well as employee information and consultation procedures. All such actions and their respective timings may be subject to change, or additional actions may be required, including as a result of external and internal factors including further

regulatory, corporate or other developments.

## Report of the directors

On 1 January 2017 RBS made a number of key changes to the

legal entity structure as detailed below to support the move towards a ring-fenced structure. There are also plans to make further changes prior to 1 January 2019.

### NatWest Holdings Limited (NatWest Holdings)

RBS introduced an intermediate holding company, NatWest Holdings, as a direct subsidiary of RBS plc. This is an interim structure as NatWest Holdings is expected to become a direct subsidiary of RBSG in mid 2018.

National Westminster Bank Plc (NatWest) and Adam & Company Group PLC (Adam & Co) transferred from being direct subsidiaries of RBS plc, and Ulster Bank (Ireland) Holdings Unlimited Company (UBIH) transferred from being a direct subsidiary of Ulster Bank Limited, to become direct subsidiaries of NatWest Holdings.

### RBS International

RBSI Holdings transferred from being an indirect subsidiary of RBS plc to become a direct subsidiary of RBSG. The intention is for RBS International's operating companies to remain as subsidiaries of RBSI Holdings.

NatWest bought Lombard North Central PLC and RBS Invoice Finance (Holdings) Limited from RBS plc and some smaller companies from other members of the Group.

## Business structure

RBS continues to deliver on its plan to build a strong, simple and fair bank for both customers and shareholders. On 5 December 2016 the Corporate & Institutional Banking (CIB) business was re-branded as NatWest Markets (NWM) in readiness for our future ring-fenced structure; this included the renaming of the reportable operating segment as NatWest Markets. NatWest Markets will continue to offer financing, rates and currencies products to its customers. During 2016 RBS's activities were organised on a franchise basis as follows:

**Personal & Business Banking (PBB)** comprises two reportable segments, UK Personal & Business Banking (UK PBB) and Ulster Bank RoI. UK PBB serves individuals and mass affluent customers in the UK together

with small businesses (generally up to £2 million turnover). UK PBB includes Ulster Bank customers in Northern Ireland. Ulster Bank RoI serves individuals and businesses in the Republic of Ireland (RoI).

**Commercial & Private Banking (CPB)** comprises three reportable segments, Commercial Banking, Private Banking and RBS International (RBSI). Commercial Banking serves commercial and corporate customers in the UK and Western Europe. Private Banking serves UK connected high net worth individuals and RBSI serves retail, commercial, corporate and financial institution customers in Jersey, Guernsey, Isle of Man and Gibraltar and financial institution customers in Luxembourg.



## Report of the directors

**NatWest Markets**, formerly Corporate and Institutional Banking (CIB), serves UK and Western Europe corporate customers, and global financial institutions, supported by trading and distribution platforms in the UK, US and Singapore.

**Capital Resolution** was established to execute the sale or wind down of most of the global footprint, from 38 countries to 13, and trade finance and cash management outside the UK and Ireland. Additionally non-strategic markets, portfolio and banking assets

identified are being sold or wound down.

**Williams & Glyn (W&G)** refers to the business formerly intended to be divested as a separate legal entity and comprises RBS England and Wales branch-based businesses, along with certain small and medium enterprises and corporate activities across the UK. During the periods presented W&G has not operated as a separate legal entity. The perimeter of the segment currently reported does not include certain portfolios that were intended to be divested such as the Scottish branch based activity of NatWest and NatWest Business Direct.

**Central items & other** includes corporate functions, such as RBS treasury, finance, risk management, compliance, legal, communications and human resources. Central functions manages RBS capital resources and RBS-wide regulatory projects and provides services to the reportable segments. Balances in relation to Citizens and the international private banking business are included in Central items in the relevant periods.

## Results and dividends

The loss attributable to the ordinary shareholders of the Group for the year ended 31 December 2016 amounted to £6,955 million compared with a loss of £1,979 million for the year ended 31 December 2015, as set out in the consolidated income statement on page 378.

The company did not pay a dividend on ordinary shares in 2014, 2015 or 2016.

In the context of prior macro-prudential policy discussions, the Board decided to partially neutralise any impact on Core Tier 1 capital of coupon and dividend payments in respect of 2015 and 2016 Group hybrid capital instruments through equity issuances of c.£300 million. Consequently, approximately £300 million was raised during 2015 and 2016 through the issue of new ordinary shares and the Board has decided a further £300 million of new equity will be issued during the course of 2017 to again partially neutralise the

CET1 impact of coupon and dividend payments.

## Report of the directors

The Dividend Access Share (DAS) retirement agreement was approved at the General Meeting of shareholders held on 25 June 2014. The first dividend payment on the DAS of £320 million was made in the third quarter of 2014. The balance of £1.2 billion was paid to HMT in March 2016, effecting the immediate retirement of the DAS which was redesignated as a single B share and subsequently cancelled, further normalising the capital structure of RBS and removing an obstacle toward the resumption of capital distributions.

## Business review

### Activities

RBS is engaged principally in providing a wide range of banking and other financial services. Further details of the organisational structure and business overview of RBS, including the products and services provided by each of its operating segments and the competitive markets in which they operate are contained in the Business review on pages 171 to 217. Details of the strategy for delivering the company's objectives can be found in the Strategic report.

### Risk factors

RBS's future performance and results could be materially different from expected results depending on the outcome of certain potential risks and uncertainties. Full details of these and other risk factors are set out on pages 509 to 578.

The reported results of RBS are also sensitive to the accounting policies, assumptions and estimates that underlie the preparation of its financial statements. Details of RBS's critical accounting policies and key sources of accounting judgments are included in Accounting policies on pages 385 to 401.

RBS's approach to risk management, including its financial risk management objectives and policies and information on RBS's exposure to price, credit, liquidity and cash flow risk, is discussed in the Capital and risk management section.

### Financial performance

A review of RBS's performance during the year ended 31 December 2016, including details of each operating segment, and RBS's financial position as at that date is contained in the Business review on pages 171 to 217.

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

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

## Report of the directors

Following the announcements in April 2011 by the Boards of RBSG, RBS plc, RBS Holdings and RBS N.V., a substantial part of the business activities of RBS N.V. had been successfully transferred to RBS plc by 2014. There is continued focus on further de-risking the RBS N.V. balance sheet. Ultimately, the objective is that RBS N.V. is in a position to relinquish its banking licence in the Netherlands.

## Business divestments

To comply with the European Commission State Aid requirements RBS agreed a series of restructuring measures. These include the sale of 80.01% of RBS's Global Merchant Services business (completed in 2010), the sale of substantially all of the RBS Sempra Commodities joint venture business (largely completed in 2010), the divestment of Direct Line Insurance Group plc (completed in 2014), as well as the divestment of the RBS branch-based business in England and Wales and the NatWest branches in Scotland, along with the direct SME customers across the UK ("UK branch-based businesses").

During 2016 work has continued to explore means to achieve separation and divestment of the business previously described as Williams & Glyn. On 17 February 2017, RBS announced that it had been informed by HM Treasury (HMT) that the Commissioner responsible for EU competition policy plans to propose to the College of Commissioners to open proceedings to gather evidence on an alternative plan for RBS to meet its remaining State Aid obligations. If adopted, this alternative plan would replace the existing requirement to achieve separation and divestment by 31 December 2017 of the business previously described as Williams & Glyn.

As previously disclosed, none of the proposals to acquire the business received by RBS can deliver full separation and divestment before the 31 December 2017 deadline. As RBS no longer intends to pursue divestment of Williams & Glyn by way of an Initial Public Offering, the £600 million exchangeable bond issued to a consortium of investors, led by Centerbridge and Corsair, was redeemed on 21 October 2016 in accordance with the terms of the bond.

RBS completed its divestment of Citizens Financial Group Inc (IPO completed in 2015).

## Employees

### Our colleagues

As at 31 December 2016, RBS employed 77,900 people (full-time equivalent basis, including temporary workers) throughout the world. Details of related costs are included in Note 3 on the consolidated accounts.

## Building a healthy culture

Building a healthy culture that embodies Our Values is one of our core priorities.

Our Values guide the way we identify the right people to serve our customers well, and how we manage, engage and reward our colleagues. They are at the heart of both Our Standards (the bank wide behavioural framework) and Our Code (the bank wide Code of Conduct).

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## Report of the directors

To really live our values we continue to reinforce them in our systems, our policies and processes, our communications, training and leadership role modelling.

We monitor our progress against our goals. We gather feedback from our colleagues, and through metrics and key performance indicators to assess our progress and respond accordingly. We do this in tandem with feedback from regulators and industry bodies.

## Engaging our colleagues

We know that building an engaged, healthy and inclusive workforce is crucial to achieving our ambition. Every year we ask our colleagues to share their thoughts on what it's like to work here via our annual colleague survey (OurView). The results help us monitor levels of engagement and enable our people leaders to work with their teams to make improvements. It also helps us measure the progress we are making towards our goals.

Our most recent survey, in which almost 63,000 colleagues took part, showed that we are changing the culture of RBS for the better. We remain above the global financial services norm for wellbeing, our inclusion scores continue to improve and there is a strong sense that managers act consistently with Our Values. However, the choices we've had to make as we move RBS forward have taken a toll on our colleagues. The scaling down of RBS and the impact of dealing with some difficult legacy issues have contributed to a decline in the improvements in engagement, pride and leadership that we saw in 2015.

## Rewarding our colleagues

Our approach to performance management provides clarity for our colleagues about how their contribution links to our ambition. It recognises behaviour that supports our values and holds individuals to account for behaviour and performance that does not. In 2016 we refreshed our behavioural framework to create one framework for all our colleagues.

We have a focus on paying the right wage to colleagues and our rates of pay continue to exceed the Living Wage Foundation Benchmarks.

At the start of 2016 we removed sales incentives and we gave every eligible frontline colleague in Personal & Business Banking an increase to their guaranteed pay. This approach remains popular with our colleagues and ensures that our customers can be certain that if they take a product from us, it has no financial impact on what our colleagues are paid.

For 2017, we have simplified how we pay our clerical colleagues, consolidating bonuses, making pay fairer and easier to understand.



## Report of the directors

We remain focused on our goals in relation to gender equality and have played an active role in the consultation process for upcoming Gender Pay Gap Reporting regulations. We intend to comply fully with the regulations and to make a public disclosure during 2017.

## Developing our colleagues

In 2015, we launched 'Determined to Lead', a core management system for RBS. It is the means by which leaders put our values into practice every day and is transforming the way we operate by creating a common language, consistent operating rhythm and improving the competence of our leaders across RBS. It provides consistent tools to lead and engage our colleagues. This programme has continued in 2016 with over 16,000 leaders participating in the programme.

In October 2016 we launched Service Excellence training, our new customer service programme. The first module introduces our Core Service Behaviours and provides an awareness of the tools and techniques that will help us to deliver the best possible service, every time. Service Excellence gives us a shared service language and the behaviours to help us achieve our ambition. Since October over 34,000 colleagues have completed this module.

Professionalising our colleagues is important to us. We work closely with the Chartered Banker Institute (CBI) and Chartered Banker Professional Standards Board (CB:PSB) to offer our colleagues professional qualifications. Over 8,000 of our colleagues completed their CBI qualification in 2016.

We are especially pleased that we achieved an Excel rating in the CB:PSB Foundation Standard review for 2015. We are one of only two CB:PSB member firms to have secured 'Earned Autonomy' - meaning we are exempt from quarterly monitoring over the next 3 years. 95% of our in-scope population have achieved the Foundation Standard. This is a great reflection of the focus we continue to place on professionalising our colleagues.

We also offer a wide range of learning which can be mandatory, role specific or related to personal development. Our mandatory learning has to be completed by everyone and is focused on keeping our our customers, colleagues and RBS safe.

## Youth employment

In 2016 we welcomed over 500 people across our Graduate and Apprenticeship schemes, 40% being female hires.

## Health and wellbeing of our colleagues

Wellbeing is a big part of how we create a great place to work.

We offer a wide range of health benefits and services to help maintain physical and mental health, and support our colleagues if they become unwell.

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## Report of the directors

In 2016, we focused on physical, mental health and social wellbeing. We participated in the Global Corporate Challenge (GCC) - more than 50,000 colleagues took part helping us to win the GCC World Most Active Organisation Gold Award. We also continued to promote Lifeworks (RBS's Employee Assistance Programme) and launched our Mindfulness toolkit. We continued our support of Time to Change (the UK's biggest programme to challenge mental health stigma).

## Employee consultation

We recognise employee representatives such as trade unions and work councils in a number of businesses and countries. There has been ongoing engagement and discussion with those bodies given the scale of change taking place across RBS. Management have continued to meet regularly with our European Employee Council to discuss developments and update on the progress of our strategic plans.

## Inclusion

Building a more inclusive RBS is essential for our customers and colleagues. Our inclusion policy standard applies to all our colleagues globally.

During 2016, we continued to roll out unconscious bias learning to all our colleagues to create a solid platform for the wider inclusion agenda. Almost 30,000 colleagues participated in unconscious bias training in 2016 meaning we have trained around 66,000 colleagues across RBS to date.

We continue to work towards our goal of having at least 30% senior women in our top three leadership layers across each Franchise and Function by 2020 and to be fully gender balanced (50/50) by 2030. We have a positive action approach in place, tailored by business, according to the specific challenges they face.

Our disability plan will support us becoming a disability smart organisation by 2018. It addresses areas for improvement including branch access, accessible services, improving colleague adjustment processes and inserting disability checkpoints into our key processes and practices.

We continue to focus on building an ethnically diverse RBS. Our plan focuses on positive action and includes reciprocal mentoring, targeted development workshops and leadership programmes and ensuring we have a Black, Asian and Minority Ethnic (BAME) focus on recruitment, talent identification and promotion.

Our LGBT agenda continues to deliver a better experience for our LGBT colleagues and customers. We have processes in place to support updating gender and title on customers' banking records and to support colleagues undergoing gender transition. And, we continue to support our 16,000 strong employee-led networks.

## Report of the directors

We have been recognised for our work on Equality, Diversity and Inclusion by our Platinum ranking from Opportunity Now (gender), our Gold ranking for Race for Opportunity (race); retaining a position in the Times Top 50 Employers for Women; becoming a Top Ten Global Employer in Stonewall's Global Equality Index (LGBT), Silver Status from The Business Disability Forum and being rated a Top 10 Employer by Working Families.

## Sustainability

Our purpose is to serve customers well. We will rebuild our reputation and earn our customers' trust by putting customers first, making RBS a great place to work, supporting our communities and being mindful of environmental impacts. The Sustainable Banking Committee's role is to support the Board in overseeing, supporting and challenging actions being taken by management to run RBS as a sustainable business.

For more information on our approach and progress please read the RBS Strategic Report. Further information is available on [rbs.com/sustainability](http://rbs.com/sustainability).

## Greenhouse gas emissions

Disclosures relating to greenhouse gas emissions are included in the Strategic Report on page 39.

## Going concern

RBS's business activities and financial position, the factors likely to affect its future development and performance and its objectives and policies in managing the financial risks to which it is exposed and its capital are discussed in the Business review. The risk factors which could materially affect RBS's future results are set out on pages 509 to 578. RBS's regulatory capital resources and significant developments in 2016 and anticipated future developments are detailed on pages 230 to 269. The liquidity and funding section on pages 255 to 269 describes RBS's funding and liquidity profile, including changes in key metrics and the build up of liquidity reserves.

Having reviewed RBS's forecasts, projections and other relevant evidence, the directors have a reasonable expectation that RBS and the company will continue in operational existence for the foreseeable future. Accordingly, the financial statements of RBS and of the company have been prepared on a going concern basis.



## Report of the directors

### BBA disclosure code

RBS's 2016 financial statements have been prepared in compliance with the principles set out in the Code for Financial Reporting Disclosure published by the British Bankers' Association in 2010. The Code sets out five disclosure principles together with supporting guidance. The principles are that RBS and other major UK banks will provide high quality, meaningful and decision-useful disclosures; review and enhance their financial instrument disclosures for key areas of interest to market participants; assess the applicability and relevance of good practice recommendations to their disclosures acknowledging the importance of such guidance; seek to enhance the comparability of financial statement disclosures across the UK banking sector; and clearly differentiate in their annual reports between information that is audited and information that is unaudited.

### Enhanced Disclosure Task Force (EDTF)

The EDTF established by the Financial Stability Board, published its report 'Enhancing the Risk Disclosures of Banks' in October 2012. All EDTF recommendations are reflected in the 2016 Annual Report on Form 20-F.

### Corporate governance

The company is committed to high standards of corporate governance. Details are given in the Corporate governance report on pages 59 to 149. The Corporate governance report and compliance report (pages 150 to 155) form part of this Report of the directors.

### Share capital

Details of the ordinary and preference share capital at 31 December 2016 and movements during the year are shown in Note 25 on the consolidated accounts.

During 2016, the company allotted and issued a total of 142.2 million new ordinary shares of £1 each for the purposes of ensuring 2016 coupon payments on discretionary hybrid capital securities were partly neutralised from a Core Tier 1 capital perspective. The shares were allotted to UBS AG at the subscription prices determined by reference to the average market prices during the sale periods set out below.

Number of shares sold	Subscription price	Sale period	Gross proceeds	Share price on allotment
37.6m	226.250p	26/2/16-14/4/16	£85 million	231.6p
	220.687p	29/4/16-24/5/16	£85 million	245.3p

38.5m

35.5m	196.924p	05/8/16-02/09/16	£70 million	204.3p
30.6m	195.930p	28/10/16-16/11/16	£60 million	208.4p

In the three years to 31 December 2016, the percentage increase in issued share capital due to non-pre-emptive issuance (excluding employee share schemes) for cash was 2.71%.

In addition, the company issued 56 million shares in connection with employee share schemes during 2016.

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## Report of the directors

In October 2015, HMT converted its entire holding of 51 billion B shares into 5.1 billion new ordinary shares of £1 each.

In March 2016, the company paid a final dividend of £1.2 billion in respect of the Dividend Access Share (DAS) held by HMT, effecting the immediate retirement of the DAS which was redesignated as a single B share and subsequently cancelled.

## Authority to repurchase shares

At the Annual General Meeting in 2016 shareholders authorised the company to make market purchases of up to 1,166,108,903 ordinary shares. The directors have not exercised this authority to date. Shareholders will be asked to renew this authorisation at the Annual General Meeting in 2017.

## Additional information

Where not provided elsewhere in the Report of the directors, the following additional information is required to be disclosed by Part 6 of Schedule 7 to the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008.

The rights and obligations attached to the company's ordinary shares and preference shares are set out in the company's Articles of Association, copies of which can be obtained from Companies House in the UK or can be found at [rbs.com/about/board-and-governance](http://rbs.com/about/board-and-governance).

On a show of hands at a general meeting of the company every holder of ordinary shares and cumulative preference shares present in person or by proxy and entitled to vote shall have one vote. On a poll, every holder of ordinary shares or cumulative preference shares present in person or by proxy and entitled to vote shall have four votes for every share held. The notices of Annual General Meetings and General Meetings specify the deadlines for exercising voting rights and appointing a proxy or proxies to vote in relation to resolutions to be passed at the meeting.

The cumulative preference shares represent less than 0.008% of the total voting rights of the company, the remainder being represented by the ordinary shares.

There are no restrictions on the transfer of ordinary shares in the company other than certain restrictions which may from time to time be imposed by laws and regulations (for example, insider trading laws).

Pursuant to the Listing Rules of the FCA, certain employees of the company require the approval of the company to deal in the company's shares.

The rules governing the powers of directors, including in relation to issuing or buying back shares and their appointment are set out in the company's Articles of Association. It will be proposed at the 2017 Annual General Meeting that the directors be granted authorities to allot shares under the Companies Act 2006. The company's Articles of Association may only be amended by a special resolution at a general meeting of shareholders.

## Report of the directors

The rights and obligations of holders of non-cumulative preference shares are set out in Note 25 on the consolidated accounts.

The company is not aware of any agreements between shareholders that may result in restrictions on the transfer of securities and/or voting rights. There are no persons holding securities carrying special rights with regard to control of the company.

A number of the company's employee share plans include restrictions on transfers of shares while shares are subject to the plans or the terms under which the shares were awarded.

Under the rules of certain employee share plans, eligible employees are entitled to acquire shares in the company, and shares are held in trust for participants by The Royal Bank of Scotland plc and Ulster Bank Dublin Trust Company as Trustees. Voting rights are exercised by the Trustees on receipt of participants' instructions. If a participant does not submit an instruction to the Trustee no vote is registered.

The Royal Bank of Scotland plc 1992 Employee Share Trust, The Royal Bank of Scotland Group plc 2001 Employee Share Trust and The Royal Bank of Scotland Group plc 2007 US Employee Share Trust hold shares on behalf of RBS's employee share plans. The voting rights are exercisable by the Trustees, however, in accordance with investor protection guidelines, the Trustees abstain from voting. The Trustees would take independent advice before accepting any offer in respect of their shareholdings for the company in a takeover bid situation.

Awards granted under the company's employee share plans may be met through a combination of newly issued shares and shares acquired in the market by the company's employee benefit trusts.

A change of control of the company following a takeover bid may cause a number of agreements to which the company is party to take effect, alter or terminate. All of the company's employee share plans contain provisions relating to a change of control. Outstanding awards and options may vest and become exercisable on change of control, subject where appropriate to the satisfaction of any performance conditions at that time and pro-rating of awards. In the context of the company as a whole, these agreements are not considered to be significant.

## Directors

The names and brief biographical details of the current directors are shown on pages 59 to 65.

Sandy Crombie, Howard Davies, Alison Davis, Morten Friis, Robert Gillespie, Penny Hughes, Ross McEwan, Brendan Nelson, Baroness Noakes and Ewen Stevenson all served throughout the year and to the date of signing of the financial statements.

## Report of the directors

Mike Rogers was appointed to the Board on 26 January 2016 and Frank Dangeard was appointed on 16 May 2016.

All directors of the company are required to stand for election or re-election annually by shareholders at the Annual General Meeting and, in accordance with the UK Listing Rules, the election or re-election of independent directors requires approval by all shareholders and also by independent shareholders.

## Directors' interests

The interests of the directors in the shares of the company at 31 December 2016 are shown on page 135. None of the directors held an interest in the loan capital of the company or in the shares or loan capital of any of the subsidiary undertakings of the company, during the period from 1 January 2016 to 23 February 2017.

## Directors' indemnities

In terms of section 236 of the Companies Act 2006 (the "Companies Act"), Qualifying Third Party Indemnity Provisions have been issued by the company to its directors, members of the RBS Executive Committee, individuals authorised by the PRA/FCA and certain directors and/or officers of RBS subsidiaries.

In terms of section 236 of the Companies Act, Qualifying Pension Scheme Indemnity Provisions have been issued to all trustees of RBS pension schemes.

## Post balance sheet events

Other than the matter disclosed on page 483, there have been no significant events between the year end and the date of approval of these accounts which would require a change to or disclosure in the accounts.

## Controlling shareholder

In accordance with the UK Listing Rules, the company has entered into an agreement with HM Treasury (the 'Controlling Shareholder') which is intended to ensure that the Controlling Shareholder complies with the independence provisions set out in the UK Listing Rules. The company has complied with the independence provisions in the relationship agreement and as far as the company is aware the independence and procurement provisions in the relationship agreement have been complied with in the period by the controlling shareholder.

## Shareholdings

The table below shows shareholders that have notified RBS that they hold more than 3% of the total voting rights of the company at 31 December 2016.

Solicitor For The Affairs of Her Majesty's Treasury as Nominee for Her Majesty's Treasury	Number of shares		% of total voting rights held
	(millions)	% of share class held	
Ordinary shares	8,434	71.3	71.3

As at 23 February 2017, there were no changes to the shareholdings shown in the table above.

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## Report of the directors

### Listing Rule 9.8.4

In accordance with the UK Financial Conduct Authority's Listing Rules the information to be included in the Annual Report and Accounts under LR 9.8.4, is set out in this Directors' report with the exception of details of contracts of significance under LR 9.8.4. (10) and (11) given in Additional Information on pages 505 to 508.

### Political donations

At the Annual General Meeting in 2016, shareholders gave authority under Part 14 of the Companies Act, for a period of one year, for the company (and its subsidiaries) to make political donations and incur political expenditure up to a maximum aggregate sum of £100,000. This authorisation was taken as a precaution only, as the company has a longstanding policy of not making political donations or incurring political expenditure within the ordinary meaning of those words. During 2016, RBS made no political donations, nor incurred any political expenditure in the UK or EU and it is not proposed that RBS's longstanding policy of not making contributions to any political party be changed. Shareholders will be asked to renew this authorisation at the Annual General Meeting in 2017.

### Directors' disclosure to auditors

Each of the directors at the date of approval of this report confirms that:

(a) so far as the director is aware, there is no relevant audit information of which the company's auditors are unaware; and

(b) the director has taken all the steps that he/she ought to have taken as a director to make himself/herself aware of any relevant audit information and to establish that the company's auditors are aware of that information.

This confirmation is given and should be interpreted in accordance with the provisions of section 418 of the Companies Act.

### Auditors

EY LLP are the auditors. EY were appointed to fill the casual vacancy arising from Deloitte LLP's resignation following the signing of the 2015 accounts and the Group's Form 20-F and appointed by

shareholders at the 2016 Annual General Meeting . A resolution to reappoint EY as the company's auditors will be proposed at the forthcoming Annual General Meeting.

By order of the Board

Aileen Taylor

Company Secretary

23 February 2017

The Royal Bank of Scotland Group plc

is registered in Scotland No. SC45551



## Statement of directors' responsibilities

This statement should be read in conjunction with the responsibilities of the auditor set out in their report on page 376 to 377.

The directors are responsible for the preparation of the Annual Report and Accounts. The directors are required by Article 4 of the IAS Regulation (European Commission Regulation No 1606/2002) to prepare Group accounts, and as permitted by the Companies Act 2006 have elected to prepare company accounts, for each financial year in accordance with International Financial Reporting Standards as adopted by the European Union. They are responsible for preparing accounts that present fairly the financial position, financial performance and cash flows of the Group and the company. In preparing those accounts, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent; and
- state whether applicable accounting standards have been followed, subject to any material departures disclosed and explained in the accounts.

The directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the Group and to enable them to ensure that the Annual Report and Accounts complies with the Companies Act 2006. They are also responsible for safeguarding the assets of the Group and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The directors confirm that to the best of their knowledge:

- the financial statements, prepared in accordance with International Financial Reporting Standards, give a true and fair view of the assets, liabilities, financial position and profit or loss of the company and the undertakings included in the consolidation taken as a whole; and
- the Strategic Report and Directors' report (incorporating the Business review) include a fair review of the development and performance of the business and the position of the company and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face.

In addition, the directors are of the opinion that the Annual Report and Accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the company's position and performance, business model and strategy.

By order of the Board

Howard Davies Ross McEwan Ewen Stevenson  
Chairman Chief Executive Chief Financial Officer

23 February 2017

### Board of directors

Chairman	Executive directors	Non-executive directors
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Howard Davies	Ross McEwan Ewen Stevenson	Sandy Crombie  Frank Dangeard  Alison Davis  Morten Friis  Robert Gillespie Penny Hughes Brendan Nelson  Baroness Noakes  Mike Rogers
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## Presentation of information

### Franchises and reportable segments

RBS continues to deliver on its plan to build a strong, simple and fair bank for both customers and shareholders. On 5 December 2016 the Corporate & Institutional Banking (CIB) business was re-branded as NatWest Markets (NWM) in readiness for the future ring-fenced structure. This included the renaming of the reportable operating segment as NatWest Markets. NatWest Markets will continue to offer financing, rates and currencies products to its customers.

During 2016 RBS's activities were organised on a franchise basis as follows:

**Personal & Business Banking (PBB)** comprises two reportable segments: UK Personal & Business Banking (UK PBB) and Ulster Bank RoI. UK PBB serves individuals and mass affluent customers in the UK together with small businesses (generally up to £2 million turnover). UK PBB includes Ulster Bank customers in Northern Ireland. Ulster Bank RoI serves individuals and businesses in the Republic of Ireland (RoI).

**Commercial & Private Banking (CPB)** comprises three reportable segments: Commercial Banking, Private Banking and RBS International (RBSI). Commercial Banking serves commercial and corporate customers in the UK and Western Europe. Private Banking serves UK connected high net worth individuals and RBSI serves retail, commercial, corporate and financial institution customers in Jersey, Guernsey, Isle of Man and Gibraltar and financial institution customers in Luxembourg.

**NatWest Markets**, formerly Corporate and Institutional Banking (CIB), serves UK and Western European corporate customers, and global financial institutions, supported by trading and distribution platforms in the UK, US and Singapore.

**Capital Resolution** was established to execute the sale or wind down of most of the global footprint, from 38 countries to 13, and trade finance and cash management outside the UK and Ireland. Additionally non-strategic markets, portfolio and banking assets identified are being sold or wound down.

**Williams & Glyn (W&G)** refers to the business formerly intended to be divested as a separate legal entity and comprises RBS England and Wales branch-based businesses, along with certain small and medium enterprises and corporate activities across the UK. During the periods presented W&G has not operated as a separate legal entity. The perimeter of the segment currently reported does not include certain portfolios that were intended to be divested such as the Scottish branch based activity of NatWest and NatWest Business Direct.

**Central items & other** includes corporate functions, such as RBS treasury, finance, risk management, compliance, legal, communications and human resources. Central functions manages RBS capital resources and RBS-wide regulatory projects and provides services to the reportable segments. Balances in relation to Citizens and the international private banking business are included in Central items in the relevant periods.

#### Allocation of central balance sheet items

RBS allocates all central costs relating to Services and Functions to the business using appropriate drivers, these are reported as indirect costs in the segmental income statements. Assets (and risk-weighted assets) held centrally, mainly relating to RBS Treasury, are allocated to the business using appropriate drivers.

#### Citizens

RBS sold the final tranche of its interest in Citizens Financial Group, Inc. during the second half of 2015. Consequently, Citizens was classified as a disposal group at 31 December 2014 and presented as a discontinued operation until October 2015. From 3 August 2015 until the final tranche was sold in October 2015, Citizens was an associated undertaking.

#### RBS Group ring-fencing

The UK ring-fencing legislation requiring the separation of essential banking services from investment banking services will take effect from 1 January 2019.

To comply with these requirements it is RBS's intention to place the majority of the UK and Western European banking business in ring-fenced banking entities under an intermediate holding company. NatWest Markets will be a separate non ring-fenced bank and The Royal Bank of Scotland International (Holdings) Limited (RBSI Holdings) will also be placed outside the ring-fence, both as direct subsidiaries of RBSG.

The final ring-fenced legal structure and the actions to be taken to achieve it, remain subject to, amongst other factors, additional regulatory, Board and other approvals as well as employee information and consultation procedures. All such actions and their respective timings may be subject to change, or additional actions may be required, including as a result of external and internal factors including further regulatory, corporate or other developments.

On 1 January 2017 RBS made a number of key changes to the

legal entity structure as detailed below to support the move towards a ring-fenced structure. There are also plans to make further changes prior to 1 January 2019.

### NatWest Holdings Limited (NatWest Holdings)

RBS introduced an intermediate holding company, NatWest Holdings, as a direct subsidiary of RBS plc. This is an interim structure as NatWest Holdings is expected to become a direct subsidiary of RBSG in mid 2018.

National Westminster Bank Plc (NatWest) and Adam & Company Group PLC (Adam & Co) transferred from being direct subsidiaries of RBS plc, and Ulster Bank (Ireland) Holdings Unlimited Company (UBIH) transferred from being a direct subsidiary of Ulster Bank Limited, to become direct subsidiaries of NatWest Holdings.

## Presentation of information

### RBS International

RBSI Holdings transferred from being an indirect subsidiary of RBS plc to become a direct subsidiary of RBSG. The intention is for RBS International's operating companies to remain as subsidiaries of RBSI Holdings.

NatWest bought Lombard North Central PLC and RBS Invoice Finance (Holdings) Limited from RBS plc and some smaller companies from other members of the Group.

### Competition

#### Personal & Business Banking (comprising UK PBB and Ulster Bank RoI)

In the personal and small business banking business, the Bank competes with a range of providers including UK banks and building societies, major retailers and life assurance companies, as well as the UK subsidiaries of major international banks. In the mortgage market, the Bank competes with UK banks, building societies and specialist lenders. Increasingly, the ambitions of non-traditional players in the UK market are gaining credibility, with new entrants active and seeking to build their platforms either through organic growth or in some cases by acquiring businesses made available through the restructuring of incumbents. Entrants with new business models such as peer-to-peer lending platforms, while currently small, continue to grow rapidly and are emerging as significant competitors. Such competitors often target specific elements of the value chain, providing specialised services to particular customer segments.

RBS distributes life assurance products to banking customers in competition with independent advisors and life assurance companies.

In Ireland, Ulster Bank competes in retail and commercial banking with the major Irish banks and building societies, and with other UK and international banks and building societies active in the market.

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

In an environment in which central banks have maintained very low interest rates for an unusually long period or introduced negative rates, competitive dynamics have changed in some of the principal markets in which we operate. In this environment an ability to attract and manage funding remains a critical competitive advantage. Other key competitive factors in this market segment include cost management, growing digital sales focus, branch network re-shaping, and product simplification. Cost management remains a key focus in the market, as banks seek to simplify their organisational and IT architectures while at the same time investing to ensure that they can meet customers' evolving channel preferences. Customers have increasingly focused on the use of internet and mobile as sales and service channels for certain types of products. Therefore, competitive position and performance in the sector increasingly depends on the possession of user-friendly, diverse and efficient online solutions.

Although conveniently located branches are still important, RBS faces competitive pressure to adjust its branch formats to meet changing customer expectations and to manage its branch footprint as over-the-counter transaction volumes decline. In terms of product offering, the industry trend is to limit the number of products and present the product structure and costs in a clear and transparent manner.

### Commercial & Private Banking (comprising Commercial Banking, Private Banking and RBS International)

Competition for corporate and institutional customers in the UK is from UK banks, from specialised global and regional investment banks and from large foreign universal banks that offer combined investment and commercial banking capabilities as well as from new entrants and non-bank challengers. In asset finance and invoice finance, the bank competes with banks and specialist finance providers, both captive and non-captive. In the small business banking market, the bank competes with other UK banks, specialist finance providers and building societies. In all of these areas, entrants with new technology-based business model are also showing rapid growth. RBS International competes with other UK and international banks to offer offshore banking services as well as domestic banking services in the Channel Islands, Gibraltar and the Isle of Man. Coutts and Adam & Company compete as private banks with UK clearing and private banks, asset managers 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.

### NatWest Markets

NatWest Markets (formerly CIB) focuses on the needs of large corporates operating in the UK and Western Europe as well as global financial institution customers. NatWest Markets provides financing and risk management for these customers, and trades with financial institutions and counterparties for distribution and market making. There are sales and trading operations in London, the US and Singapore and offices in a select number of countries. NatWest Markets therefore competes with large domestic banks, major international banks and a number of investment banks that offer such products in these regions.

The Bank's product proposition is built around our core strengths: supporting customers across currencies, rates and financing. Key competitive factors in this market include the ability to develop automation across flow products as well as delivering value-adding bespoke solutions for our customers.



With an evolving regulatory landscape and continued pressure on margins, competition in this market remains strong. Many market participants are also revising their strategy in order to ensure they deliver sustainable returns.

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**Business review****Consolidated income statement for the year ended 31 December 2016**

	2016	2015	2014
	£m	£m	£m
Interest receivable	11,258	11,925	13,079
Interest payable	(2,550)	(3,158)	(3,821)
<b>Net interest income</b>	<b>8,708</b>	<b>8,767</b>	<b>9,258</b>
Fees and commissions receivable	3,340	3,742	4,414
Fees and commissions payable	(805)	(809)	(875)
Income from trading activities	974	1,060	1,285
(Loss)/gain on redemption of own debt	(126)	(263)	20
Other operating income	499	426	1,048
<b>Non-interest income</b>	<b>3,882</b>	<b>4,156</b>	<b>5,892</b>
<b>Total income</b>	<b>12,590</b>	<b>12,923</b>	<b>15,150</b>
Staff costs	(5,124)	(5,726)	(5,757)
Premises and equipment	(1,388)	(1,827)	(2,081)
Other administrative expenses	(8,745)	(6,288)	(4,568)
Depreciation and amortisation	(778)	(1,180)	(930)
Write down of goodwill and other intangible assets	(159)	(1,332)	(523)
<b>Operating expenses</b>	<b>(16,194)</b>	<b>(16,353)</b>	<b>(13,859)</b>
<b>(Loss)/profit before impairment (losses)/releases</b>	<b>(3,604)</b>	<b>(3,430)</b>	<b>1,291</b>
Impairment (losses)/releases	(478)	727	1,352
<b>Operating (loss)/profit before tax</b>	<b>(4,082)</b>	<b>(2,703)</b>	<b>2,643</b>
Tax charge	(1,166)	(23)	(1,909)
<b>(Loss)/profit from continuing operations</b>	<b>(5,248)</b>	<b>(2,726)</b>	<b>734</b>
Profit/(loss) from discontinued operations, net of tax	—	1,541	(3,445)
<b>Loss for the year</b>	<b>(5,248)</b>	<b>(1,185)</b>	<b>(2,711)</b>
<b>Attributable to:</b>			
Non-controlling interests	10	409	60
Preference shareholders	260	297	330
Paid-in equity holders	244	88	49
Dividend access share	1,193	—	320
Ordinary shareholders	(6,955)	(1,979)	(3,470)
	(5,248)	(1,185)	(2,711)


<b>Key metrics and ratios</b>			
Net interest margin	2.18%	2.12%	2.13%
Cost:income ratio	129%	127%	91%
(Loss)/earnings per ordinary share from continuing operations (pence)			
- basic	(59.5p)	(27.7p)	0.5p
Return on tangible equity (1)	(17.9%)	(4.7%)	(8.2%)

Note:

(1) Tangible equity is equity attributable to ordinary shareholders less intangible assets.

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**Business review**

<b>Analysis of results</b>			
<b>Net interest income</b>			
	2016	2015	2014
	£m	£m	£m
Interest receivable (1,2,3)	11,258	11,925	13,079
Interest payable (1,2,3)	(2,550)	(3,158)	(3,821)
Net interest income	8,708	8,767	9,258
<b>Yields, spreads and margins of the banking business</b>	%	%	%
Gross yield on interest-earning assets of the banking business (4)	2.80	2.89	3.02
Cost of interest-bearing liabilities of the banking business	(0.95)	(1.14)	(1.26)
Interest spread of the banking business (5)	1.85	1.75	1.76
Benefit from interest-free funds	0.33	0.37	0.38
Net interest margin of the banking business (3,6)	2.18	2.12	2.14

Gross yield (4,7,8)			
- Group	2.80	2.89	3.02
- UK	3.12	3.35	3.57
- Overseas	1.08	1.32	1.55
Interest spread (5,7,8)			
- Group	1.85	1.75	1.76
- UK	2.17	2.24	2.34
- Overseas	0.03	—	0.15
Net interest margin (3,6,7,8)			
- Group	2.18	2.12	2.14
- UK	2.45	2.49	2.53
- Overseas	0.73	0.87	1.08
The Royal Bank of Scotland plc base rate (average)	0.40	0.50	0.50
London inter-bank three month offered rates (average)			
- Sterling	0.50	0.57	0.54
- Eurodollar	0.69	0.32	0.23
- Euro	(0.26)	(0.02)	0.21

Notes:

(1) Interest receivable includes £290 million (2015 - £400 million; 2014 - £453 million) in respect of loan fees forming part of the effective interest rate of loans and receivables.

- (2) Negative interest on loans and advances is classed as interest payable.
- (3) Interest receivable and interest payable on trading assets and liabilities are included in income from trading activities.
- (4) Gross yield is the interest earned on average interest-earning assets of the banking book.
- (5) Interest spread is the difference between the gross yield and the interest rate paid on average interest-bearing liabilities of the banking business.
- (6) Net interest margin is net interest income of the banking business as a percentage of interest-earning assets (IEA) of the banking business.
- (7) For the purpose of calculating gross yields and interest spread, interest receivable and interest payable have both been decreased by £76 million in respect of negative interest relating to financial assets that attracted negative interest.
- (8) The analysis into UK and overseas has been compiled on the basis of location of office.

## Business review

### 2016 compared with 2015

Net interest income of £8,708 million reduced by £59 million compared with 2015 principally driven by a £126 million reduction in Capital Resolution, in line with the planned shrinkage of the balance sheet.

Net interest margin (NIM) was 2.18% for 2016, 6 basis points higher than 2015 as the benefit associated with reductions in low yielding 'non-core' assets has been partially offset by modest asset margin pressure and mix impacts across PBB (comprising the reportable segments UK PBB and Ulster Bank RoI) and CPB (comprising the reportable segments Commercial Banking, Private Banking and RBSI).

Average interest earning assets<sup>(1)</sup> across the combined PBB and CPB increased by 11% on 2015, compared with a 3% decline for RBS total, and represented 82% of total average interest earning assets (2015 - 72%). NIM across PBB and CPB was 2.31%, 13 basis points lower than 2015.

UK PBB NIM decreased by 17 basis points to 3.01% reflecting the impact of the overall portfolio mix being increasingly weighted towards secured lending and mortgage customers switching from standard variable rate (SVR) to lower rate products. During the second half of 2016 SVR balances stabilised at approximately 12% of mortgage balances.

Ulster Bank RoI NIM increased by 5 basis points to 1.62% driven by a continued reduction in the cost of deposits and a reduced volume of low yielding liquid assets, partly offset by reduced income on free funds.

Commercial Banking NIM fell by 12 basis points to 1.76% driven by asset margin pressure in a competitive market and low rate environment.

Private Banking NIM reduced by 9 basis points to 2.66% principally driven by asset margin pressure.

RBSI NIM fell by 12 basis points to 1.36% reflecting asset and liability margin pressures, partially offset by mitigating pricing actions.

Structural hedges of £123 billion generated a benefit of £1.3 billion through net interest income for the year. Around 73% of these hedges are part of a five year rolling hedge programme with around 27% as part of a

ten year hedge) that will progressively roll-off over the coming years.

## 2015 compared with 2014

Net interest income declined by £491 million, or 5% to £8,767 million compared with £9,258 million, driven principally by a 46% reduction in Capital Resolution, down from £673 million to £365 million, in line with the planned shrinkage of the balance sheet.

Net interest margin (NIM) declined by 2 basis points to 2.12% reflecting new business volumes in core UK businesses, primarily mortgages remaining under competitive margin pressures combined with an increased portion of the book shifting toward lower margin secured assets. This was partly offset by deposit re-pricing and the planned run down of low margin assets in Capital Resolution.

UK PBB net interest income fell by £69 million, 2% to £4,152 million, as competitive front book margin pressures impacted. In addition, customers continued to roll off standard variable rate products (17% of overall mortgage book in 2015) and onto lower margin fixed rate products. As a result NIM fell by 14 basis points to 3.18% compared with 3.32% in 2014.

Ulster Bank RoI net interest income fell by £102 million, 22% to £365 million compared with £467 million primarily due to the weakening of the euro relative to sterling and reduced income on free funds. Ulster Bank RoI NIM continues to be impacted by the low yielding tracker mortgage book.

Note:

(1) See table below for combined net interest income, average interest earning assets and NIM calculation.

Reportable segment	Net interest income		Average interest earning assets		NIM	
	2016	2015	2016	2015	2016	2015
UK PBB	4,287	4,152	142,458	130,702	3.01%	3.18%
Ulster Bank RoI	409	365	25,193	23,232	1.62%	1.57%
Commercial Banking	2,143	1,997	121,677	106,429	1.76%	1.88%
Private banking	449	436	16,887	15,835	2.66%	2.75%
RBSI	303	303	22,254	20,518	1.36%	1.48%
PBB & CPB combined	7,591	7,253	328,469	296,716	2.31%	2.44%

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**Business review**

<b>Non-interest income</b>			
The following table reconciles adjusted non-interest income (a non-GAAP financial measure) to the statutory basis.			
	2016	2015	2014
	£m	£m	£m
Fees and commissions receivable - statutory basis	3,340	3,742	4,414
Fees and commissions payable - statutory basis	(805)	(809)	(875)
Own credit adjustments (1)			
- adjusted basis	180	309	(146)
- income from trading activities	(154)	(254)	40
- other non interest income	(26)	(55)	106
Statutory basis	—	—	—
Income from trading activities			
- adjusted basis	820	806	1,325
- own credit adjustments	154	254	(40)
Statutory basis	974	1,060	1,285
(Loss)/gain on redemption of own debt - statutory basis	(126)	(263)	20
Strategic disposals (1)			
- adjusted basis	164	(157)	191
- other operating income	(164)	157	(191)
Statutory basis	—	—	—
Other operating income			
- adjusted basis	309	528	963
- own credit adjustments	26	55	(106)
- strategic disposals	164	(157)	191
Statutory basis	499	426	1,048
<b>Total non-interest income - adjusted basis</b>	<b>3,882</b>	<b>4,156</b>	<b>5,892</b>
<b>Total non-interest income - statutory basis</b>	<b>3,882</b>	<b>4,156</b>	<b>5,892</b>

Note:

(1) Items reallocated to other income lines, not reconciling items.

## Business review

### 2016 compared with 2015

Non-interest income was £3,882 million, a reduction of £274 million, or 7%, compared with 2015. Capital Resolution non-interest income reduced by £775 million reflecting planned asset disposal, including £572 million of disposal losses compared with £367 million in 2015, and a funding valuation adjustment of £170 million. In addition, we recognised a charge of £510 million for volatile items under IFRS compared with a £15 million gain in 2015. Partially offsetting, we reported a strategic disposal gain of £164 million, compared with a loss of £157 million in 2015, a loss on redemption of own debt of £126 million, compared with £263 million in 2015, an FX gain of £349 million following the significant weakening of sterling against the dollar and a £97 million foreign exchange reserve recycling gain.

Net fees and commissions decreased by £398 million, or 14%, compared with 2015 reflecting the planned Capital Resolution asset run-down, £168 million, a reduction in NatWest Markets, £175 million, and a £36 million reduction in UK PBB, driven by lower credit card interchange fees and increased cash back payments following the launch of the Rewards account.

Income from trading activities decreased by £86 million to £974 million including a £133 million decrease in Capital Resolution, own credit adjustments of £154 million (2015 - £254 million) and an increased charge for volatile items under IFRS, partially offset by an increase in NatWest Markets, £219 million.

Other operating income increased by £73 million principally reflecting a strategic disposal gain of £164 million, compared with a loss of £157 million in 2015 partially offset by planned asset disposals in Capital Resolution. Own credit adjustments represented a gain of £26 million compared with £55 million in 2015.

### 2015 compared with 2014

Non-interest income totalled £4,156 million, a decline of £1,736 million, or 29%, compared with £5,892 million in 2014, primarily driven by a reduction of £945 million in Capital Resolution as the business accelerated the planned shrinkage of the balance sheet, including disposal losses from the sale of several portfolios in the year. A movement of £530 million from volatile items under IFRS was recorded, which represented a gain of £15 million in 2015 compared with a charge of £501 million in 2014.

Net fees and commissions fell by £606 million, or 17%, to £2,933 million, compared with £3,539 million, principally from the reduced scale of activity in NatWest Markets (formerly CIB), run down of Capital

Resolution and lower card interchange fees in UK PBB, down £59 million.

Income from trading activities declined by £225 million, or 18%, to £1,060 million compared with £1,285 million, due to the reduced scale and resources in NatWest Markets (formerly CIB) and the continued planned reduction of the Capital Resolution business and the impact of disposal losses partially offset by a gain on own credit adjustments of £254 million compared with a charge of £40 million in 2014.

A loss of £263 million was recognised on redemption of own debt, from a liability management exercise to repurchase certain US dollar, sterling and euro senior debt securities, compared with a gain of £20 million in 2014.

Total disposal losses in Capital Resolution were £367 million, including £38 million of strategic disposal losses. Total strategic disposal losses were £157 million, compared with a gain of £191 million in 2014, principally relating to the international private banking business.

Other operating income reduced by £622 million, or 59%, to £426 million compared with £1,048 million, principally due to the reduced scale of NatWest Markets (formerly CIB) together with the run down of Capital Resolution and the impact of disposal losses. A loss of £67 million on the disposal of available-for-sale securities in Treasury was recorded compared with a gain of £149 million in 2014. Own credit adjustments represented a gain of £55 million compared with a charge of £106 million in 2014.

**Business review**

<b>Operating expenses</b>			
The following table reconciles adjusted operating expenses (a non-GAAP financial measure) to the statutory basis.			
	2016	2015	2014
	£m	£m	£m
<b>Staff costs</b>			
- adjusted basis (1)	4,482	4,896	5,376
- restructuring costs	642	830	381
<b>Statutory basis</b>	<b>5,124</b>	<b>5,726</b>	<b>5,757</b>
<b>Premises and equipment</b>			
- adjusted basis (1)	1,297	1,483	1,812
- restructuring costs	91	344	269
<b>Statutory basis</b>	<b>1,388</b>	<b>1,827</b>	<b>2,081</b>
<b>Other administrative expenses</b>			
- adjusted basis (1)	1,619	2,124	2,120
- litigation and conduct costs	5,868	3,568	2,194
- restructuring costs	1,258	596	254
<b>Statutory basis</b>	<b>8,745</b>	<b>6,288</b>	<b>4,568</b>
<b>Restructuring costs (2)</b>			
- adjusted basis	2,106	2,931	1,154
- staff expenses	(642)	(830)	(381)
- premises and equipment	(91)	(344)	(269)
- other administrative expenses	(1,258)	(596)	(254)
- Depreciation and amortisation	(73)	(402)	(3)
- write down of other intangible assets	(42)	(759)	(247)
<b>Statutory basis</b>	<b>—</b>	<b>—</b>	<b>—</b>
<b>Litigation and conduct costs (2)</b>			
- adjusted basis	5,868	3,568	2,194
- other administrative expenses	(5,868)	(3,568)	(2,194)
<b>Statutory basis</b>	<b>—</b>	<b>—</b>	<b>—</b>
<b>Administrative expenses - adjusted basis</b>	<b>15,372</b>	<b>15,002</b>	<b>12,656</b>

Administrative expenses - statutory	15,257	13,841	12,406
Depreciation and amortisation			
- adjusted basis (1)	705	778	927
- restructuring costs	73	402	3
Statutory basis	778	1,180	930
Write down of goodwill (2)			
- adjusted basis	—	498	130
- Write down of goodwill	—	(498)	(130)
Statutory basis	—	—	—
Write down of other intangible assets			
- adjusted basis (1)	117	75	146
- write down of other intangible assets	(117)	(75)	(146)
Statutory basis	—	—	—
Write-down of other goodwill and other intangible assets			
- adjusted basis (1)	—	—	—
- write down of goodwill	—	498	130
- write off of intangible assets	117	75	146
- restructuring costs	42	759	247
Statutory basis	159	1,332	523
Operating expenses - adjusted basis	16,194	16,353	13,859
Operating expenses - statutory basis	16,194	16,353	13,859

Notes:

(1) Adjusted basis is calculated as operating expenses before restructuring costs, and litigation and conduct costs.

(2) Items reallocated to other expense lines, not reconciling items.

## Business review

### 2016 compared with 2015

Operating expenses of £16,194 million were £159 million, or 1%, lower than 2015 reflecting a £1,136 million, or 12%, reduction in adjusted operating expenses which excludes a £825 million, or 28%, reduction in restructuring costs. In addition, 2015 included a £498 million write down of goodwill relating to Private Banking. Partially offsetting the above, litigation and conduct costs increased by £2,300 million.

Adjusted operating expenses (which exclude restructuring costs £2,106 million (2015 - £2,931 million), litigation and conduction costs £5,868 million (2015 - £3,568 million), and write down of goodwill in 2015 of £498 million) reduced by £1,136 million, or 12%, compared with 2015 to £8,220 million. Excluding expenses associated with Williams & Glyn £393 million (2015 -£359 million), write down of intangibles £117 million (2015 -£75 million) and a £227 million VAT recovery, expenses reduced by £985 million, or 11%, in excess of our £800 million target. RBS has achieved a cumulative cost reduction of £3.1 billion across 2014 – 2016.

Staff costs of £5,124 million were £602 million, or 11%, lower than 2015 underpinned by a 13,700, or 15%, reduction in FTEs and a reduction in restructuring costs of £188 million, or 23% to £642 million.

Restructuring costs were £2,106 million for 2016, compared with £2,931 million in 2015, and included a £750 million provision in respect of the 17 February 2017 update on RBS's remaining State Aid obligation regarding Williams & Glyn. In addition, £706 million of the remaining restructuring costs relate to Williams & Glyn, including £146 million of termination costs associated with the decision to discontinue the programme to create a cloned banking platform.

Litigation and conduct costs of £5,868 million included; a £3,107 million provision in relation to various investigations and litigation matters relating to RBS's issuance and underwriting of residential mortgage-backed securities (RMBS), £601 million of additional PPI provisions, a £400 million provision in respect of the FCA review of RBS's treatment of SMEs, an additional £169 million charge in respect of the settlement with the National Credit Union Administration Board to resolve two outstanding RMBS lawsuits in the United States relating to residential mortgage backed securities, a £172 million provision in Ulster Bank RoI, principally in respect of remediation and programme costs associated with an industry wide examination of tracker mortgages, and a provision in respect of the UK 2008 rights issue shareholder litigation.

### 2015 compared with 2014

Total operating expenses of £16,353 million included significantly higher litigation and conduct costs of £3,568 million (2014 - £2,194 million), restructuring costs of £2,931 million (2014 - £1,154 million) and a goodwill impairment of £498 million attributed to Private Banking (2014 - £130 million in Capital Resolution).

Adjusted operating expenses which excludes litigation and conduct costs of £3,568 million (2014 - £2,194 million), restructuring costs of £2,931 million (2014 - £1,154 million) and a write-down of goodwill of £498 million (2014 - £130 million) fell by £1,025 million, 10% to £9,356 million compared with £10,381 million. Excluding expenses associated with Williams & Glyn (2015 - £261 million; 2014 - £232 million) and the benefit of lower intangible asset write offs (2015 - £75 million; 2014 - £146 million), operating expenses reduced by £983 million, exceeding the revised 2015 cost saving target of over £900 million.

Staff costs were 1% lower totalling £5,726 million compared with £5,757 million, with the reductions as a result of lower headcount in NatWest Markets and Capital Resolution offset by increases in restructuring costs to £830 million as the transformation of the bank accelerated, particularly in NatWest Markets.

Restructuring costs totalled £2,931 million compared with £1,154 million in 2014, as the transformation of the bank accelerated, particularly re-engineering the NatWest Markets business. This is in line with prior guidance for total restructuring costs of c.£5 billion from 2015 to 2019. NatWest Markets restructuring costs totalled £524 million, including software and property write downs. Capital Resolution restructuring costs were much higher totalling £1,307 million as the business continues its planned rundown. Williams & Glyn separation costs totalled £630 million. Private Banking also recorded a £91 million asset write down related to software.

Litigation and conduct costs increased by £1,374 million, or 63% to £3,568 million, compared with £2,194 million in 2014. This includes: additional provisions for mortgage backed securities litigation in the US of £2,100 million; provisions for foreign exchange investigations in the US of £334 million; customer redress provisions primarily relating to PPI of £600 million; packaged accounts provisions of £157 million; and other conduct provisions of £377 million.



**Business review**

<b>Analysis of results continued</b>			
<b>Impairment losses</b>			
	2016	2015	2014
	£m	£m	£m
New impairment losses/(releases)	587	(552)	(1,250)
Less: recoveries of amounts previously written-off	(109)	(175)	(102)
Losses/(releases) to income statement	478	(727)	(1,352)
Comprising:			
Loan impairment losses/(releases)	537	(853)	(1,364)
Securities	(59)	126	12
Losses/(releases) to income statement	478	(727)	(1,352)

**2016 compared with 2015**

A net impairment loss of £478 million, 15 basis points of gross customer loans, compared with a net impairment release of £727 million in 2015.

Capital Resolution reported a net impairment loss of £253 million in 2016 compared with a release of £725 million in 2015. The loss for the year included a charge of £424 million in respect of the shipping portfolio reflecting difficult conditions in some parts of the sector.

Commercial Banking net impairment loss of £206 million was £137 million higher than 2015 principally reflecting a single name charge in respect of the oil and gas portfolio.

UK PBB reported a net impairment loss of £83 million compared with a net release of £7 million in 2015.

Ulster Bank RoI reported a net impairment release of £113 million (€138 million) compared with £141 million (€194 million) in 2015. The 2016 impairment release included a write back associated with the sale of a portfolio of loans. REIL remained stable at £3.5 billion in 2016 due to the strengthening of the euro but in euro terms reduced by €0.6 billion driven by the portfolio sale, partially offset by a widening of the definition of loans which are considered to be impaired.

REIL reduced by £1,847 million during 2016 to £10,310 million reflecting Capital Resolution run-down and a portfolio sale in Ulster Bank RoI partially offset by an increase in the shipping portfolio, foreign exchange movements and the implementation of a revised mortgage methodology in Ulster Bank RoI. REIL represented 3.1% of gross customer loans compared with 3.9% at 31 December 2015. Provision coverage was 43% compared with 59% at 31 December 2015, with the reduction largely driven by Ulster Bank RoI and Capital Resolution.

Excluding Ulster Bank RoI and Capital Resolution, REIL represented 1.5% of gross customer loans, compared with 2.0% at end 2015, and provision coverage was 54% compared with 56% in 2015.

### 2015 compared with 2014

Net impairment releases of £727 million were 46% lower compared with net impairment releases of £1,352 million in 2014. Although releases were at lower levels than in 2014, credit quality remained stable, reflecting supportive economic conditions in UK and Ireland with continued elevated recoveries in certain businesses.

Capital Resolution recorded net releases of £725 million, compared with £1,307 million in 2014, with disposal activity continuing. Ulster Bank RoI recorded net impairment releases of £141 million, down from £306 million in 2014, as economic conditions in Ireland continue to improve. UK PBB recorded a release of £7 million compared with a loss of £154 million, due to lower debt flows and increased releases and recoveries. Net impairment releases were also reported in NatWest Markets (formerly CIB), although at more modest levels.

Securities losses rose to £126 million from £12 million in 2014, principally related to a small number of single name exposures, mainly an exposure in the RBS N.V. liquidity portfolio.

Risk elements in lending (REIL) declined from £28.2 billion to £12.2 billion, with REIL as a percentage of gross loans falling from 6.8% to 3.9%. The reduction was driven by the disposal of Citizens and the continued rundown of Capital Resolution.

**Business review**

<b>Tax</b>			
	2016	2015	2014
	£m	£m	£m
Tax charge	(1,166)	(23)	(1,909)
UK corporation tax rate	20.00%	20.25%	21.50%

**2016 compared with 2015**

The tax charge for the year ended 31 December 2016 reflects the impact of the banking surcharge, non-deductible bank levy and conduct charges for which no tax relief has been recognised, a reduction in the carrying value and impact of UK tax rate changes on deferred tax balances, and the release of tax provisions that reflect the reduction of exposures in countries where RBS is ceasing operations.

**2015 compared with 2014**

The tax charge for the year ended 31 December 2015 reflects the impact of non-deductible goodwill and bank levy charges, conduct charges for which no tax relief has been recognised, the impact of UK tax rate changes on the carrying value of deferred tax balances and the release of tax provisions that reflect the reduction of exposures in countries where RBS is ceasing operations.

## Business review

<b>Segment performance</b>			
<b>UK Personal &amp; Business Banking</b>			
	2016	2015	2014
<b>Income statement</b>	£m	£m	£m
Net interest income	4,287	4,152	4,221
Net fees and commissions	984	1,020	1,162
Other non-interest income	19	28	61
Non-interest income	1,003	1,048	1,223
<b>Total income</b>	<b>5,290</b>	<b>5,200</b>	<b>5,444</b>
Direct expenses			
- staff costs	(690)	(801)	(824)
- other costs	(293)	(272)	(346)
Indirect expenses	(2,022)	(1,965)	(1,958)
Restructuring costs			
- direct	(51)	(38)	(10)
- indirect	(136)	(129)	(101)
Litigation and conduct costs	(634)	(972)	(918)
Operating expenses	(3,826)	(4,177)	(4,157)
Operating profit before impairment (losses)/releases	1,464	1,023	1,287
Impairment (losses)/releases	(83)	7	(154)
<b>Operating profit</b>	<b>1,381</b>	<b>1,030</b>	<b>1,133</b>
Operating expenses - adjusted (1)	(3,005)	(3,038)	(3,128)
Operating profit - adjusted (1)	2,202	2,169	2,162
<b>Analysis of income by product</b>			
Personal advances	845	747	842
Personal deposits	731	747	664
Mortgages	2,331	2,305	2,399
Cards	614	621	700
Business Banking	732	726	663
Other	37	54	176
Total income	5,290	5,200	5,444
<b>Analysis of impairments by sector</b>			
Personal advances	84	69	128
Mortgages	(22)	4	(29)

Business Banking	(10)	(79)	46
Cards	31	10	75
Other	—	(11)	(66)
Total impairment losses/(releases)	83	(7)	154
Loan impairment charge/(release) as a % of gross customer loans and advances			
(excluding reverse repurchase agreements) by sector			
Personal advances	1.4%	1.2%	2.0%
Business Banking	(0.2%)	(1.5%)	0.8%
Cards	0.8%	0.2%	1.6%
Other	—	(0.8%)	(4.4%)
Total	0.1%	—	0.1%
Performance ratios			
Return on equity (2)	16.2%	11.7%	11.9%
Return on equity - adjusted (1,2)	26.8%	26.2%	23.7%
Net interest margin	3.01%	3.18%	3.32%
Cost:income ratio	72%	80%	76%
Cost:income ratio - adjusted (1)	57%	58%	57%

## Notes:

(1) Excluding restructuring costs and litigation and conduct costs.

(2) Return on equity is based on segmental operating profit after tax adjusted for preference dividends divided by average notional equity based on 15% of the monthly average of segmental RWAs, assuming 28% tax rate.

**Business review**

<b>UK Personal &amp; Business Banking continued</b>			
	2016	2015	2014
Capital and balance sheet	£bn	£bn	£bn
Loans and advances to customers (gross)			
- personal advances	6.0	6.0	6.5
- mortgages	117.1	104.8	95.5
- business banking	6.4	5.3	5.9
- cards	3.9	4.1	4.7
- other	—	1.4	1.5
Total loans and advance to customers (gross)	133.4	121.6	114.1
Loan impairment provisions	(1.3)	(1.8)	(2.5)
Net loans and advances to customers	132.1	119.8	111.6
Total assets	155.6	143.9	137.8
Funded assets	155.6	143.9	137.8
Risk elements in lending	2.0	2.7	3.6
Provision coverage (1)	65%	69%	69%
Customer deposits			
- personal current accounts	42.1	37.2	34.4
- personal savings	81.4	78.9	76.3
- business banking	22.3	19.6	19.5
- other	—	2.1	2.4
Total customer deposits	145.8	137.8	132.6
Assets under management (excluding deposits)	4.2	4.3	4.9
Loan:deposit ratio (excluding repos)	91%	87%	84%
Risk-weighted assets			
Credit risk (non-counterparty)	24.8	25.4	29.0
- Operational risk	7.9	7.9	7.6
Total risk-weighted assets	32.7	33.3	36.6

Note:

(1) Provision coverage represents loan impairment provisions as a percentage of risk elements in lending.



## Business review

### Serving our customers

The strategic goal of UK PBB is to become the number one personal and business bank for customer service, trust and advocacy in the UK. As part of our culture change, the removal of frontline incentives has been matched by a reinvestment in our people, both in terms of their fixed pay and their capability, including over seven thousand frontline employees completing their Professional Banking Certificate by the end of 2016. Our values have been reinforced by the huge organisational commitment to our customer focused leadership programme, 'Determined to Lead', and a simple but powerful set of service excellence behaviours. Along with our continued investment in technology, this has helped us deliver strong growth in key areas whilst at the same time making our business simpler and more efficient.

Gross new mortgage lending of £29.8 billion was 29% higher than 2015. Across 2016, our market share of new mortgages was approximately 12%, supporting a growth in stock share to 8.8% from 8.2% at 31 December 2015. Mortgage processing time has reduced by 40 minutes through increased automation and 42% of existing customers in 2016 re-mortgaged on-line in a matter of minutes. In addition, the introduction of electronic signatures has reduced the mortgage switching documentation process from 7 days to less than 2 days. NatWest was awarded Best Bank for Mortgages and Best First Time Buyer Mortgage Lender with NatWest Intermediary Solutions awarded the industry leading 5 star service award.

Gross new business lending to small and medium-sized enterprises of £1.6 billion was up 43% compared with 2015, supported by our business loan application process reducing from 11 days to less than 24 hours on average. Our new business banking 'Online Account Opening' service allows start up business customers to submit an application online in just ten minutes and get a sort code and account number in under an hour. RBS was awarded a Moneyfacts 5 star rating for Business Banking accounts.

Personal unsecured loan gross new lending of £2.3 billion was up 24% versus 2015 supported by the launch of functionality for a customer to apply via the mobile app. Over 2016, the personal loan mobile application process has been significantly simplified making it even easier for our customers.

The Reward account continued to show positive momentum and now has 1,149,000 fee-paying customers compared with 202,000 at 31 December 2015. We have seen positive evidence of increased levels of engagement, with overall current account attrition levels falling by 7% in the year. This is particularly evident across our Private and Premium customer, with attrition 12% lower. We continue to embed the product across our population of valuable main bank customers.



We continued to make better use of our digital channels to make it simpler to serve our customers and easier for them to do business with us. We now have 4.2 million customers regularly using our mobile app, 19% higher than the end of 2015, and around 60% of our personal customers used a digital channel within the last 90 days. In 2016, we more than doubled the number of customers who purchased a product through our mobile channel compared with 2015. NatWest customers can now apply for personal loans, credit cards and overdrafts via the mobile app, facilitating approximately 8% of total applications. Advocacy amongst our active mobile customers increased significantly over 2016 with NatWest mobile NPS at an all time high of +52.

The additional choice, flexibility and convenience provided to customers has, in turn, given our colleagues more time to focus on helping over 750,000 of our customers with a Financial Health Check, discussing the benefits of the Reward current account, and guiding them through more complex financial goals and ambitions such as buying a home.

In addition to our digital channels UK PBB continues to provide multiple physical channels for serving customers, including access to a network of c.11,500 Post Office branches and 39 mobile banking vans alongside our existing network of 1,315 branches and 4,437 ATMs.

## Business review

### 2016 compared with 2015

Operating profit was £1,381 million, compared with £1,030 million in 2015, and included a £634 million litigation and conduct charge, principally in respect of additional PPI provisions. Adjusted operating profit, which excludes restructuring costs of £187 million (2015 - £167 million) and litigation and conduct costs of £634 million (2015 - £972 million), of £2,202 million was £33 million, or 2%, higher than 2015 principally reflecting increased net interest income combined with lower costs, partially offset by a higher impairment charge.

Total income of £5,290 million increased by £90 million, or 2%, compared with 2015, despite the lower rate environment depressing earnings on current accounts and the impact of regulatory changes impacting interchange fees. Net interest income was robust, increasing by £135 million, or 3%, reflecting continued strong asset growth combined with the active repricing of our deposit book. This more than offset the impact of lower current account hedge returns and lower mortgage margins. Net interest margin declined by 17 basis points to 3.01% reflecting the change in the overall portfolio mix and reduced mortgage margins. During the second half of 2016 mortgage SVR balances stabilised at approximately 12%, broadly in line with historical levels.

Non-interest income reduced by £45 million, or 4%, principally reflecting lower credit card interchange fees, following regulatory changes introduced in 2015. In addition, cash back payments on the Reward account have impacted fee income, however, we have seen increased levels of customer engagement. Partially offsetting, we recognised a £19 million debt sale gain in 2016.

Operating expenses decreased £351 million, or 8%, to £3,826 million. Adjusted operating expenses, which exclude restructuring costs of £187 million (2015 - £167 million) and litigation and conduct costs of £634 million (2015 - £972 million), decreased by £33 million, or 1%, to £3,005 million. Direct staff costs were £111 million, or 14%, lower driven by an 18% reduction in headcount reflecting the continued movement to digital channels, exiting of business lines with returns below required levels and some centralisation of administrative activities. This was partially offset by additional investment costs of £102 million, including one-off intangible asset write-downs of £56 million in 2016, together with a £21 million increase in regulatory charges.

The net impairment charge of £83 million reflects continued benign credit conditions and compared with a £7 million release in 2015, with the increase principally reflecting reduced portfolio provision releases. The default driven charge was 13% lower than 2015 with REIL 26% lower and provision coverage remaining strong at 65%.

Net loans and advances of £132.1 billion increased by £12.3 billion, or 10%, compared with 2015 principally driven by mortgage growth of 12%. We continue to see positive momentum across business and personal unsecured lending, up by 6%, excluding transfers<sup>(1)</sup>, and 7% respectively.

## Business review

### UK Personal & Business Banking [continued](#)

We continue to build on our strong mortgage market position with gross balances increasing by 12% to £117.1 billion compared with 3% growth for the overall mortgage market. Gross new lending in 2016 was £29.8 billion, representing a market share of approximately 12% compared with a stock share of approximately 8.8% at 31 December 2016, up from 8.2% in 2015. New business margins were stable over 2016 whilst margins on existing customers remortgaging have improved. Gross new business lending to small and medium-sized enterprises of £1.6 billion was up 43% compared with 2015. Personal loan gross new lending of £2.3 billion was up 24% supported by the launch of functionality for a customer to apply via the mobile app combined with improvements to customer experience. We have continued to take a cautionary risk approach to personal unsecured lending. As a result, personal unsecured cards and overdrafts balances have decreased by £0.3 billion, or 5%, compared with 2015, and margins have widened.

Deposit balances performed strongly, increasing by £8.0 billion, or 6%, to £145.8 billion driven by 13% growth in personal current account balances. Personal savings balances increased 3% despite repricing activity.

RWAs decreased by £0.6 billion, or 2%, to £32.7 billion due to asset mix benefits and overall improved credit quality, largely reflecting the current benign credit conditions, partly offset by increased lending.

### 2015 compared with 2014

UK PBB recorded an operating profit of £1,030 million in 2015, a reduction of 9% or £103 million from 2014. This was primarily driven by lower non-interest income combined with increased restructuring costs and litigation and conduct costs. This was partially offset by a small net impairment release compared to a prior year charge. Adjusted operating profit which excludes restructuring costs of £167 million (2014 - £111 million) and litigation and conduct costs of £972 million (2014 - £918 million) was £2,169 million compared to £2,162 million and return on equity of 11.7% were broadly flat compared to prior year.

Total income was £5,200 million, a reduction of 4% from £5,444 million. Net interest income declined 2% to £4,152 million primarily as a result of continued margin pressure in the mortgage market as customers move to lower margin fixed rate products together with higher internal funding costs. The decline was partly offset by improved deposit margins. Reflecting strong mortgage balance growth, net interest margin (NIM) declined 14 basis points from 2014 to 3.18% as the overall portfolio mix continues to be increasingly weighted toward secured lending, together with the decline in unsecured balances. The decline was slightly

offset by improved deposit margins.

Non-interest income was £1,048 million, a reduction of 14% compared with the prior year as interchange fees on credit and debit cards declined £59 million, combined with reduced advice income. Operating expenses were £4,177 million, remaining broadly stable against 2014. Litigation and conduct costs increased 6% due to customer redress provisions, primarily relating to PPI, to £972 million, whilst higher restructuring costs were up £56 million, to £167 million. This was principally offset by a reduction in staff and other costs. Adjusted operating expenses which excludes restructuring costs of £167 million (2014 - £111 million) and litigation and conduct costs of £972 million (2014 - £918 million) totalled £3,038 million (2014 - £3,128 million), 3% lower than 2014.

Net impairment releases totalled £7 million, compared with a net charge of £154 million in 2014, driven by decreased charges from bad debt flows and benefit of provision releases and recoveries.

2015 was a strong year for the mortgage business with net balances growing by £9.3 billion or 10% to £104.8 billion. Gross new lending rose 29% to £23 billion with market share of new mortgages of 10.5% versus a stock share of 8.2%. Mortgage growth was the principal driver of an £8.2 billion increase in net loans and advances to customers. Unsecured balances continued to decline gradually, albeit at a much slower rate.

Customer deposit balances increased £5.2 billion to £137.8 billion due to growth in personal savings, current accounts and business banking. RWAs fell £3.3 billion to £33.3 billion due to the improved quality of portfolio.

Note:

(1) The business transfers included: net loans and advances to customers of £0.8 billion as at 31 December 2016.

## Business review

<b>Ulster Bank RoI</b>						
	2016	2015	2014	2016	2015	2014
	€m	€m	€m	£m	£m	£m
<b>Income statement</b>						
Net interest income	501	503	579	409	365	467
Net fees and commissions	100	116	116	82	85	93
Other non-interest income	100	139	54	82	100	44
Own credit adjustments	3	—	—	3	—	—
Non-interest income	203	255	170	167	185	137
<b>Total income</b>	<b>704</b>	<b>758</b>	<b>749</b>	<b>576</b>	<b>550</b>	<b>604</b>
<b>Direct expenses</b>						
- staff costs	(252)	(220)	(203)	(207)	(160)	(164)
- other costs	(68)	(116)	(104)	(55)	(85)	(83)
Indirect expenses	(239)	(251)	(224)	(195)	(182)	(180)
<b>Restructuring costs</b>						
- direct	(46)	(17)	10	(38)	(12)	8
- indirect	(2)	(4)	(26)	(2)	(3)	(21)
Litigation and conduct costs	(211)	18	24	(172)	13	19
Operating expenses	(818)	(590)	(523)	(669)	(429)	(421)
Operating (loss)/profit before impairment releases	(114)	168	226	(93)	121	183
Impairment releases	138	194	380	113	141	306
<b>Operating profit</b>	<b>24</b>	<b>362</b>	<b>606</b>	<b>20</b>	<b>262</b>	<b>489</b>
<b>Total income - adjusted (1)</b>	<b>701</b>	<b>758</b>	<b>749</b>	<b>573</b>	<b>550</b>	<b>604</b>
<b>Operating expenses - adjusted (2)</b>	<b>(559)</b>	<b>(587)</b>	<b>(531)</b>	<b>(457)</b>	<b>(427)</b>	<b>(427)</b>
<b>Operating profit - adjusted (1,2)</b>	<b>280</b>	<b>365</b>	<b>598</b>	<b>229</b>	<b>264</b>	<b>483</b>
<b>Average exchange rate - €/£</b>				<b>1.224</b>	<b>1.377</b>	<b>1.241</b>
<b>Analysis of income by business</b>						
Corporate	215	202	230	176	147	185
Retail	479	443	361	392	321	291
Other	10	113	158	8	82	128
<b>Total income</b>	<b>704</b>	<b>758</b>	<b>749</b>	<b>576</b>	<b>550</b>	<b>604</b>
<b>Analysis of impairments by sector</b>						
Mortgages	35	(100)	(212)	29	(73)	(171)

Commercial real estate						
- investment	(30)	7	(10)	(24)	5	(7)
- development	(25)	—	(3)	(20)	(1)	(3)
Other lending	(118)	(101)	(155)	(98)	(72)	(125)
Total impairment releases	(138)	(194)	(380)	(113)	(141)	(306)
Loan impairment charge/(release) as a % of gross customer						
loans and advances (excluding reverse repurchase agreements) by sector						
Mortgages	0.2%	(0.5%)	(1.1%)	0.2%	(0.5%)	(1.1%)
Commercial real estate						
- investment	(3.8%)	0.8%	(0.8%)	(3.4%)	0.7%	(0.7%)
- development	(8.3%)	—	(1.0%)	(10.0%)	(0.5%)	(1.0%)
Other lending	(2.6%)	(1.9%)	(3.0%)	(2.5%)	(1.8%)	(3.2%)
Total	(0.6%)	(0.8%)	(1.4%)	(0.6%)	(0.8%)	(1.5%)
Performance ratios						
Return on equity (3)	0.7%	10.6%	18.6%	0.7%	10.6%	18.6%
Return on equity - adjusted (1,2,3)	8.4%	10.6%	18.4%	8.4%	10.6%	18.4%
Net interest margin	1.62%	1.57%	1.92%	1.62%	1.57%	1.92%
Cost:income ratio	116%	78%	70%	116%	78%	70%
Cost:income ratio - adjusted (1,2)	80%	78%	71%	80%	78%	71%

## Notes:

- (1) Excluding own credit adjustments.
- (2) Excluding restructuring costs and litigation and conduct costs.
- (3) Return on equity is based on segmental operating profit after tax adjusted for preference dividends divided by average notional equity based on 11% of the monthly average of segmental RWAs, assuming 15% tax rate.

## Business review

<b>Ulster Bank RoI continued</b>						
	2016	2015	2014	2016	2015	2014
Capital and balance sheet	€bn	€bn	€bn	£bn	£bn	£bn
Loans and advances to customers (gross)						
Mortgages	17.9	18.8	19.6	15.3	13.8	15.3
Commercial real estate						
- investment	0.8	0.9	1.3	0.7	0.7	1.0
- development	0.3	0.3	0.3	0.2	0.2	0.3
Other lending	4.5	5.3	5.2	3.9	3.9	3.9
Total loans and advances to customers (gross)	23.5	25.3	26.4	20.1	18.6	20.5
Loan impairment provisions						
- mortgages	(1.1)	(1.4)	(1.8)	(0.9)	(1.1)	(1.4)
- commercial real estate						
- investment	—	(0.2)	(0.2)	—	(0.1)	(0.1)
- development	—	(0.1)	(0.1)	—	(0.1)	(0.1)
Other lending	(0.3)	(0.9)	(1.0)	(0.3)	(0.6)	(0.8)
Total loan impairment provisions	(1.4)	(2.6)	(3.1)	(1.2)	(1.9)	(2.4)
Net loans and advances to customers	22.1	22.7	23.3	18.9	16.7	18.1
Total assets	28.2	29.0	28.9	24.1	21.3	22.5
Funded assets	28.0	28.8	28.7	24.0	21.2	22.4
Risk elements in lending						
- mortgages	3.7	3.5	4.2	3.1	2.6	3.3
- Commercial real estate						
- investment	—	0.2	0.3	—	0.2	0.2
- development	—	0.1	0.2	—	0.1	0.1
- other lending	0.4	0.9	0.9	0.4	0.6	0.8
Total risk elements in lending	4.1	4.7	5.6	3.5	3.5	4.4
Provision coverage (1)	34%	55%	55%	34%	55%	55%
Customer deposits	18.8	17.8	18.9	16.1	13.1	14.7
Loan:deposit ratio (excluding repos)	117%	127%	124%	117%	127%	124%
Risk-weighted assets						
- Credit risk						
- non-counterparty	19.7	24.6	26.1	16.9	18.1	20.3
- counterparty	0.1	0.1	0.1	0.1	0.1	0.1
- Operational risk	1.3	1.7	1.8	1.1	1.2	1.4
Total risk-weighted assets	21.1	26.4	28.0	18.1	19.4	21.8



Spot exchange rate - €/£					1.168	1.362 1.285

Note:

(1) Provision coverage represents loan impairment provisions as a percentage of risk elements in lending.

## Business review

### Ulster Bank RoI *continued*

#### Serving our customers

Ulster Bank RoI continued to strengthen and reshape its balance sheet in 2016, whilst also delivering a number of positive changes to the customer proposition.

The completion of a sale of £1.5 billion (€1.8 billion) of largely underperforming loans in Q4 2016 has served to strengthen and de-risk the balance sheet, building a strong foundation for future growth.

Gross new lending of £2.2 billion (€2.5 billion in euro terms) increased 31% in 2016 supported by investment in the mortgage and asset and invoice finance businesses combined with a revitalisation of the Ulster Bank brand 2016 was a strong year for mortgage lending with gross new lending of £0.9 billion (€1.0 billion in euro terms), an increase of 48%, on the prior year, contributing to an increase in market share of new lending. Performance in personal lending was also positive, growing 44%, while commercial lending increased 19% year on year.

Further strategic investments were made to our digital platform and award winning mobile app in 2016 including product applications for loans, credit cards and overdrafts and clearer transaction detail. Our market leading 'Get Cash' facility is used over 2,000 times a week ensuring customers are never without access to cash. Continued developments in the mobile platform supported a 22% increase in active users of the mobile app in 2016 reflecting the growing customer preference for banking services through this channel.

Ulster Bank RoI continued to make progress on its cost saving programme supported by process automation and an acceleration of digital adoption balanced with investments to support business growth in opportunities.

Ulster Bank RoI became the first major bank in the Republic of Ireland to pay a dividend since the financial crisis.

Significant movements of the euro relative to sterling during 2016 and 2015 had a material impact on Ulster Bank Rol's financial comparison with 2015 and 2014.

## 2016 compared with 2015

Operating profit decreased by £242 million (€338 million) to £20 million (€24 million) compared with 2015 primarily due to an increase in litigation and conduct costs of £185 million (€229 million) and a £28 million (€56 million) reduction in net impairment releases. Adjusted operating profit of £229 million (€280 million), which excludes own credit adjustments of £3 million (€3 million) (2015 – nil), restructuring costs of £40 million (€48 million) (2015 - £15 million (€21 million)) and litigation and conduct costs of £172 million (€211 million) (2015 – recoveries of £13 million (€18 million)), was £35 million, or 13% (€85 million or 23% in euro terms), lower than prior year. Excluding the impact of the strengthening euro, the decrease in adjusted operating profit was driven by a reduction in adjusted operating expenses which was more than offset by the non recurrence of certain income benefits in 2015 and lower impairment releases.

Net interest income increased £44 million to £409 million compared with 2015 due to the strengthening of the euro but net interest income was stable year on year in euro terms. Net interest margin increased by 5 basis points to 1.62%, compared with 2015, driven by a continued reduction in the cost of deposits and a reduced volume of low yielding liquid assets, partly offset by reduced income on free funds.

Non-interest income decreased by £18 million, or 10% (€52 million or 20% in euro terms), principally reflecting a £24 million (€33 million) gain realised on the closure of a foreign exchange exposure in 2015 and a £11 million (€13 million) interim adjustment to the pricing of FX transactions between Ulster Bank Rol and NatWest Markets in 2016, pending completion of a detailed pricing review.

Operating expenses increased £240 million, or 56%, to £669 million (€228 million, or 39%, to €818 million). Adjusted operating expenses, which excludes restructuring costs of £40 million (€48 million) (2015 - £15 million (€21 million)) and litigation and conduct costs of £172 million (€211 million) (2015 – recoveries of £13 million (€18 millions)), increased £30 million, or 7%, to £457 million due to the strengthening of the euro but reduced by €28 million in euro terms, or 5%, to €559 million reflecting a combination of progress made on cost saving initiatives, the non recurrence of certain costs in 2015 and accrual releases in 2016.

A realignment of costs within direct expenses contributed to an increase in staff costs in 2016 with an offsetting reduction in other costs. This reflects the reallocation of 660 staff from UK PBB to align with current management responsibilities following the separation of the Northern Ireland and Republic of Ireland businesses. Excluding the reallocation from UK PBB and staff supporting the tracker mortgage examination and asset disposal programmes, headcount decreased by 9% year on year.



## Business review

### Ulster Bank RoI continued

Litigation and conduct costs of £172 million (€211 million) principally reflects a provision for remediation and programme costs associated with an industry wide examination of tracker mortgages. Restructuring costs increased by £25 million (€27 million) to £40 million (€48 million), primarily driven by costs associated with asset disposal activity.

A net impairment release of £113 million (€138 million) comprised write-backs associated with asset disposals and benefited from improved macroeconomic conditions.

Risk elements in lending remained stable at £3.5 billion in 2016 due to the strengthening of the euro but in euro terms the sale of a portfolio of loans contributed to a €0.6 billion, or 13%, reduction in 2016 to €4.1 billion. This was partially offset by a widening of the definition of loans which are considered to be impaired to include multiple forbearance arrangements and probationary mortgages. The provision coverage ratio reduced from 55% in 2015 to 34% in 2016 largely reflecting a further de-risking of the balance sheet following recent asset sales of largely non-performing loans.

Gross new lending increased 31% in 2016, net loans and advances increased £2.2 billion due to the strengthening of the euro but decreased €0.6 billion, or 3%, as new lending was offset by asset disposals and repayments. The low yielding tracker mortgage portfolio increased by £0.6 billion or 7% including the impact of the euro exchange rate movement (decreased €1.0 billion or 9% in euro terms), to £9.2 billion (€10.8 billion) at 31 December 2016 supported by repayments and asset disposals.

RWAs reduced by £1.3 billion or 7% (€5.3 billion or 20% in euro terms) during 2016 to £18.1 billion (€21.1 billion) driven by the sale of a portfolio of loans combined with adjustments to the mortgage modelling approach and an improvement in the macro economic environment. RWAs on the tracker mortgage portfolio reduced by £1.5 billion, or 19% (€3.3 billion or 31% in euro terms), during 2016 to £6.3 billion (€7.4 billion).

Loan:deposit ratio decreased 10 percentage points to 117% in 2016, this was supported by a £3.0 billion (€1.0 billion) growth in deposits.

### 2015 compared with 2014

Ulster Bank RoI recorded an operating profit of £262 million (€362 million) compared with an operating profit of £489 million (€606 million) in 2014, with the decline primarily due to considerably lower net impairment releases in 2015. Adjusted operating profit, which excludes restructuring costs of £15 million (€21 million) (2014 - £13 million (€16 million)) and litigation and conduct recoveries of £13 million (€18 million) (2014 – recoveries of £19 million (€24 million)), was £264 million (€365 million), a decrease of £219 million (€233 million) from 2014. Return on equity was 10.6%, down from 18.6% in 2014.

Total income was £550 million, a decrease of 9% from the prior year reflecting the weakening of the euro during 2015. In euro terms total income of €758 million increased €9 million or 1% compared with prior year due to a continued improvement in deposit pricing in line with market trends, combined with benefits, including a gain on the sale of a buy-to-let portfolio of £12 million (€17 million) and the closure of a foreign exchange exposure of £24 million (€33 million). These benefits were largely offset by reduced income on free funds.

Net interest margin (NIM) was 1.57%, a decrease of 35 basis points from 2014, primarily driven by reduced income on free funds and an increased drag from liquidity management requirements. NIM continues to reflect a sizeable drag from the low yielding tracker mortgage book.

Operating expenses increased by £8 million (€67 million) from £421 million (€523 million) to £429 million (€590 million), reflecting an increase in pension servicing costs, totalling £22 million (€30 million). Cost savings delivered through a further reduction in both employee numbers and the property footprint, as well as the weakening of euro (an impact of £41 million), were somewhat offset by further investment in the business and operational infrastructure.

Net impairment releases reduced by £165 million (€186 million) to £141 million (€194 million), and although at lower levels, continued to reflect the improving economic conditions and the benefits of proactive debt management.

Gross new mortgage lending increased 53% to £0.5 billion (€0.7 billion in euro terms) whilst gross new lending to commercial customers increased 65% to £1.1 billion (€1.5 billion in euro terms). Strong new lending volumes across the business in 2015 were offset by high levels of customer repayments and the sale of a £0.3 billion (€0.4 billion) buy-to-let mortgage portfolio. Net loans and advances to customers decreased £1.4 billion (€0.6 billion) to £16.7 billion (€22.7 billion), £1 billion of which related to exchange rate movements. The low yielding tracker mortgage portfolio balances reduced from £9.9 billion (€12.7 billion) in 2014 to £8.7 billion (€11.8 billion), but continues to make up a significant part of the overall mortgage book.

RWAs reduced 11% (6% in euro terms) from £21.8 billion (€28.0 billion) to £19.4 billion (€26.4 billion) due to improved credit metrics and the impact of a weakening euro an impact of £1.2 billion, while RWA intensity reduced by 2 percentage points to 104%. RWAs on the tracker mortgage portfolio reduced from £9.3 billion

(€12.0 billion) in 2014 to £7.8 billion (€10.6 billion).

**Business review**

<b>Commercial Banking</b>			
	2016	2015	2014
	£m	£m	£m
<b>Income statement</b>			
Net interest income	2,143	1,997	1,976
Net fees and commissions	1,031	984	983
Other non-interest income	241	273	346
Non-interest income	1,272	1,257	1,329
<b>Total income</b>	<b>3,415</b>	<b>3,254</b>	<b>3,305</b>
Direct expenses			
- staff costs	(522)	(483)	(495)
- operating lease costs	(141)	(141)	(141)
- other costs	(94)	(97)	(100)
Indirect expenses	(1,179)	(1,080)	(1,008)
Restructuring costs			
- direct	(25)	(52)	(41)
- indirect	(83)	(17)	(67)
Litigation and conduct costs	(423)	(51)	(112)
Operating expenses	(2,467)	(1,921)	(1,964)
Operating profit before impairment losses	948	1,333	1,341
Impairment losses	(206)	(69)	(85)
<b>Operating profit</b>	<b>742</b>	<b>1,264</b>	<b>1,256</b>
Operating expenses - adjusted (1)	(1,936)	(1,801)	(1,744)
Operating profit - adjusted (1)	1,273	1,384	1,476
<b>Analysis of income by business</b>			
Commercial lending	1,875	1,634	1,618
Deposits	474	477	375
Asset and invoice finance	712	710	740
Other	354	433	572
Total income	3,415	3,254	3,305
<b>Analysis of impairments by sector</b>			
Commercial real estate	4	18	3
Asset and invoice finance	35	9	11
Private sector services (education, health, etc)	8	9	—
Banks & financial institutions	2	—	2
Wholesale and retail trade repairs	15	3	17



Hotels and restaurants	27	(2)	7
Manufacturing	3	1	9
Construction	18	6	11
Other	94	25	25
Total impairment losses	206	69	85
Loan impairment charge as a % of gross customer loans and advances by sector			
Commercial real estate	—	0.1%	—
Asset and invoice finance	0.2%	0.1%	0.1%
Private sector services (education, health, etc)	0.1%	0.1%	—
Wholesale and retail trade repairs	0.2%	—	0.3%
Hotels and restaurants	0.7%	(0.1%)	0.2%
Manufacturing	—	—	0.2%
Construction	0.8%	0.3%	0.6%
Other	0.3%	0.1%	0.1%
Total	0.2%	0.1%	0.1%

Note:

(1) Excluding restructuring costs and litigation and conduct costs.

**Business review**

<b>Commercial Banking continued</b>			
<b>Performance ratios</b>	2016	2015	2014
Return on equity (1)	4.1%	9.8%	10.2%
Return on equity - adjusted (1,2)	8.4%	10.9%	12.2%
Net interest margin	1.76%	1.88%	1.91%
Cost:income ratio	72%	59%	59%
Cost:income ratio - adjusted (2)	57%	55%	53%
<b>Capital and balance sheet</b>	£bn	£bn	£bn
Loans and advances to customers (gross)			
- Commercial real estate	16.9	16.7	16.6
- Asset and invoice finance	14.1	14.4	14.2
- Private sector services (education, health, etc)	6.9	6.7	6.8
- Banks & financial institutions	8.9	7.1	5.5
- Wholesale and retail trade repairs	8.4	7.5	6.8
- Hotels and restaurants	3.7	3.3	3.3
- Manufacturing	6.6	5.3	3.9
- Construction	2.1	2.1	2.0
- Other	33.3	28.9	26.7
Total loan and advances to customers (gross)	100.9	92.0	85.8
Loan impairment provisions	(0.8)	(0.7)	(0.9)
Net loans and advances to customers	100.1	91.3	84.9
Total assets	150.5	133.5	127.9
Funded assets	150.5	133.5	127.9
Risk elements in lending	1.9	1.9	2.4
Provision coverage (3)	43%	39%	39%
Customer deposits (excluding repos)	97.9	88.9	84.9
Loan:deposit ratio (excluding repos)	102%	103%	100%
Risk-weighted assets			
- Credit risk (non-counterparty)	72.0	65.3	55.8
- Operational risk	6.5	7.0	7.4
Total risk-weighted assets	78.5	72.3	63.2

Notes:

- (1) Return on equity is based on segmental operating profit after tax adjusted for preference dividends divided by average notional equity based on 11% of the monthly average of segmental RWAs, assuming 28% tax rate.
- (2) Excluding restructuring costs and litigation and conduct costs.
- (3) Provision coverage represents loan impairment provisions as a percentage of risk elements in lending.

## Business review

### Serving our customers

Commercial Banking continued to support the UK and Western Europe business community with lending growth of £8.8 billion, 10% higher compared with 2015, across a variety of sectors and exceeding market indicators.

A continuing focus on end to end business performance aimed at improving customer service, trust and advocacy continues to show signs of success, reporting the largest, and only significant, year on year improvement in NPS amongst major UK banks.

Commercial Banking made progress towards improving customer experience by becoming easier and simpler to do business with through operational investment and process simplifications. Continued enhancements within the business contributed to commercial lending growth in 2016.

We continued to support UK business growth through the launch of 6 new business accelerator hubs in 2016, bringing the total to 12. In addition, NatWest launched a £1 billion lending fund to support small businesses.

We launched several innovative products for our customers. Firstly, Nift a new digital solution that helps encourage increased engagement and understanding of contracts by customers. Secondly, we are supporting business through ESME, an automated lending platform that enables eligible SMEs to borrow up to £150k, with capability to process and fund within an hour.

Our Lending Transformation Programme reached a major milestone with its latest systems upgrade, 79% of Commercial Banking customers can now be automatically assessed against our business appetite.

Nearly 80% of our commercial customers' interaction with us is via digital channels, with around 270,000 payments processed every day.



## Business review

### Commercial Banking *continued*

#### 2016 compared with 2015

Operating profit was £742 million compared with £1,264 million in 2015 and included a £423 million litigation and conduct charge, principally relating to a provision in respect of the FCA review of RBS's treatment of SMEs. Adjusted operating profit, which excludes restructuring costs of £108 million (2015 - £69 million) and litigation and conduct costs of £423 million (2015 - £51 million) of £1,273 million, was £111 million, or 8%, lower than 2015, mainly reflecting increased impairments, partially offset by increased income.

Total income increased by £161 million to £3,415 million. Excluding the impact of transfers<sup>(1)</sup>, a benefit of £218 million (2015 - £79 million), income increased by £21 million, or 1%, reflecting higher asset and deposit volumes. Net interest margin fell by 12 basis points to 1.76% driven by asset margin pressure in a competitive market and low rate environment.

Operating expenses increased by £546 million to £2,467 million. Adjusted operating expenses, which exclude restructuring costs of £108 million (2015 - £69 million) and litigation and conduct costs of £423 million (2015 - £51 million), and excluding business transfers of £109 million (2015 - £25 million), increased by £51 million reflecting a £25 million intangible asset write-down and increased investment spend.

Net impairment losses increased by £137 million to £206 million primarily reflecting a single name charge taken in respect of the oil and gas portfolio.

Net loans and advances of £100.1 billion increased by £8.8 billion, or 10%, compared with 2015 reflecting increased borrowing across a number of sectors.

RWAs were £78.5 billion, an increase of £6.2 billion compared with 2015 reflecting asset growth partially offset by reduced RWA intensity.

#### 2015 compared with 2014

Comparisons with prior periods are affected by a number of internal business transfers. In line with changes to the business model, the UK and Western European corporate loan portfolios transferred to Commercial Banking on 1 May 2015 and 1 October 2015 respectively. The prior period financials were adjusted for the UK Transaction Services business transfer and do not affect comparisons. The results exclude RBS International which is reported as a separate segment for the first time.

Commercial Banking recorded an operating profit of £1,264 million, broadly in line with the prior year. Adjusted operating profit, which excludes restructuring costs of £69 million (2014 - £108 million) and litigation and conduct costs of £51 million (2014 - £112 million) was £1,384 million, a decrease of £92 million from 2014 due to a marginal fall in income reflecting margin pressure. Return on equity was broadly stable year on year.

## Business review

Total income was £3,254 million, compared with £3,305 million in 2014. Net interest income was £1,997 million, a 1% increase from 2014, driven largely by higher asset and deposit volumes. Net interest margin decreased three basis points to 1.88% with improved deposit margins partly offsetting competitive pressures on new business asset margins. Non-interest income fell by 5% to £1,257 million driven by a loss of £34 million from the sale of non-strategic asset portfolios and the transfer of the commercial cards business to UK PBB in 2014.

Operating expenses totalled £1,921 million, a reduction of 2% from 2014, principally driven by tight control on discretionary costs and lower litigation and conduct costs, down 54% to £51 million, combined with restructuring costs falling 36% to £69 million. Adjusted operating expenses, which excludes restructuring costs of £69 million (2014 - £108 million) and litigation and conduct costs of £51 million (2014 - £112 million) were £1,801 million, an increase of £57 million, primarily as a result of a higher UK bank levy charge.

Net impairment losses decreased £16 million to £69 million due to lower individual charges, offsetting lower net provision releases.

Commercial Banking recorded volume growth across segments, resulting in net loans and advances to customers increasing by £6.4 billion to £91.3 billion. This included £5.0 billion from the transferred businesses, offset by strategic run-off and sale of selected assets totalling £2.2 billion. Total net new lending was £1.4 billion.

Customer deposits totalled £88.9 billion, an increase of £4.0 billion reflecting high levels of liquidity in the market.

RWAs increased £9.1 billion to £72.3 billion in 2015, of which £8.4 billion relates to £5 billion of assets transferred in. The higher capital intensity reflects increased level of undrawn commitments in the transferred businesses.

The Commercial Banking run-off portfolio includes funded assets of £12.5 billion and RWAs of £8.5 billion.

Note:



(1) The business transfers included impact of: total income of £218 million (2015 - £79 million; 2014 - nil); operating expenses of £109 million (2015 - £25 million; 2014 - nil); impairment losses of £50 million (2015 - £1 million releases; 2014 - nil); net loans and advances to customers of £6.2 billion (2015 - £5.0 billion; 2014 - nil); customer deposits of £0.4 billion (2015 and 2014 - nil); and RWAs of £9.3 billion (2015 - £8.4 billion; 2014 - nil).

**Business review**

<b>Private Banking</b>			
	2016	2015	2014
<b>Income statement</b>	£m	£m	£m
Net interest income	449	436	454
Net fees and commissions	181	186	214
Other non-interest income	27	22	21
Non-interest income	208	208	235
<b>Total income</b>	<b>657</b>	<b>644</b>	<b>689</b>
Direct expenses			
- staff costs	(154)	(176)	(178)
- other costs	(44)	(35)	(37)
Indirect expenses	(313)	(307)	(289)
Restructuring costs			
- direct	(7)	(7)	(1)
- indirect	(30)	(66)	—
Litigation and conduct costs	(1)	(12)	(90)
Write down of goodwill	—	(498)	—
Operating expenses	(549)	(1,101)	(595)
Operating profit/(loss) before impairment releases/(losses)	108	(457)	94
Impairment releases/(losses)	3	(13)	5
<b>Operating profit/(loss)</b>	<b>111</b>	<b>(470)</b>	<b>99</b>
Operating expenses - adjusted (1)	(511)	(518)	(504)
Operating profit - adjusted (1)	149	113	190
<b>Analysis of income by business</b>			
Investments	97	86	104
Banking	560	558	585
Total income	657	644	689
<b>Performance ratios</b>			
Return on equity (2)	5.6%	(27.7%)	4.1%
Return on equity - adjusted (1,2)	7.8%	4.9%	9.1%
Net interest margin	2.66%	2.75%	2.89%
Cost:income ratio	84%	171%	86%
Cost:income ratio - adjusted (1)	78%	80%	73%

	2016	2015	2014
Capital and balance sheet	£bn	£bn	£bn
Loans and advances to customers (gross)			
- Personal	2.3	2.7	2.6
- Mortgages	7.0	6.5	6.1
- Other	2.9	2.0	2.3
Total loans and advances to customers (gross)	12.2	11.2	11.0
Total assets	18.6	17.0	17.7
Funded assets	18.5	17.0	17.7
Assets under management (3)	17.0	13.9	13.8
Risk elements in lending	0.1	0.1	0.1
Provision coverage (4)	30%	28%	25%
Customer deposits (excluding repos)	26.6	23.1	22.3
Loan:deposit ratio (excluding repos)	46%	48%	49%
Risk-weighted assets			
- Credit risk (non-counterparty)	7.5	7.6	7.6
- Market risk	—	—	0.1
- Operational risk	1.1	1.1	1.0
Total risk-weighted assets	8.6	8.7	8.7

## Notes:

- (1) Excluding restructuring costs and litigation and conduct costs and write down of goodwill.
- (2) Return on equity is based on segmental operating profit after tax adjusted for preference dividends divided by average notional equity based on 15% of the monthly average of segmental RWAs, assuming 28% tax rate.
- (3) Comprises assets under management, assets under custody and investment cash.
- (4) Provision coverage represents loan impairment provisions as a percentage of risk elements in lending.

## Business review

### Private Banking [continued](#)

#### Serving our customers

Private Banking has been through a period of transition and is now being repositioned to focus on its UK target customer base. The focus will be on creating deep and lasting relationships and implementing growth initiatives that will create long term sustainable returns. Significant progress has been made in rebuilding the business and it continues to drive forward with its goal of being the leading UK-based private bank and wealth manager, through a focus on supporting our customers and reducing complexity:

Continued support of UK customers with balance and AUM growth through an enhanced product proposition, including a range of execution only funds as well as the launch of an investment backed lending product and a market leading multi-currency debit card.

Private Banking Wealth Management globally orientated Tailored Portfolio Service is first quartile compared to peers over 1 & 3 years and Coutts Multi Asset funds continue to outperform peers in Defensive, Balanced and Growth strategies.

Coutts won the best private bank in the UK for the fifth year running, best private bank for philanthropy services and best initiative of the year in client facing technology at the Global Private Banking Awards, and was highly commended for innovation for its 'Coutts Concierge Online'.

Significant progress made to refocus the business and invest for growth with a reduced office footprint, creation of a Jersey booking platform to support on-going customer base following the sale of International Private Banking, and a centralised investment management proposition. This has contributed to a significant improvement in NPS during 2016, from +9 at the start of the year to +18.

Launched Direct to Consumer (D2C) investment proposition, enabling customers to model investment options, target returns and complete transactions themselves.

Incorporated behavioural biometric technology to protect customers and reduce fraud, becoming the first UK bank to allow a client's smart phone to act as the authentication device.

Launch of Coutts Concierge service, an industry first service which allows customers to manage restaurant bookings, purchase tickets, hotels and flights online, 24 hours a day.

Improved mortgage processing for clients with the creation of a mortgage specialist team focused on speeding up the lending process.

Our customers continue to benefit from the synergies between Commercial and Private Banking, with 1,100 referrals between Commercial and Private Banking in 2016.

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## Business review

### 2016 compared with 2015

An operating profit of £111 million compared with an operating loss of £470 million in 2015 which included a goodwill impairment of £498 million. Adjusted operating profit, which excludes restructuring costs of £37 million (2015 - £73 million), litigation and conduct costs of £1 million (2015 - £12 million) and write down of goodwill (2015 - £498 million) of £149 million was £36 million, or 32%, higher than 2015 reflecting increased income, lower operating expenses and lower impairments.

Total income increased by £13 million to £657 million primarily reflecting higher asset volumes. Net interest margin fell by 9 basis points to 2.66% reflecting asset margin pressures.

Operating expenses of £549 million were £552 million, or 50% lower than 2015. Adjusted operating expenses, which exclude restructuring costs of £37 million (2015 - £73 million), litigation and conduct costs of £1 million (2015 - £12 million) and write down of goodwill (2015 - £498 million) of £511 million were £7 million, or 1%, lower than 2015 driven by reductions in the direct cost base, with employee numbers down 10%, partially offset by increased infrastructure costs absorbed following the sale of the international business.

Net loans and advances of £12.2 billion increased by £1.0 billion compared with 2015 driven by mortgages. Assets under management of £17.0 billion were £3.1 billion higher compared with 2015 reflecting underlying growth and equity index inflation. In addition, investment cash balances were included in assets under management for the first time in Q3 2016, excluding this, growth was £2.0 billion.

### 2015 compared with 2014

Private Banking recorded an operating loss of £470 million compared with an operating profit of £99 million in 2014. A goodwill impairment charge of £498 million attributed to the business drove this loss. Adjusted operating profit, which excludes restructuring costs of £73 million (2014 - £1 million), litigation and conduct costs of £12 million (2014 - £90 million) and write down of goodwill of £498 million (2014 - nil) was £113 million in 2015, a fall of £77 million from 2014 reflecting lower income and higher net impairment losses.

Total income was £644 million, a reduction of £45 million from 2014. Net interest income was £436 million, down 4% primarily due to lower net interest margin. Non-interest income totalled £208 million, a decrease of 11% driven by lower investment and transactional income as the business adjusted pricing to reflect a more competitive market.

Operating expenses totalled £1,101 million, an increase of £506 million, driven by a £498 million goodwill impairment charge, and considerably higher restructuring costs of £73 million which includes a share of an asset write down related to software of £91 million, and lower litigation and conduct costs of £12 million. Adjusted operating expenses, which exclude restructuring costs of £73 million (2014 - £1 million), litigation and conduct costs of £12 million (2014 - £90 million) and write down of goodwill of £498 million (2014 - nil) were £518 million, up 3%, with reductions in the direct cost base offset by a higher UK bank levy charge.

Net impairment losses totalled £13 million, compared with a release of £5 million, due to higher individual and latent charges.

Despite challenging market conditions, assets under management and net loans and advances to customers were broadly stable compared with the prior year.

**Business review**

<b>RBS International</b>			
	2016	2015	2014
<b>Income statement</b>	£m	£m	£m
Net interest income	303	303	323
Net fees and commissions	50	40	43
Other non-interest income	21	24	25
Non-interest income	71	64	68
<b>Total income</b>	<b>374</b>	<b>367</b>	<b>391</b>
Direct expenses			
- staff costs	(45)	(42)	(44)
- other costs	(17)	(16)	(15)
Indirect expenses	(107)	(98)	(94)
Restructuring costs			
- direct	(2)	—	(2)
- indirect	(3)	(4)	(5)
Operating expenses	(174)	(160)	(160)
Operating profit before impairment (loss)/releases	200	207	231
Impairment (loss)/releases	(10)	—	7
<b>Operating profit</b>	<b>190</b>	<b>207</b>	<b>238</b>
Operating expenses - adjusted (1)	(169)	(156)	(153)
Operating profit - adjusted (1)	195	211	245
<b>Performance ratios</b>			
Return on equity (2)	13.8%	18.5%	24.2%
Return on equity - adjusted (1,2)	14.2%	18.9%	24.9%
Net interest margin	1.36%	1.48%	1.65%
Cost:income ratio	47%	44%	41%
Cost:income ratio - adjusted (1)	45%	43%	39%

	2016	2015	2014
<b>Capital and balance sheet</b>	£bn	£bn	£bn
Loans and advances to customers (gross)			
- Corporate	6.2	4.5	4.5
- Mortgages	2.6	2.5	2.6
- Other	—	0.4	0.2
Total loans and advances to customers (gross)	8.8	7.4	7.3



Loan impairment provisions	—	(0.1)	(0.1)
Net loans and advances to customers	8.8	7.3	7.2
Total assets	23.4	23.1	23.4
Funded assets	23.4	23.1	23.4
Risk elements in lending	0.1	0.1	0.2
Provision coverage (3)	35%	34%	27%
Customer deposits	25.2	21.3	20.8
Loan:deposit ratio (excluding repos)	35%	35%	35%
Risk-weighted assets			
- Credit risk - non-counterparty	8.8	7.6	6.8
- Operational risk	0.7	0.7	0.7
Total risk-weighted assets	9.5	8.3	7.5

## Notes:

(1) Excluding restructuring costs.

(2) Return on equity is based on segmental operating profit after tax adjusted for preference dividends divided by average notional equity based on 12% of the monthly average of segmental RWAs, assuming 10% tax rate.

(3) Provision coverage represents loan impairment provisions as a percentage of risk elements in lending.

## Business review

### RBS International continued

#### Serving our customers

RBS International (RBSI) continues to focus on supporting retail, commercial, corporate and financial institution customers in Jersey, Guernsey, Isle of Man, Gibraltar and Luxembourg by leveraging a strong multi-currency banking platform combined with a comprehensive product suite:

Continued to support personal and non-personal businesses with lending growth of 21% during 2016. Meeting customer needs, through improved end to end customer experience, has resulted in Funds sector growth of £0.7 billion and gross new mortgage lending of £0.5 billion.

The business is the market leader in the Isle of Man and has top three market positions in Guernsey and Jersey. It has established strong customer advocacy, with broadly no change in NPS in the past year, despite an ongoing customer remediation programme.

Licensing remains on track as we received our banking licence to operate in Luxembourg, and the application to open a London branch has been submitted with technical build underway thus providing the foundations for growth while supporting the legal entity transfers as part of the Group's ring-fencing programme.

We've made it easier for our customers to do their banking with us through investment in our multi-currency banking platform for Funds, Intermediaries and Corporate customer and transforming our branches.

#### 2016 compared with 2015

Operating profit decreased by £17 million to £190 million principally reflecting increased impairment losses and operating expenses. Adjusted operating profit, which excludes restructuring costs of £5 million (2015 - £4 million), was £195 million, £16 million lower than 2015.

Total income increased by £7 million to £374 million primarily reflecting higher asset volumes. Net interest margin fell by 12 basis points to 1.36% reflecting asset margin pressures.

Operating expenses of £174 million were £14 million, or 9% higher than 2015. Adjusted operating expenses, which exclude restructuring costs of £5 million (2015 - £4 million), were £169 million, £13 million, or 8%, higher than 2015, reflecting a number of one-off charges.

A net impairment loss of £10 million was reported in 2016.

Net loans and advances of £8.8 billion increased by £1.5 billion compared with 2015 reflecting balance draw-downs in the corporate lending portfolio, mainly within the Funds sector.

Customer deposits of £25.2 billion grew by £3.9 billion compared with 2015 principally reflecting the transfer of the Luxembourg branch into RBSI from Capital Resolution during Q2 2016.

RWAs were £9.5 billion, an increase of £1.2 billion compared with 2015 reflecting asset growth.

### 2015 compared with 2014

RBSI reported an operating profit of £207 million, £31 million lower than 2014, largely due to lower income from deposits which in turn drove return on equity down to 18.5%, from 24.2%.

Total income decreased 6% to £367 million, mainly due to reductions in net interest income, falling £20 million to £303 million, principally reflecting lower deposit margins and lower return on free funds partly offset by higher asset volumes. Non-interest income declined £4 million to £64 million as a result of a lower CIB revenue share and lower net lending fees.

There were no impairments in 2015 compared with modest impairment releases of £7 million in the prior year.

Operating expenses remained stable at £160 million due to control in direct expenditure offset by a slightly higher UK bank levy charge.

Net loans and advances to customers increased by £0.1 billion to £7.3 billion. Customer deposit balances grew £0.5 billion to £21.3 billion. The business is a liability heavy business with a loan:deposit ratio of 35%.

RWAs increased by £0.8 billion to £8.3 billion as a result of a change in business mix and foreign exchange movements.

## Business review

<b>NatWest Markets</b>			
	2016	2015	2014
Income statement	£m	£m	£m
Net interest income from banking activities	104	87	(11)
Net fees and commissions	43	218	408
Income from trading activities	1,372	1,153	1,386
Own credit adjustments	53	120	(9)
Other operating income	2	(51)	157
Non-interest income	1,470	1,440	1,942
<b>Total income</b>	<b>1,574</b>	<b>1,527</b>	<b>1,931</b>
Direct expenses			
- staff costs	(256)	(348)	(446)
- other costs	(35)	(122)	(190)
Indirect expenses	(1,029)	(997)	(1,080)
Restructuring costs			
- direct	(19)	(44)	(13)
- indirect	(93)	(480)	(89)
Litigation and conduct costs	(528)	(378)	(832)
Operating expenses	(1,960)	(2,369)	(2,650)
Operating loss before impairment releases	(386)	(842)	(719)
Impairment releases	—	5	9
<b>Operating loss</b>	<b>(386)</b>	<b>(837)</b>	<b>(710)</b>
Total income - adjusted (1)	1,521	1,407	1,940
Operating expenses - adjusted (2)	(1,320)	(1,467)	(1,716)
Operating profit/(loss) - adjusted (1,2)	201	(55)	233
<b>Analysis of income by product</b>			
Rates	868	725	883
Currencies	551	390	551
Financing	246	273	515
Other	(144)	(79)	(232)
Total excluding own credit adjustments	1,521	1,309	1,717
Own credit adjustments	53	120	(9)
Businesses transferred to Commercial Banking	—	98	223
<b>Total income</b>	<b>1,574</b>	<b>1,527</b>	<b>1,931</b>

Performance ratios			
Return on equity (3)	(6.6%)	(11.1%)	(7.9%)
Return on equity - adjusted (1,2,3)	1.1%	(2.0%)	1.3%
Net interest margin	0.84%	0.53%	(0.07%)
Cost:income ratio	125%	155%	137%
Cost:income ratio - adjusted (1,2)	87%	104%	88%

## Notes:

- (1) Excluding own credit adjustments.
- (2) Excluding restructuring costs and litigation and conduct costs.
- (3) Return on equity is based on segmental operating profit after tax adjusted for preference dividends divided by average notional equity based on 15% of the monthly average of segmental RWAs, assuming 28% tax rate.

**Business review**

<b>NatWest Markets</b> continued			
	2016	2015	2014
Capital and balance sheet	£bn	£bn	£bn
Loans and advances to customers (gross, excluding reverse repos)	17.4	16.1	26.5
Loans and advances to banks (excluding reverse repos) (1)	3.3	5.7	2.5
Reverse repos	38.6	38.6	45.9
Securities	22.0	23.7	43.7
Cash and eligible bills	13.4	14.3	10.4
Other	6.2	4.9	8.7
Total assets	240.0	215.3	276.2
Funded assets	100.9	103.3	137.7
Customer deposits (excluding repos)	8.4	5.7	11.8
Bank deposits (excluding repos)	9.8	6.7	10.8
Repos	27.3	35.2	52.8
Debt securities in issue	5.4	3.3	4.9
Loan:deposit ratio (excluding repos)	208%	284%	226%
Risk-weighted assets			
- Credit risk			
- non-counterparty	5.5	5.0	10.3
- counterparty	14.1	11.3	12.5
- Market risk	11.6	13.8	15.4
- Operational risk	4.0	3.0	3.7
Total risk-weighted assets	35.2	33.1	41.9

Note:

(1) Excludes disposal groups.

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## Business review

### NatWest Markets *continued*

#### Serving our customers

NatWest Markets provides financing and risk management solutions and is built around three product lines: Rates, Currencies and Financing. NatWest Markets puts its customers at the centre of the way it does business.

The NatWest Markets brand was introduced on 5 December 2016. The new brand is an important step towards our ambition to become #1 for customers.

NatWest Markets started a multi-year transformation in February 2015 and real progress is being made towards building a technology-led business with ongoing investment to improve efficiency and reduce costs while sustaining a well-controlled end-to-end model. The business's progress against its transformation plan is already being recognised externally:

- for Gilts by Market Share – EMEA FI (Source: Greenwich Associates, European Fixed Income 2016 - Government Bonds)
- for GBP Options, GBP Inflation and GBP 2Y – 10Y IRS (Source: Total Derivatives Dealer Rankings 2016)
- Best bank for FX post-trade services (FX Week Best Bank Awards 2016)
- for all European Issuers in the private placement market (Source: Dealogic Private Placement Review, Full Year 2016)
- Best for putting corporate client's interest before the bank's (Source: Global Capital Bond Awards 2016)
- NatWest Markets gained or held share in every Rates & FX product category for EMEA and the Americas (Source: Coalition Client Analytics Top 500 FI Wallets: G10 Foreign Exchange, G10 Rates)

### 2016 compared with 2015

An operating loss of £386 million compared with an operating loss of £837 million in 2015 and included litigation and conduct costs of £528 million. The increase was driven by lower operating expenses and increased income. Adjusted operating profit, which excludes own credit adjustments of £53 million (2015 -



£120 million), restructuring costs of £112 million (2015 - £524 million) and litigation and conduct costs of £528 million (2015 - £378 million) was £201 million compared with a loss of £55 million in 2015.

Total income increased by £47 million to £1,574 million. Excluding the impact of transfers, £98 million in 2015 and own credit adjustments of £53 million (2015 - £120 million) income increased by £212 million, or 16%, to £1,521 million. The increase was driven by Rates and Currencies, reflecting sustained customer activity throughout the year and favourable market conditions following the EU referendum and subsequent central bank actions.

Operating expenses decreased from £2,369 million to £1,960 million in 2016, driven by lower restructuring costs and lower adjusted expenses. Excluding business transfers of £31 million in 2015, restructuring costs of £112 million (2015 - £524 million) and litigation and conduct costs of £528 million (2015 - £378 million) adjusted expenses reduced by £116 million, or 8% reflecting c.£250 million of cost reductions partially offset by higher investment spend.

NatWest Markets are currently in the middle of a substantial investment programme which will equip the franchise for new regulatory requirements and provide opportunity to reduce back office support costs. We expect that NatWest Markets adjusted operating expenses, which exclude restructuring costs and litigation and conduct costs will reduce by around £500 million over the next four years.

Total assets of £240.0 billion increased by £24.7 billion compared with 2015. An increase in derivative balances was partially offset by a decrease in funded assets of £2.4 billion compared with 2015 to £100.9 billion, as the business continues to work through re-shaping, despite the headwind from foreign exchange movements following the EU referendum and the substantial weakening of sterling.

RWAs increased by £2.1 billion compared with 2015 to £35.2 billion principally due to business movements and the impact of the weakening of sterling.

## Business review

### 2015 compared with 2014

NatWest Markets (formerly CIB) reported an operating loss of £837 million in 2015, compared with an operating loss of £710 million in 2014. This included restructuring costs of £524 million and litigation and conduct costs of £378 million. The reduction was driven by lower income partially offset by the continued reduction in expenses, down £281 million, or 11%, to £2,369 million as the business continues to take costs out and move towards a more sustainable cost base.

Adjusted operating loss, which excludes a gain on own credit adjustments of £120 million (2014 - £9 million charge), restructuring costs of £524 million (2014 - £102 million) and litigation and conduct costs of £378 million (2014 - £832 million) was £55 million, compared with a profit of £233 million in 2014.

Total income declined by £404 million, or 21%, to £1,527 million in 2015. This includes £120 million relating to own credit adjustments and £98 million relating to the transfer of portfolio businesses to Commercial Banking. NatWest Markets income excluding own credit adjustments (2015 - £120 million; 2014 - £9 million charge), was £1,407 million, in line with previous guidance.

- Rates income declined, reflecting the reduced scale and risk appetite of the business.
- Currencies incurred losses when the Swiss Central Bank unexpectedly removed the Swiss Franc's peg to the Euro.
- Financing was impacted by the strategically reduced corporate footprint especially in the US and by lower levels of EMEA investment grade issuance.

Operating expenses fell by £281 million, or 11%, to £2,369 million in 2015. This includes £31 million relating to the transfer of portfolio businesses to Commercial Banking. Expenses remaining in NatWest Markets were £2,338 million as the business reshaped, including a considerable reduction in headcount. Litigation and conduct costs fell by £454 million, or 55%, to £378 million, primarily relating to foreign exchange settlements in the US. This reduction was offset by an increase in restructuring costs of £422 million to £524 million, primarily relating to property and intangible asset write downs. Adjusted operating expenses, which exclude restructuring costs of £524 million (2014 - £102 million) and litigation and conduct costs of £378 million (£832 million) fell by £249 million or 15% to £1,467 million.

Total assets fell by £60.9 billion to £215.3 billion as the business continues to work through re-shaping, and included £17 billion (2014 - £20 billion) relating to the transfer to Treasury of the Short Term Markets

business and £5 billion from the transfer of the UK and Western European corporate loan portfolios to Commercial Banking. Funded assets fell by £34.4 billion to £103.3 billion.

RWAs reduced by £8.8 billion to £33.1 billion compared with £41.9 billion, nearing the end-state target of c.£30 billion. The reduction was primarily driven by the transfer of the UK and Western European portfolio businesses to Commercial Banking.

## Business review

### Capital Resolution

	2016	2015	2014
	£m	£m	£m
<b>Income statement</b>			
Net interest income	239	365	673
Net fees and commissions	98	266	483
(Loss)/income from trading activities	(543)	(410)	401
Other operating income	(209)	181	271
Own credit adjustments	134	175	(36)
Strategic disposals	(81)	(38)	—
Non-interest income	(601)	174	1,119
<b>Total income</b>	<b>(362)</b>	<b>539</b>	<b>1,792</b>
Direct expenses			
- staff costs	(102)	(296)	(444)
- other costs	(84)	(202)	(293)
Indirect expenses	(578)	(1,041)	(1,283)
Restructuring costs			
- direct	(56)	(380)	(80)
- indirect	(22)	(927)	(105)
Litigation and conduct costs	(3,413)	(2,105)	(162)
Write down of goodwill	—	—	(130)
Operating expenses	(4,255)	(4,951)	(2,497)
Operating loss before impairment (losses)/releases	(4,617)	(4,412)	(705)
Impairment (losses)/releases	(253)	725	1,307
<b>Operating (loss)/profit</b>	<b>(4,870)</b>	<b>(3,687)</b>	<b>602</b>
Total income - adjusted (1)	(415)	402	1,828
Operating expenses - adjusted (2)	(764)	(1,539)	(2,020)
Operating (loss)/profit - adjusted (1,2)	(1,432)	(412)	1,115
<b>Analysis of income by portfolio</b>			
APAC portfolio (3)	(6)	74	94
Americas portfolio	13	60	98
EMEA portfolio (4)	39	76	146
Legacy loan portfolio	(1)	129	416
Shipping	43	80	95
Markets	(171)	180	866

GTS	123	346	563
Other	36	(214)	(481)
Income excluding disposals and own credit adjustments	76	731	1,797
Disposal (losses)/profit	(572)	(367)	31
Own credit adjustments	134	175	(36)
Total income	(362)	539	1,792

## Notes:

- (1) Excluding own credit adjustments and strategic disposals.
- (2) Excluding restructuring costs, litigation and conduct costs and write down of goodwill.
- (3) Asia-Pacific portfolio.
- (4) European, the Middle East and Africa portfolio.

## Business review

<b>Capital Resolution continued</b>			
	2016	2015	2014
<b>Capital and balance sheet</b>	£bn	£bn	£bn
Loans and advances to customers (gross)	13.6	25.9	64.0
Loan impairment provisions	(0.8)	(2.3)	(11.1)
Net loans and advances to customers	12.8	23.6	52.9
Net loans and advances to banks	4.6	7.1	14.5
Total assets	132.5	201.5	327.3
Funded assets	27.6	53.4	115.6
Risk elements in lending	2.3	3.4	15.6
Provision coverage (1)	35%	67%	71%
Customer deposits (excluding repos)	9.5	26.0	36.4
Bank deposits (excluding repos)	11.5	14.7	19.8
Repos	—	—	8.3
Debt securities in issue	1.3	4.3	9.3
Risk-weighted assets			
- Credit risk			
- non-counterparty	18.2	27.3	62.6
- counterparty	8.7	12.0	16.9
- Market risk	4.8	5.7	8.5
- Operational risk	2.8	4.0	7.1
Total risk-weighted assets	34.5	49.0	95.1
<b>Analysis of RWAs by portfolio</b>			
APAC portfolio (2)	0.1	0.5	4.0
Americas portfolio	0.2	1.0	7.8
EMEA portfolio (3)	1.0	1.2	5.9
Legacy loan portfolio	1.4	3.7	10.5
Shipping	2.8	4.5	5.8
Markets	15.8	20.7	33.3
GTS	0.5	3.6	9.8
Alawwal Bank	7.9	6.9	5.9
Other	2.0	2.9	5.0

Total credit and market risk RWAs	31.7	45.0	88.0
Operational RWAs	2.8	4.0	7.1
Total RWAs	34.5	49.0	95.1

## Notes:

- (1) Provision coverage represents loan impairment provisions as a percentage of risk elements in lending.
- (2) Asia-Pacific portfolio.
- (3) European, the Middle East and Africa portfolio.

## Business review

### Capital Resolution *continued*

#### Serving our customers

Capital Resolution continues to run down and dispose of non-strategic assets and remove risk from the balance sheet and good progress has been made in 2016 with RWAs falling by £14.5 billion to £34.5 billion. Key highlights include:

Completion of the sale of our Russia and Kazakhstan subsidiaries.

Significant balance sheet reduction in GTS with almost all customers exited by the end of 2016 with focus on managing the day to day customer exit journey, helping them re-bank and providing transition advice.

Significant Markets derivative mitigation sales and restructure activity.

#### 2016 compared with 2015

RWAs decreased by £14.5 billion, or 30%, to £34.5 billion reflecting disposal activity partially offset by an increase due to the weakening of sterling. Since the end of 2014, RWAs have reduced by £60.6 billion, or 64%.

Total assets decreased by £69.0 billion to £132.5 billion. Funded assets decreased by £25.8 billion to £27.6 billion with the most significant reductions across Markets and GTS.

An operating loss of £4,870 million compared with a loss of £3,687 million in 2015 and included litigation and conduct costs of £3,413 million. The adjusted operating loss, which excludes restructuring costs of £78 million (2015 - £1,307 million) and litigation and conduct costs of £3,413 million (2015 - £2,105 million) was £1,432 million compared with £412 million in 2015.



Income disposal losses were £572 million, £205 million higher than 2015, and included £259 million in respect of the shipping portfolio. In addition, a funding valuation adjustment charge of £170 million was incurred in 2016.

Operating expenses decreased from £4,951 million to £4,255 million in 2016. Adjusted operating expenses, which exclude restructuring costs of £78 million (2015 - £1,307 million) and litigation and conduct costs of £3,413 million (2015 - £2,105 million) decreased by £775 million, or 50%, to £764 million, principally reflecting a 1,000 reduction in headcount.

A net impairment loss of £253 million compared with a net impairment release of £725 million in 2015 and principally comprised charges relating to a number of shipping assets (£424 million).

### 2015 compared with 2014

Capital Resolution RWAs reduced from £95.1 billion to £49.0 billion driven by significant reductions across a number of business areas, which primarily reflected disposals and repayments activity.

Capital Resolution made an operating loss of £3,687 million, including income related disposal losses of £367 million, restructuring costs of £1,307 million together with litigation and conduct costs of £2,105 million. Operating expenses increased by £2,454 million to £4,951 million, principally reflecting increases in litigation and conduct costs relating to additional provisions for mortgage-backed securities litigation in the United States. Adjusted operating expenses, which exclude restructuring costs of £1,307 million (2014 - £185 million) and litigation and conduct costs of £2,105 million (2014 - £162 million) were reduced by £481 million, or 24% to £1,539 million, principally reflecting a fall in headcount of approximately 1,100. Net impairment releases of £725 million were recorded, driven by the disposal strategy and favourable market and economic conditions.

Capital Resolution total assets fell by £125.8 billion to £201.5 billion, funded assets fell £62.2 billion to £53.4 billion, primarily due to loan portfolio disposals.

## Business review

<b>Williams &amp; Glyn (1)</b>			
	2016	2015	2014
	£m	£m	£m
<b>Income statement</b>			
Net interest income	658	658	664
Net fees and commissions	163	160	170
Other non-interest income	16	15	18
Non-interest income	179	175	188
<b>Total income</b>	<b>837</b>	<b>833</b>	<b>852</b>
Direct expenses			
- staff costs	(250)	(215)	(200)
- other costs	(59)	(52)	(36)
Indirect expenses	(84)	(92)	(94)
Restructuring costs			
- direct	(57)	(28)	—
Operating expenses	(450)	(387)	(330)
Operating profit before impairment losses	387	446	522
Impairment losses	(42)	(15)	(55)
<b>Operating profit</b>	<b>345</b>	<b>431</b>	<b>467</b>
Operating expenses - adjusted (2)	(393)	(359)	(330)
Operating profit - adjusted (2)	402	459	467
<b>Analysis of income by product</b>			
Retail	480	472	502
Commercial	357	361	350
Total income	837	833	852
<b>Analysis of impairments by sector</b>			
Retail	28	16	48
Commercial	14	(1)	7
Total impairment losses	42	15	55
<b>Loan impairment charge as a % of gross customer loans and advances (excluding reverse repurchase agreements) by sector</b>			
Retail	0.2%	0.1%	0.4%
Commercial	0.2%	—	0.1%
Total	0.2%	0.1%	0.3%

Performance ratios			
Net interest margin	2.71%	2.87%	2.93%
Cost:income ratio	54%	46%	39%
Cost:income ratio - adjusted (2)	47%	43%	39%

## Notes:

(1) Williams & Glyn refers to the business formerly intended to be divested as a separate legal entity and comprises RBS England and Wales branch-based businesses, along with certain small and medium enterprises and corporate activities across the UK. During the period presented W&G has not operated as a separate legal entity.

(2) Excluding restructuring costs.

**Business review**

<b>Williams &amp; Glyn continued</b>			
	2016	2015	2014
Capital and balance sheet (1)	£bn	£bn	£bn
Loans and advances to customers (gross)			
- Retail	12.3	11.6	11.3
- Commercial	8.5	8.7	8.6
Total loans and advance to customers (gross)	20.8	20.3	19.9
Loan impairment provisions	(0.2)	(0.3)	(0.4)
Net loans and advances to customers	20.6	20.0	19.5
Total assets	25.8	24.1	23.6
Funded assets	25.8	24.1	23.6
Risk elements in lending	0.4	0.5	0.6
Provision coverage (2)	65%	60%	61%
Customer deposits			
- Retail	12.6	11.4	10.3
- Commercial	11.6	12.7	11.7
Total customer deposits	24.2	24.1	22.0
Loan:deposit ratio (excluding repos)	85%	83%	88%
Risk-weighted assets			
- Credit risk (non-counterparty)	8.2	8.5	8.6
- Operational risk	1.4	1.4	1.5
Total risk-weighted assets	9.6	9.9	10.1

## Notes:

(1) Williams & Glyn refers to the business formerly intended to be divested as a separate legal entity and comprises RBS England and Wales branch-based businesses, along with certain small and medium enterprises and corporate activities across the UK. During the period presented W&G has not operated as a separate legal entity.

(2) Provision coverage represents loan impairment provisions as a percentage of risk elements in lending.



## Business review

### Williams & Glyn continued

#### Serving our customers

This view of W&G, as it stands as a reportable segment within RBS Group, reflects the contribution made by W&G's ongoing business to RBS, as distinct to the financial effects of any disposal transaction itself. These figures do not reflect the cost base, funding, liquidity and capital profile of W&G as a standalone bank and do not contain certain customer portfolios which are currently reported through other segments within RBS.

Williams & Glyn refers to the business formerly intended to be divested as a separate legal entity and principally comprises RBS England and Wales branch-based businesses, along with certain small and medium enterprises and corporate activities across the UK.

In 2016 both the retail and commercial businesses of W&G continued to perform well despite the competitive low interest rate environment. Gross new lending for mortgages increased by £0.2 billion, or 10%, to £2.1 billion while commercial remained resilient with gross new lending of £2.6 billion.

#### 2016 compared with 2015

An operating profit of £345 million compared with £431 million in 2015. Adjusting operating profit, which excludes restructuring costs of £57 million (2015 - £28 million) was down £57 million to £402 million reflecting higher adjusted operating expenses (which exclude restructuring costs) and increased impairments.

Total income increased by £4 million to £837 million as the benefit of increased volumes was mainly offset by margin pressure from the impact of the competitive lending environment and a further reduction in interest rates. Net interest margin reduced by 16 basis points to 2.71%.

Operating expenses of £450 million increased by £63 million, or 16%, and included a £29 million increase in restructuring costs. Adjusted operating expenses, which exclude restructuring costs of £57 million (2015 - £28 million), increased by £34 million, or 9%, to £393 million reflecting activity undertaken in H1 to create a standalone bank, partially offset by the benefit of the commercial business restructuring which was announced in Q4 2015. Following the announcement to discontinue the programme to create a cloned

banking platform, a further restructuring programme commenced in Q4 2016 resulting in an additional reduction in headcount.

Net impairment losses remained low at £42 million compared with a loss of £15 million in 2015. The 2015 charge benefited from a number of releases, totalling £28 million, in the commercial business.

Net loans and advances increased by £0.6 billion, or 3%, to £20.6 billion principally reflecting growth in mortgages of £0.4 billion, or 4%.

Customer deposits were broadly stable at £24.2 billion, a £1.2 billion increase in retail deposits was offset by a £1.1 billion reduction in commercial deposits.

### 2015 compared with 2014

Operating profit was £431 million, compared with a profit of £467 million in 2014. The reduction was principally driven by lower non-interest income and restructuring costs attributed to Commercial Banking, partly offset by a lower net impairment charge. Adjusted operating profit, which excludes restructuring costs of £28 million (2014 - nil) was down £8 million from £467 million to £459 million.

Total income was £833 million, compared with £852 million in 2014. Net interest income reduced £6 million to £658 million due to mortgage margin pressure from the impact of market competition on new business pricing. Net interest margin declined 6 basis points to 2.87%, due to the aforementioned margin pressure on new mortgage volumes and a reduction in the number of customers on the standard variable rate. Non-interest income fell by 7%, primarily due to lower fee income from credit and debit cards as well as lower overdraft usage and tariffs.

Operating expenses totalled £387 million, an increase of £57 million as the business continued to stand up the central functions and operations areas resulting in an increase in staff costs of 8% or £15 million, this further included a restructuring charge of £28 million in commercial banking.

Net impairment losses were £15 million, lower than the £55 million loss incurred in 2014 due to portfolio provision releases and reduced levels of defaults in portfolios reflecting a benign UK economy.

Loans and advances grew by £0.4 billion, or 2%, to £20.3 billion. Excluding the transfer of £0.3 billion of commercial lending back to CPB, lending grew £0.7 billion, or 4%, driven by good growth in both mortgage lending and commercial loans. Customer deposits rose £2.1 billion, or 10%, to £24.1 billion with growth in both transactional accounts and savings accounts.

RWAs fell £0.2 billion to £9.9 billion due to the better credit quality of the overall portfolio.





**Business review**

<b>Central items and other</b>			
	2016	2015	2014
	£m	£m	£m
Central items not allocated	(1,615)	(903)	(931)

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

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

**2016 compared with 2015**

Central items not allocated represented a charge of £1,615 million in 2016, compared with a £903 million charge in 2015, and included restructuring costs of £1,482 million and litigation and conduct costs of £697 million. Restructuring costs included a £750 million provision in respect of the 17 February 2017 update on RBS's remaining State Aid obligation regarding Williams & Glyn. Treasury funding costs were a charge of £94 million, compared with a gain of £169 million in 2015, and included a £510 million charge for volatile items under IFRS, due to reductions in long term interest rates, and a £349 million foreign exchange gain, principally associated with the weakening of sterling against the US dollar. In addition, there was a £126 million loss on redemption of own debt in 2016. These were partially offset by a VAT recovery of £227 million and a £246 million gain on the sale of the stake in VISA Europe.

**2015 compared with 2014**

Central items not allocated represented a charge of £903 million compared with a charge of £931 million in 2014. This includes restructuring costs relating to Williams & Glyn of £630 million, a write-off of intangible assets of £59 million, a loss of £263 million on the repurchase of certain US dollar, Sterling and Euro senior debt securities and a loss of £67 million on the disposal of available-for-sale securities. These were partially offset by Treasury funding costs, including volatile items under IFRS, a gain of £169 million. Also included are £56 million of income, £109 million of direct operating expenses and £122 million of indirect operating expenses in relation to the international private banking business.

**Business review**

<b>Consolidated balance sheet as at 31 December 2016</b>		
	2016	2015
	£m	£m
<b>Assets</b>		
Cash and balances at central banks	74,250	79,404
Net loans and advances to banks	17,278	18,361
Reverse repurchase agreements and stock borrowing	12,860	12,285
Loans and advances to banks	30,138	30,646
Net loans and advances to customers	323,023	306,334
Reverse repurchase agreements and stock borrowing	28,927	27,558
Loans and advances to customers	351,950	333,892
Debt securities subject to repurchase agreements	18,107	20,224
Other debt securities	54,415	61,873
Debt securities	72,522	82,097
Equity shares	703	1,361
Settlement balances	5,526	4,116
Derivatives	246,981	262,514
Intangible assets	6,480	6,537
Property, plant and equipment	4,590	4,482
Deferred tax	1,803	2,631
Prepayments, accrued income and other assets	3,700	4,242
Assets of disposal groups	13	3,486
<b>Total assets</b>	<b>798,656</b>	<b>815,408</b>
<b>Liabilities</b>		
Bank deposits	33,317	28,030
Repurchase agreements and stock lending	5,239	10,266
Deposits by banks	38,556	38,296
Customers deposits	353,872	343,186
Repurchase agreements and stock lending	27,096	27,112
Customer accounts	380,968	370,298
Debt securities in issue	27,245	31,150
Settlement balances	3,645	3,390
Short positions	22,077	20,809
Derivatives	236,475	254,705
Provisions for liabilities and charges	12,836	7,366
Accruals and other liabilities	6,991	7,749
Retirement benefit liabilities	363	3,789
Deferred tax	662	882

Subordinated liabilities	19,419	19,847
Liabilities of disposal groups	15	2,980
Total liabilities	749,252	761,261
Non-controlling interests	795	716
Owners' equity	48,609	53,431
Total equity	49,404	54,147
Total liabilities and equity	798,656	815,408

## Business review

### Commentary on consolidated balance sheet

#### 2016 compared with 2015

Total assets of £798.7 billion as at 31 December 2016 were down £16.8 billion, 2%, compared with 31 December 2015. This was primarily driven by decreases in derivative assets, primarily reflecting Capital Resolution run-down, partly offset by loan growth in UK PBB and Commercial Banking.

Loans and advances to banks decreased by £0.5 billion, 2%, to £30.1 billion. Excluding reverse repurchase agreements and stock borrowing ('reverse repos'), up £0.6 billion, 5%, to £12.9 billion, bank placings declined £1.1 billion, 6%, to £17.3 billion, mainly reflecting Capital Resolution run-down.

Loans and advances to customers increased £18.1 billion, 5%, to £352.0 billion. Within this, reverse repos were up £1.4 billion, 5%, to £28.9 billion. Customer lending increased by £16.7 billion, 5%, to £323.0 billion, or £14.0 billion to £327.5 billion before impairments. This reflected increases in UK PBB reflecting growth in mortgages, Commercial Banking which recorded strong new business volumes, partially offset by run-down and disposals in Capital Resolution.

Debt securities were down £9.6 billion, 12%, to £72.5 billion, mainly due to reductions in held-for-trading government and financial institution securities in RBS Treasury.

Equity shares decreased by £0.7 billion, 48%, to £0.7 billion, primarily due to the continuing risk reduction and run-down in Capital Resolution.

Movements in the value of derivative assets, down £15.5 billion, 6%, to £247.0 billion, and liabilities, down £18.2 billion, 7% to £236.5 billion, reflecting lower trading volumes of £34 million, partially offset by the impact of foreign exchange movements. Increases in trading activity in NatWest Markets of £15 billion was more than offset by disposals and run-off in Capital Resolution.

Assets and liabilities of disposal groups, decreased £3.5 billion to £13 million and £3.0 billion to £15 million respectively, primarily reflecting the sale of the international private banking business.

Deposits by banks increased by £0.3 billion, 1%, to £38.6 billion, with increases in inter-bank deposits, up £5.3 billion, 19%, to £33.3 billion, primarily driven by increases in NatWest Markets and RBS Treasury offset by reductions in Capital Resolution. Repurchase agreements and stock lending ('repos'), decreased by £5.0 billion, 49%, to £5.2 billion, primarily driven by reductions in NatWest Markets.

Customer accounts increased £10.7 billion, 3%, to £381.0 billion. Within this, repos were stable at £27.1 billion. Excluding repos, customer deposits were up £10.7 billion, 3%, to £353.9 billion, primarily reflecting growth in UK PBB, Commercial Banking, and NatWest Markets offset by run-down in Capital Resolution.

Debt securities in issue decreased £3.9 billion, 13%, to £27.2 billion reflecting a decrease in Capital Resolution and RBS Treasury given the lower funding requirements of a reduced balance sheet.

Subordinated liabilities decreased by £0.4 billion, 2% to £19.4 billion, primarily as a result of the net decrease in dated and undated loan capital with redemptions of £0.9 billion and £2.6 billion respectively. This was offset by exchange rate movements and mark-to-market adjustments of £3.1 billion.

Owners' equity decreased by £4.1 billion, 8%, to £49.4 billion, primarily driven by the £4.5 billion loss for the year.

**Business review**

<b>Cash flow</b>			
	2016	2015	2014
	£m	£m	£m
Net cash flows from operating activities	(3,650)	918	(20,387)
Net cash flows from investing activities	(4,359)	(4,866)	6,609
Net cash flows from financing activities	(5,107)	(940)	(404)
Effects of exchange rate changes on cash and cash equivalents	8,094	576	909
Net decrease in cash and cash equivalents	(5,022)	(4,312)	(13,273)

**2016**

The major factors contributing to the net cash outflow from operating activities of £3,650 million were the elimination of foreign exchange differences £6,518 million, contribution to defined benefit schemes of £4,786 million, loans and advances written-off net of recoveries of £3,586 million, operating loss before tax of £4,082 million and other provisions utilised of £2,699 million. These were partially offset by inflows from an increase of £8,413 million in operating assets and liabilities, other provisions charged net of releases of £7,216 million, interest on subordinated liabilities of £845 million and depreciation and amortisation of £778 million.

Net cash outflows from investing activities of £4,359 million related to the net outflows from purchase and sale of securities of £3,008 million, the purchase of property, plant and equipment of £912 million and £886 million outflows from disposals, offset by net cash inflows from the sale of property, plant and equipment of £447 million.

Net cash outflows from financing activities of £5,107 million relate primarily to the redemption of subordinated liabilities of £3,606 million, redemption of equity preference shares of £1,160 million, the final payment to retire the Dividend Access Share of £1,193 million and interest paid on subordinated liabilities of £813 million. These outflows were partly offset by the inflow from the issuance of Additional Tier 1 capital notes of £2,046 million.

**2015**

The major factors contributing to the net cash inflow from operating activities of £918 million were the increase of £8,589 million in operating assets and liabilities, other provisions charged net of releases of £4,566 million, write down of goodwill and other intangible assets £1,332 million and depreciation and amortisation of £1,180 million. These were partially offset by loans and advances written-off net of

recoveries of £8,789 million, other provisions utilised of £2,202 million, elimination of foreign exchange differences of £1,501 million, profit on sale of subsidiaries and associates of £1,135 million, cash contribution to defined benefit pension schemes of £1,060 million, decrease in income accruals of £1,075 million and the operating loss before tax of £937 million.

Net cash outflows from investing activities of £4,866 million related to the net outflows from purchase of securities of £5,906 million and the purchase of property, plant and equipment of £783 million, offset by inflows of £391 million from disposals, primarily Citizens and net cash inflows from the sale of property, plant and equipment of £1,432 million.

Net cash outflows from financing activities of £940 million relate primarily to the redemption of subordinated liabilities of £3,047 million, redemption of preference shares of £1,214 million and interest paid on subordinated liabilities of £975 million partly offset by the proceeds of non-controlling interests issued of £2,537 million and the issue of Additional Tier 1 capital notes of £2,012 million

## 2014

The major factors contributing to the net cash outflow from operating activities of £20,387 million were the decrease of £18,260 million in operating assets and liabilities, loans and advances written-off net of recoveries of £5,073 million, other provisions utilised of £3,528 million and the loss before tax of £564 million from continuing and discontinued operations. These were partially offset by the loss on reclassification to disposal groups of £3,994 million and other provisions charged net of releases of £2,711 million.

Net cash inflows from investing activities of £6,609 million related to the net inflows from sales and maturity of securities of £7,744 million and the sale of property, plant and equipment of £1,162 million, offset by net investments in business interests and intangible assets of £1,481 million and net cash outflows from the purchase of property, plant and equipment of £816 million.

Net cash outflows from financing activities of £404 million relate primarily to the redemption of subordinated liabilities of £3,480 million and interest paid on subordinated liabilities of £854 million partly offset by the issue of subordinated liabilities of £2,159 million and proceeds of non-controlling interests issued of £2,147 million.

## Business review

### Analysis of balance sheet pre and post disposal groups

In accordance with IFRS 5, assets and liabilities of disposal groups are presented as a single line on the face of the balance sheet. As allowed by IFRS, disposal groups are included within risk measures in the Capital and risk management section.

	2016			2015		
	Balance	Disposal	Gross of disposal	Balance	Disposal	Gross of disposal
	sheet	groups	groups	sheet	groups (1)	groups
	£m	£m	£m	£m	£m	£m
<b>Assets</b>						
Cash and balances at central banks	74,250	—	74,250	79,404	535	79,939
Net loans and advances to banks	17,278	13	17,291	18,361	642	19,003
Reverse repurchase agreements and stock borrowing	12,860	—	12,860	12,285	67	12,352
Loans and advances to banks	30,138	13	30,151	30,646	709	31,355
Net loans and advances to customers	323,023	—	323,023	306,334	1,639	307,973
Reverse repurchase agreement and stock borrowing	28,927	—	28,927	27,558	—	27,558
Loans and advances to customers	351,950	—	351,950	333,892	1,639	335,531
Debt securities	72,522	—	72,522	82,097	419	82,516
Equity shares	703	—	703	1,361	24	1,385
Settlement balances	5,526	—	5,526	4,116	—	4,116
Derivatives	246,981	—	246,981	262,514	30	262,544
Intangible assets	6,480	—	6,480	6,537	—	6,537
Property, plant and equipment	4,590	—	4,590	4,482	19	4,501
Deferred tax	1,803	—	1,803	2,631	—	2,631
Prepayments, accrued income and other assets	3,700	—	3,700	4,242	111	4,353
Assets of disposal groups	13	(13)	—	3,486	(3,486)	—
<b>Total assets</b>	<b>798,656</b>	<b>—</b>	<b>798,656</b>	<b>815,408</b>	<b>—</b>	<b>815,408</b>
<b>Liabilities</b>						
Bank deposits	33,317	—	33,317	28,030	32	28,062
Repurchase agreements and stock lending	5,239	—	5,239	10,266	—	10,266
Deposits by banks	38,556	—	38,556	38,296	32	38,328
Customer deposits	353,872	—	353,872	343,186	2,805	345,991



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Repurchase agreements and stock lending	27,096		— 27,096	27,112		— 27,112
Customer accounts	380,968		— 380,968	370,298	2,805	373,103
Debt securities in issue	27,245		— 27,245	31,150		— 31,150
Settlement balances	3,645		— 3,645	3,390	7	3,397
Short positions	22,077		— 22,077	20,809		— 20,809
Derivatives	236,475		— 236,475	254,705	28	254,733
Provisions for liabilities and charges	12,836		— 12,836	7,366		— 7,366
Accruals and other liabilities	6,991	15	7,006	7,749	97	7,749
Retirement benefit liabilities	363		— 363	3,789	3	3,792
Deferred tax	662		— 662	882	8	890
Subordinated liabilities	19,419		— 19,419	19,847		— 19,847
Liabilities of disposal groups	15	(15)	—	2,980	(2,980)	—
<b>Total liabilities</b>	<b>749,252</b>		<b>— 749,252</b>	<b>761,261</b>		<b>— 761,261</b>
For the notes to this table refer to the following page.						

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## Business review

	2016			2015		
	Balance	Disposal	Gross of disposal	Balance	Disposal	Gross of disposal
	sheet	groups	groups	sheet	groups (1)	groups
	£m	£m	£m	£m	£m	£m
<b>Selected financial data</b>						
Gross loans and advances to customers	327,478	—	327,478	313,452	1,659	315,111
Customer loan impairment provisions	(4,455)	—	(4,455)	(7,118)	(20)	(7,138)
Net loans and advances to customers (2)	323,023	—	323,023	306,334	1,639	307,973
Gross loans and advances to banks	17,278	13	17,291	18,362	642	19,004
Bank loan impairment provisions	—	—	—	(1)	—	(1)
Net loans and advances to banks (2)	17,278	13	17,291	18,361	642	19,003
Total loan impairment provisions	(4,455)	—	(4,455)	7,119	20	7,139
Customer REIL	10,310	—	10,310	12,136	20	12,156
Bank REIL	—	—	—	1	—	1
REIL	10,310	—	10,310	12,137	20	12,157
Gross unrealised gains on debt securities	1,431	—	1,431	876	4	880
Gross unrealised losses on debt securities	(198)	—	(198)	(140)	—	(140)

Notes:

(1) Primarily international private banking.

(2) Excludes reverse repos.

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**Business review** **Capital and risk management**

**Presentation of information**

Except as otherwise indicated by an asterisk (\*), information in the Capital and risk management section (pages 218 to 374) is within the scope of the Report of Independent Registered Public Accounting Firm. Unless otherwise indicated, disclosures in this section include disposal groups in relevant exposures and measures. Refer to page 216 for the Analysis of the balance sheet pre and post disposal groups.

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## Business review **Capital and risk management**

### **Risk overview\***

#### **Risk culture and appetite**

##### Risk culture

A strong risk culture is essential if RBS is to achieve its ambition to build a truly customer-focused bank.

RBS has measured and benchmarked its risk culture across all functions and businesses. It has set a risk culture target, making risk simply part of the way that employees work and think.

Such a culture must be built on strong risk capabilities, with robust risk practices and appropriate risk behaviours embedded across the organisation.

To achieve this RBS is focusing on leaders as role models and taking actions to build clarity, develop capability and motivate employees to reach the required standards of risk culture behaviours including:

- Taking personal accountability and proactively managing risk;
- Respecting risk management and the part that it plays in daily work;
- Understanding clearly the risks associated with individual roles;
- Aligning decision-making to RBS's risk appetite;
- Considering risk in all actions and decisions;
- Escalating risks and issues early;
- Taking action to mitigate risks;
- Learning from mistakes and near-misses;
- Challenging others' attitudes, ideas and actions; and
- Reporting and communicating about risks transparently.

To embed and strengthen the required risk culture behaviours, a number of RBS-wide activities have been undertaken.

To support a consistent tone from the top, senior management frequently communicate the importance of the required risk behaviours through various channels, linking them to the achievement of good customer outcomes.

RBS's target risk culture behaviours have been embedded into a statement of "Our Standards", which are clearly aligned to the core values of "serving customers", "working together", "doing the right thing" and "thinking long term". They act as a clear starting point for a strong and effective risk culture, as "Our Standards" are used for performance management, recruitment and selection and development.

In addition to embedding risk culture behaviours into performance management, in 2016 an objective aligned to RBS' risk culture target was set for the Executive Committee and made integral to performance reviews.

RBS's policies require that risk behaviour assessment is incorporated into performance assessment and compensation processes for enhanced governance staff.

To track progress towards RBS's risk culture target a programme of assessment commenced in 2016.

\*unaudited

## Business review **Capital and risk management**

### **Risk overview\*** continued

#### Risk-based key performance indicators

RBS-wide remuneration policy ensures that the remuneration arrangements for all employees reflect the principles and standards prescribed by the UK Remuneration Code. For further information refer to page 101.

#### Training

Enabling employees to have the capabilities and confidence to manage risk is core to RBS's learning strategy.

RBS offers a wide range of risk learning, both technical and behavioural, across the risk disciplines. This training can be mandatory, role-specific or for personal development.

Mandatory learning for all staff is focused on keeping employees, customers and RBS safe. This is easily accessed online and is assigned to each person according to their role and business area. The system allows monitoring at all levels to ensure completion.

#### Code of Conduct

Aligned to RBS's values is the Code of Conduct. The Code provides guidance on expected behaviour and sets out the standards of conduct that support the values. It explains the effect of decisions that are taken and describes the principles that must be followed.

These principles cover conduct-related issues as well as wider business activities. They focus on desired outcomes, with practical guidelines to align the values with commercial strategy and actions. The embedding of these principles facilitates sound decision-making and a clear focus on good customer outcomes. They are also consistent with the people management and remuneration processes and support a positive and strong risk culture through appropriate incentive structures.

A simple decision-making guide (called the "YES check") has been included in the Code of Conduct. It is a simple, intuitive set of five questions, designed to ensure RBS values guide day-to-day decisions:



- Does what I am doing keep our customers and RBS safe and secure?
- Would customers and colleagues say I am acting with integrity?
- Am I happy with how this would be perceived on the outside?
- Is what I am doing meeting the standards of conduct required?
- In five years' time would others see this as a good way to work?

Each of the five questions is a prompt to think about how the situation fits with RBS Group's values. It ensures that employees can think through decisions that do not have a clear answer, and guides their judgements.

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## Business review **Capital and risk management**

### **Risk overview\*** continued

If conduct falls short of RBS's required standards, the accountability review process is used to assess how this should be reflected in pay outcomes for those individuals concerned. The Group Performance and Remuneration Committee also considers risk performance and conduct when determining overall bonus pools. The Committee's decisions on pay aim to reinforce the need for good behaviours by all employees.

### **Risk appetite**

Risk capacity defines the maximum level of risk RBS can assume before breaching constraints determined by regulatory capital and liquidity needs, the operational environment, and from a conduct perspective. Articulating risk capacity is helpful in determining where risk appetite should be set, ensuring there is a buffer between internal risk appetite and RBS's ultimate capacity to absorb losses.

Risk appetite defines the types of risk RBS is willing to accept, within risk capacity, in order to achieve strategic objectives and business plans. It links the goals and priorities to risk management in a way that guides and empowers staff to serve customers well and achieve financial targets.

### **Risk Appetite Framework**

The Risk Appetite Framework bolsters effective risk management by promoting sound risk taking and ensuring emerging risk and risk taking activities are recognised, assessed, escalated and addressed in a timely manner.

The Board approves the Risk Appetite Framework annually.

### **Strategic risks**

Strategic risks are the foundations on which RBS ensures it remains safe and sound while implementing its strategic business objectives. They are:

- Capital adequacy;
- Earnings volatility;
- Funding and liquidity; and
- Stakeholder confidence.

The Board sets risk appetite for strategic risks to help ensure RBS is well placed to meet its priorities and long-term targets even under challenging economic environments.

All other risk appetites for material risks (such as credit risk, market risk and operational risk) should align to strategic risks. Risk appetite for our strategic risks is tested using a variety of stress tests.

### Risk appetite statements

Risk appetite is communicated across RBS through risk appetite statements. Each statement provides clarity on the scale and type of activities permitted, in a manner that is easily conveyed to staff. Risk appetite statements consist of qualitative statements of appetite supported by risk limits and triggers that operate as a defence against excessive risk-taking.

The purpose of risk appetite statements is to strengthen understanding of acceptable levels of risk.

Risk appetite statements are established at an RBS-wide level for strategic risks and material risks, and at a franchise, function and legal entity level.

\*unaudited

**Business review** **Capital and risk management**

**Risk overview\*** [continued](#)

The annual process of establishing risk appetite statements is completed alongside the business and financial planning process to ensure risk appetite remains appropriate given the levels of risk expected over the planning horizon.

The effective communication of risk appetite is essential in embedding appropriate risk-taking into RBS's culture.

RBS frequently reviews its risk profile to ensure it remains within risk appetite and that management focus is brought to bear on all strategic risks, material risks and emerging risk issues. RBS has effective processes in place to report against risk appetite to the RBS Board and senior management.

[Establishing risk appetite:](#)

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**Business review** [Capital and risk management](#)

**Risk overview\*** [continued](#)

**Risk governance**

[Governance structure](#)

The risk governance structure in 2016 and the main purposes of each of the committees are illustrated below.



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## Business review **Capital and risk management**

### **Risk overview\*** continued

#### Three lines of defence

The three lines of defence model is used industry-wide for the management of risk. It provides a clear set of principles by which to implement a cohesive operating model, one that provides a framework for the articulation of accountabilities and responsibilities for managing risk across the organisation.

#### *First line of defence - Management and supervision*

The first line of defence includes customer franchises, Technology and Operations and support functions such as Human Resources, Communications and Financial Management Information. Responsibilities include:

- Owning, managing and supervising, within a defined risk appetite, the risks which exist in business areas and support functions.
- Ensuring appropriate controls are in place to mitigate risk, balancing control, customer service and competitive advantage.
- Ensuring that the culture of the business supports balanced risk decisions and compliance with policy, laws and regulations.
- Ensuring that the business has effective mechanisms for identifying, reporting and managing risk and controls.

#### *Second line of defence - Oversight and control*

The second line of defence in 2016 included RBS Risk Management and Conduct & Regulatory Affairs (refer below for further information), Legal, and the financial control aspects of Finance. Responsibilities include:

- Working with the businesses and functions to develop the risk and control policies, limits and tools for the business to use in order to discharge its responsibilities.
- Overseeing and challenging the management of risks and controls.
- Leading the articulation, design and development of RBS's risk culture and appetite.
- Analysing the aggregate risk profile and ensuring that risks are being managed to the desired level (risk appetite).

- Providing expert advice to the business on risk management.
- Providing senior executives with relevant management information and reports and escalating concerns where appropriate.
- Undertaking risk assurance (refer below for more information).

*Third line of defence - Internal Audit*

Responsibilities include:

- Designing and delivering a risk-based audit plan to provide assurance on material risks and report on whether RBS is managing its material risks effectively.
- Monitoring, evaluating and reporting on the remediation of material risks across RBS.
- Engaging with management and participating in key governance fora to provide perspectives, insights and challenge so as to influence the building of a sustainable bank.
- Advising the Group Audit Committee and executive management with respect to RBS's material risks and their associated controls.
- Reporting any matters which warrant escalation to the RBS Board, the Board Risk Committee, Group Audit Committee and the Executive Committee as appropriate.
- Providing independent assurance to the FCA, PRA, CBI and other key jurisdictional regulators on both specific risks and control themes.

\*unaudited



**Business review** [Capital and risk management](#)

**Risk overview\*** [continued](#)

[Risk management structure](#)

RBS's management structure in 2016 and the main elements of each role are illustrated below.



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## Business review **Capital and risk management**

### **Risk overview\*** continued

Notes:

#### (1) RBS Risk Management

In 2016, the RBS Chief Risk Officer (CRO) led RBS Risk Management (since 1 January 2017 it has been known as Risk, Conduct & Restructuring). The CRO reported directly to the Chief Executive and had an indirect reporting line to the Chairman of the Board Risk Committee and had a right of access to the Committee's chairman.

RBS Risk Management was a function independent of the franchises, structured by risk discipline to facilitate the effective management of risk.

Risk Management was organised into six functional areas: Credit Risk; Enterprise-Wide Risk; Risk Infrastructure; Operational Risk; Risk Assurance; and Market Risk. There were also directors of risk for each of the franchises and for Services.

The directors of risk functions were responsible for RBS-wide risk appetite and standards within their respective disciplines and reported to the CRO.

CROs were in place for certain jurisdictions and legal entities to meet local regulatory and governance requirements. The key CRO roles reported directly to the RBS CRO.

Risk committees in the customer businesses and key functional risk committees oversaw risk exposures arising from management and business activities and focused on ensuring that they were adequately monitored and controlled.

#### (2) Conduct & Regulatory Affairs

In 2016, Conduct & Regulatory Affairs (C&RA) was led by the Chief Conduct & Regulatory Affairs Officer, who reported directly to the Chief Executive and had an indirect reporting line to the Board Risk Committee and a right of access to the committee's chairman. C&RA was responsible for providing oversight of conduct risk and regulatory risk at RBS, and did so by setting RBS-wide policy and standards, providing advice to each customer business, and ensuring that the mitigating controls were suitable. C&RA also provided leadership of RBS's relationships with its regulators.

The functional heads (the directors of Financial Crime, Advisory, Remediation, Compliance Services, and Regulatory Affairs) reported to the Chief Conduct & Regulatory Affairs Officer. Each was responsible, where appropriate, for the RBS-wide risk appetite and standards of their respective areas.

(3) Plans to merge parts of the C&RA function with Risk Management were announced in December 2016. The changes, designed to take advantage of synergies across the risk, conduct and regulatory agendas, were effective from 1 January 2017. Regulatory Affairs moved to Corporate Governance & Secretariat, and Remediation and Complaints moved to Services Chief Operating Office.

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## Business review **Capital and risk management**

### **Risk overview\*** continued

#### **Risk Assurance**

Risk Assurance is an independent second line of defence function which provides assurance to both internal and external stakeholders including the Board, senior management, risk functions, franchises, Internal Audit and regulators. Teams within Risk Assurance perform quality assurance on both credit and market risk activity, review key controls and manage model risk.

The remit of each team is summarised below.

*Franchise Risk Assurance:* These teams focus on credit risk and market risk assurance in the customer-facing franchises. The teams undertake qualitative reviews which assess various aspects of risk as appropriate, including: the quality of risk portfolios; the accuracy of the Basel Input and related probability of default/loss given default classification, the quality of risk management practices, policy compliance and adherence to risk appetite. This includes testing the bank's credit portfolios and market risk exposures to assist in early identification of emerging risks, as well as undertaking targeted reviews to examine specific concerns raised either by these teams or by their stakeholders.

*Controls Assurance:* This team tests the adequacy and effectiveness of key controls owned and operated by the Risk function (with a particular focus on credit risk and market risk controls). The team's remit includes controls within the scope of Section 404 of the US Sarbanes-Oxley Act 2002. During 2016, the team's scope extended to include testing of controls supporting risk data aggregation reporting to support compliance with Basel Committee on Banking Supervision (BCBS) 239.

#### **Risk Assurance Committee**

The Risk Assurance Committee (RAC) ensures a consistent and fair approach to all aspects of the credit risk, market risk and control assurance review activities. The RAC also monitors and validates the ongoing programme of reviews and tracks the remediation of review actions. The credit and market risk assurance teams also attend relevant committees run by the customer franchises and other risk functions.

#### **Model Risk**

##### *Model Risk Governance*

Model Risk Governance is responsible for setting policy and providing a governance framework for all of RBS's modelling processes. It is also responsible for defining and monitoring risk appetite in conjunction with model owners and model users, monitoring the model risk profile and reporting on the model population as well as escalating issues to senior management, through the Model Risk Forum, and the respective franchise and function risk committees.

### *Model Risk Management*

Model Risk Management (MRM) performs independent model validation for material models where necessary. It works with individual businesses and functions to set appropriate model standards and monitor adherence to these, ensure that models are developed and implemented appropriately and that their operational environment is fit for purpose.

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## Business review **Capital and risk management**

### **Risk overview\*** continued

MRM performs reviews of relevant risk and pricing models in two instances: (i) for new models or amendments to existing models and (ii) as part of its ongoing programme to assess the performance of these models.

A new model is typically introduced when an existing model is deemed no longer fit for purpose or when exposure to a new product requires a new approach to ensure that risks are appropriately quantified. Amendments are usually made when a weakness is identified during use of a model or following analysis either by the model developers or by MRM.

MRM reviews may test and challenge the logic and conceptual soundness of the methodology, or the assumptions underlying a model. Reviews may also test whether or not all appropriate risks have been sufficiently captured as well as checking the accuracy and robustness of calculations.

Based on the review and findings from MRM, the bank's model or risk committees with appropriate delegated authority consider whether a model can be approved for use and whether any conditions need to be imposed, including those relating to the remediation of material issues raised through the review process. Once approved through internal governance, the new or amended model is implemented. Models used for regulatory reporting may additionally require regulatory approval before implementation.

MRM reassesses the appropriateness of approved risk models on a periodic basis according to the approved Periodic Review Policy. Each periodic review begins with an initial assessment. A decision is then made by an internal model governance committee with appropriate delegated authority. Based on the initial assessment, the committee will decide to re-ratify a model based on the initial assessment or to carry out additional work prior to making a decision. In the initial assessment, MRM assesses changes since the last approval along the following dimensions, as appropriate: change in size/composition of the portfolio, market changes, model performance, model changes, status of any outstanding issues and scheduled activities including work carried over from previous reviews.

MRM also monitors the performance of RBS's portfolio of models to ensure that they appropriately capture underlying business rationale.

For specific information relating to market risk models and pricing models, refer to Model Validation in the Market Risk section.

### Models used in Risk

RBS uses a variety of models as part of its risk management process and activities. Key examples include the use of model outputs to support risk assessments in the credit approval process, ongoing credit risk management, monitoring and reporting, as well as the calculation of risk-weighted assets. Other examples include the use of models to measure market risk exposures and calculate associated capital requirements, as well as for the valuation of positions. The models used for stress-testing purposes also play a key role in ensuring the bank holds sufficient capital, even in stressed market scenarios.

\*unaudited

## Business review **Capital and risk management**

### Capital risk\*

#### Definition and sources

Capital consists of reserves and instruments issued that are available to the Group that have a degree of permanency and are capable of absorbing losses. A number of strict conditions set by regulators must be satisfied to be eligible to count as capital.

Capital risk is the risk that the Group has insufficient capital and other loss absorbing debt instruments to operate effectively including meeting minimum regulatory requirements, operating within Board approved risk appetite and supporting its strategic goals.

Capital management is the process by which the Group manages its capital risk and is a key focus of its risk management activities.

The following disclosures in this section are audited: Capital resources.

#### Key developments in 2016

##### 13.4% CET1 ratio

- The CET1 ratio decreased by 210 basis points to 13.4% in 2016, reflecting lower CET1 capital partially offset by a reduction in RWAs.
- Litigation and conduct costs of £5.9 billion in 2016 contributed to a significant reduction in the CET1 capital. Management actions to normalise the ownership structure and improve the long-term resilience of RBS also contributed to the reduction. These actions included the final Dividend Access Share payment of £1.2 billion and the impact of the accelerated pension payment of £4.2 billion.
- RWAs decreased by £14.4 billion to £228.2 billion primarily as result of run down of Capital Resolution and the reduction in operational risk (£5.9 billion) partly offset by adverse exchange rate movements (£11.5 billion) as sterling weakened against all major currencies.
- Tier 1 capital benefitted from the successful issuance of £2 billion of Additional Tier 1 (AT1) capital notes in August 2016. Total end-point Capital Requirements Regulation (CRR) compliant AT1 capital now stands at £4.0 billion.

### 5.1% leverage ratio

- The leverage ratio reduced by 50 basis points to 5.1% at 31 December 2016, primarily reflecting CET1 capital erosion, partially offset by additional AT1 issuance.
- The leverage exposure decreased by £19.2 billion to £683.3 billion at 31 December 2016. Growth in PBB and CPB lending has been more than offset by lower undrawn commitments and derivative potential future exposures (PFE). During 2016, approximately half the interest rate trades cleared through London Clearing House have been settled-to-market each day, rather than being collateralised, reducing PFE by £10.3 billion.
- The UK leverage ratio reflecting the post EU referendum measures announced by the Bank of England in Q3 2016 was estimated at 5.6%.
- RBS's PRA minimum leverage ratio requirement of 3% has been supplemented with an additional GSII leverage ratio buffer of 0.13125%, equivalent to £897 million of CET1 capital.

\*unaudited

## Business review **Capital and risk management**

### Capital risk\* continued

#### MREL and MDA

- RBS issued £4.2 billion of MREL-eligible senior debt, in line with the £3 - £5 billion senior debt issuance target for 2016.
- RBS successfully completed a cash tender for £2.3 billion senior debt securities, including those considered non-MREL compliant, as part of ongoing transition to a holding company capital and term funding model, in line with regulatory requirements.
- The current estimated headroom over the fully phased MDA trigger in 2019 is 2.9%, based on our target CET1 ratio of 13.0% and MDA requirement of 10.1%. This remains subject to change.

#### Determination of capital sufficiency

In determining whether the Group holds sufficient capital and other loss absorbing debt instruments, the Group assesses the amount and type of capital under a number of different bases:

#### Going concern vs. gone concern view

##### Going concern

This determination of capital sufficiency is made on the basis that there is sufficient capital to absorb losses and remain a viable going concern.

The Group is considered a going concern if it can operate in the foreseeable future to carry out its objectives and commitments without the need or intention on the part of management to liquidate.

##### Gone concern

This determination of capital sufficiency is made on the basis that there is sufficient capital and other loss absorbing instruments to enable an orderly resolution in the event of failure. Gone concern would apply if the Group had been deemed to fail by the Bank of England (BoE). Technically, the Group would have to fail or be likely to fail the BoE's threshold conditions for authorisation in a way that justifies the withdrawal of that authorisation and it must not be reasonably likely that action will be taken that will result in the Group

no longer failing or likely to fail.

### Spot vs. forward looking view

#### Spot view

This determination of capital sufficiency is made on the basis of prevailing actual positions and exposures.

#### Forward-looking view

This determination of capital sufficiency is made on the basis of positions, balance and exposures under a forward looking view of the balance sheet in line with the Group's planning horizons and parameters. This analysis examines both base and stress views.

\*unaudited



## **Business review** Capital and risk management

### **Capital risk\*** continued

#### **Regulatory vs. risk appetite view**

##### Regulatory requirements

This determination of capital sufficiency is an assessment of whether the Group has sufficient capital and other loss absorbing debt instruments to meet the requirements of prudential regulation.

Regulation may be set by rule-making bodies in the UK and at European level. Individual legal entities within the Group may be subject to requirements set by local regulators in jurisdictions outside of the UK and the EU.

Rule-making bodies may set regulation according to standards agreed at international level, such as those published by the Basel Committee on Banking Supervision (BCBS).

##### Risk appetite

This determination of capital sufficiency is an assessment of whether the Group has sufficient capital and other loss absorbing debt instruments to meet risk appetite limits.

This Group's risk appetite framework establishes quantitative and qualitative targets and limits within which the Group operates to achieve its strategic objectives.

This framework includes risk appetite in relation to the amount and quality of the Group's capital on both a risk and balance sheet measurement basis. This includes setting management buffers on top of regulatory minima such that the Group operates with sufficient cushioning against those minimum regulatory requirements.

Capital risk is one of the Group's top strategic risk appetite constituents as it is a stand-alone risk and is both influenced by, and influences, other key risks.

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**Business review** [Capital and risk management](#)

**Capital risk\*** [continued](#)

[Capital sufficiency: going concern view](#)

The regulatory requirement for going concern capital typically takes the form of a ratio of capital compared to a defined exposure amount having to exceed a minimum percentage:

<a href="#">Ratio</a>	<a href="#">Exposure type</a>	<a href="#">Description</a>
Capital adequacy ratio	Risk-weighted assets	

		Assesses capital held against both size and inherent riskiness of on and off-balance sheet exposures
Leverage ratio	Leverage exposure	Assesses capital held against the size of on and off-balance sheet exposures (largely based on accounting value with some adjustments)

### Constituents of capital held

The determination of what instruments and financial resources are eligible to be counted as capital is laid down by applicable regulation.

Capital is categorised by applicable regulation under two tiers (Tier 1 and Tier 2) according to the ability to absorb losses, degree of permanency and the ranking of absorbing losses. There are three broad categories of capital across these two tiers:

- **CET1 capital.** CET1 capital must be perpetual and capable of unrestricted and immediate use to cover risks or losses as soon as these occur. This includes ordinary shares issued and retained earnings. CET1 capital absorbs losses before other types of capital and any loss absorbing instruments.
- **AT1 capital.** This is the second form of loss absorbing capital and must be capable of absorbing losses on a going concern basis. These instruments are either written down or converted into CET1 capital when a pre-specified CET1 ratio is reached. Coupons on AT1 issuances are discretionary and may be cancelled at the discretion of the issuer at any time. AT1 capital may not be called, redeemed or repurchased for five years from issuance.
- **Tier 2 capital.** Tier 2 capital is the Group's supplementary capital and provides loss absorption on a gone concern basis. Tier 2 capital absorbs losses after Tier 1 capital. It typically consists of subordinated debt securities with a minimum maturity of five years.

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**Business review** **Capital and risk management****Capital risk\*** *continued*

In addition to capital, other specific loss absorbing instruments including senior notes issued by RBSG, may be used to cover certain gone concern capital requirements which, in the EU, is referred to as minimum requirement for own funds and eligible liabilities (MREL).

In order for liabilities to be eligible for MREL a number of conditions must be met including the BoE being able to apply its stabilisation powers to them, including the use of bail-in provisions

**Capital adequacy ratios**

The Group has to hold a minimum amount and quality of capital to satisfy capital adequacy ratio regulatory requirements.

**Risk-weighted assets**

Capital adequacy ratios compare the amount of capital held to RWAs. RWAs are a measure of the Group's assets and off-balance sheet positions that capture both the size and risks inherent in those positions.

For regulatory purposes, RWAs are grouped into four categories:

<b>Risk</b>	<b>Description</b>
Credit	Risk of loss from a borrower failing to repay amounts due by the due date
Counterparty credit	Risk of loss from a counterparty not meeting its contractual obligations  Also included is the risk of loss from changes in the fair value of derivative instruments
Market	Risk of loss arising from fluctuations in market prices
Operational	Risk of loss from inadequate or failed internal processes, people and systems or from external events

*Minimum percentage*

Regulation defines a minimum percentage of capital compared to RWAs. The percentage comprises of system-wide requirements that apply to all banks and a component where the percentage is specific to the Group. This is summarised as follows:

Type	Name	Description
System-wide	Pillar 1 Pillar 2A	Standard minimum percentages applicable to all banks Captures risks that apply to individual banks that are either not adequately captured or not captured at all under Pillar 1
Bank-specific	PRA buffer	Captures forward looking risks and potential losses under a severe stress scenario

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**Business review** **Capital and risk management****Capital risk\*** *continued*

These minimum requirements are explained in more detail on the next page. These ratios apply in full from 1 January 2019. Before this date there are transitional rules in place that mean that the minimum capital requirements that the Group has to comply with are lower although the Group, in line with other UK banks, has been reporting on a fully implemented basis since 2014.

*Pillar 1 requirements*

The Group is subject to system wide minimum capital adequacy ratio requirements that apply to all banks under applicable regulation. There are two broad categories of capital requirements:

<b>Category</b>	<b>Description</b>
Minimum capital adequacy ratio	Represents the minimum amount of capital that all banks must hold at all times
Capital buffers	Comprises of: <ul style="list-style-type: none"> <li>• Capital required to be held by banks that may be used in periods of stress</li> <li>• Capital held by banks that are deemed to be systemically important</li> </ul>

*Pillar 2 requirements*

In addition to the minimum Pillar 1 requirements that apply to all banks, the Group may be required to hold additional capital if specified by its regulators. This is captured under the Pillar 2 framework and consists of two components:

- Pillar 2A: covers risks to the Group that are not captured or not fully captured under Pillar 1. For example, pension risk is not captured in Pillar 1 therefore capital that may need to be held against this risk is assessed under Pillar 2A.
- PRA buffer: covers risks that the Group may become exposed to across a forward-looking planning horizon (for example due to changes to the economic environment).

The PRA buffer is a capital buffer that is designed to ensure that the Group can continue to meet minimum requirements (Pillar 1 and Pillar 2A) during a stressed period. The PRA buffer is required to be held if Pillar

1 capital buffers are determined to be insufficient.

The assessment of Pillar 2 requirements is an output from the Group's internal capital adequacy assessment process that is described in more detail on page 244. Pillar 2 also utilises the output of the Group's stress testing exercises which is described in more detail on pages 243 and 244.

### *Future changes to regulation*

Throughout 2015 and 2016, UK, EU and international standard and rule-making bodies have issued proposals and final standards on revising the level and measurement of capital adequacy ratios including the measurement of RWAs. This may affect the level of RWAs and the capital that the Group is required to hold in the future years. Further details of prudential regulatory changes that may impact the Group's capital adequacy ratio are set out on page 241.

### *Leverage ratios*

The Group has to hold a minimum amount and quality of capital to satisfy the leverage ratio regulatory requirements. Unlike capital adequacy ratios, leverage ratio requirements do not consider the riskiness of the Group's positions.

The leverage exposure is broadly aligned to the accounting value of the Group's on and off-balance sheet exposures but subject to certain adjustments for trading positions, repurchase agreements and off balance sheet exposures.

In common with capital adequacy ratios, the leverage ratio requirement for the Group consists of a minimum requirement and a leverage ratio buffer. Details of the Group's leverage ratio requirements are set out below.

The leverage ratio requirements that the Group must meet may be subject to change from developing regulation. Further details are set out on page 241.

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**Business review** Capital and risk management**Capital risk\*** continued**Minimum percentage for going concern capital requirements under applicable regulation**

## Capital adequacy ratios

The Group is subject to minimum requirements in relation to the amount of capital it must hold in relation to its RWAs. The table below summarises the minimum ratios of capital to RWAs that the Group is expected to have to meet once all currently adopted regulation is fully implemented by 1 January 2019. These ratios apply at the consolidated group level. Different minimum capital requirements may apply to individual legal entities or sub-groups.

Minimum requirements	Type	CET1	Total Tier 1	Total capital
System wide	Pillar 1 minimum requirements	4.50%	6.00%	8.00%
	Capital conservation buffer	2.50%	2.50%	2.50%
	UK countercyclical capital buffer <sup>(1)</sup>	0.00%	0.00%	0.00%
	G-SIB buffer <sup>(2)</sup>	1.00%	1.00%	1.00%
Bank specific	Pillar 2A <sup>(4)</sup>	2.10%	2.90%	3.80%
Total (excluding PRA buffer) <sup>(5)</sup>		10.10%	12.40%	15.30%

## Notes:

(1) The countercyclical capital buffer (CCyB) applied to UK designated assets is set by the Financial Policy Committee (FPC). The UK CCyB may be set between 0% and 2.5% and is linked to the state of the UK economy. On 5 July 2016, the FPC reduced the UK CCyB from 0.5% to 0%. Foreign exposures may be subject to different CCyBs depending on the CCyB rate set in the jurisdiction of the foreign exposure. The net CCyB for the Group is non-zero but rounds to 0.00%.

(2) Globally systemically important banks (G-SIBs), as designated by the Financial Stability Board (FSB), are subject to an additional capital buffer of between 1% and 3.5%. Based on the most recent determination of the FSB, the Group is subject to an additional capital requirement of 1.0%

(3) The Group will be subject to a systemic risk buffer (SRB) of between 0% and 3%. The SRB will apply from 1 January 2019 and will apply at the ring-fenced bank sub-group level rather than at the consolidated group level. The SRB may require the Group to hold a minimum amount of capital at the consolidated group level beyond the levels set out in the table above.

(4) Additional capital requirements under Pillar 2A may be specified by the PRA as a ratio or as an absolute value. The table sets out an implied ratio to cover the full value of Pillar 2A requirements.

(5) The Group may be subject to a PRA buffer requirement as set by the PRA. The PRA buffer consists of two components:

- A risk management and governance buffer that is set as a scalar of the Pillar 1 and Pillar 2A requirements. The scalar could range between 10% and 40%.

- A buffer relating to the results of the BoE concurrent stress testing results.

The PRA requires that the level of this buffer is not publicly disclosed.

(6) The capital conservation buffer, the countercyclical capital buffer, the G-SIB buffer and systemic risk buffer (where applicable) make up the combined buffer. If the Group fails to meet the combined buffer requirement, it is subject to restrictions on distributions on CET1 instruments, discretionary coupons on AT1 instruments and on payment of variable remuneration or discretionary pension benefits. These restrictions are calculated by reference to the Group's Maximum Distributable Amount (MDA). The MDA trigger is below the PRA buffer and MDA restrictions are not automatically triggered if the Group fails to meet its PRA buffer. The MDA is calculated as the amount of interim or year-end profits not yet incorporated into CET1 capital multiplied by a factor ranging from 0 to 0.6 depending on the size of the CET1 shortfall against the combined buffer.

### Leverage ratios

The table below summarises the minimum ratios of capital to leverage exposure under the PRA UK leverage framework that the Group must meet. In November 2016, the European Commission published a proposal for the adoption of a legally binding 3% of Tier 1 capital minimum leverage ratio with consideration of a leverage buffer ratio for G-SIBs once a final international agreement had been reached. Different minimum requirements may apply to individual legal entities or sub-groups.

Type	CET1	Total Tier 1
Minimum ratio	2.25%	3.00%
UK countercyclical leverage ratio buffer <sup>(1)</sup>	0.00%	0.00%
Additional leverage ratio buffer <sup>(2)</sup>	0.35%	0.35%
Total	2.60%	3.35%

Notes:

(1) The countercyclical leverage ratio buffer is set at 35% of the Group's CCyB. As noted above this buffer may be set between 0% and 2.5% and the FPC has currently set the UK CCyB at 0%. The applicable ratio for foreign exposures may be different.

(2) As set out in the FPC's SRB framework, published in May 2016, the FPC intends to direct the PRA to apply an additional leverage ratio buffer to UK G-SIBs set at 35% of the G-SIB buffer rate. As noted above, based on the most recent determination of the FSB, the G-SIB buffer rate for the Group is 1.0%.

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## Business review **Capital and risk management**

### **Capital risk\*** continued

#### Capital sufficiency: going concern forward looking view

The Group examines its going concern capital requirements on a forward looking basis through assessing the resilience of capital adequacy and leverage ratios under hypothetical future states of the world, including as part of its annual budgeting process.

A range of future states of the world are examined. In particular:

- The Group will assess capital requirements based on a forecast of the Group's future business performance under its expectations of economic and market conditions over the forecast period
- The Group will assess capital requirements based on a forecast of the Group's future business performance under adverse economic and market conditions over the forecast period. A range of scenarios of different severity may be examined

The examination of capital requirements under the base economic and market conditions allows the Group to demonstrate how the projected business performance allows it to meet all internal and regulatory capital requirements as they arise over the plan horizon. For example, the Group will assess its ability issue to loss absorbing debt instruments in sufficient quantity to meet regulatory timelines. The cost of issuance will be factored into business performance metrics.

The examination of capital requirements under adverse economic and market conditions is assessed through stress testing. Stress testing is used to quantify, evaluate and understand the potential impact of the financial strength of the Group, including its capital position, given specified changes to risk factors. This is described in more detail on page 243.

The results of stress tests are not only used widely across the Group but also by the Group's regulators to set bank-specific capital buffers through the PRA buffer.

The Group participates in a number of regulatory stress tests implemented by regulatory authorities to test industry-wide vulnerabilities under crystallising global and domestic systemic risks. In 2016, the Group participated in two regulatory stress tests. Details of these stress tests are set out on the following page.

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**Business review** Capital and risk management**Capital risk\*** continued

## Regulatory stress tests

In 2016, the Group participated in two regulatory stress tests set by the EBA and BoE. These scenarios are hypothetical in nature and do not represent a forecast of the Group's future business or profitability. The results of the regulatory stress tests are carefully assessed by the Group and form part of the wider risk management of the Group.

	EBA Stress Test		BoE Stress Test
Scenario	<ul style="list-style-type: none"> <li>Designed to evaluate impact over three years of an adverse macro financial scenario that examines four systemic risks identified by the European Systemic Risk Board as representing the most material threats to the stability of the EU financial sector.</li> <li>A static balance sheet assumption was made across the period of stress and therefore mitigating actions such as balance sheet reduction, business growth and cost savings are not factored into the stress outcomes.</li> </ul>		<ul style="list-style-type: none"> <li>Designed to assess the resilience of major UK banks to tail risk events. The severity of the test is related to policymakers' assessments of risk levels across markets and regions.</li> <li>The 2016 stress test examined the impact over five years of a synchronised global downturn across the UK and global economies. The stress test also assessed a stressed level of misconduct costs.</li> </ul>
	<ul style="list-style-type: none"> <li>The 2016 EBA stress test did not contain a pass/fail threshold.</li> </ul>		<ul style="list-style-type: none"> <li>Under the 2016 BoE stress test, CET1 ratio reached a low point of 5.5% in 2017, below the CET1 hurdle rate of 6.6%.</li> </ul>
Results	<ul style="list-style-type: none"> <li>On a fully loaded basis, the Group's CET1 ratio under the adverse scenario was projected to be 8.1% as at 31 December 2018. The low point CET1 ratio of 7.8% occurs in 2017.</li> </ul>		<ul style="list-style-type: none"> <li>Post the impact of management actions and the conversion of £2 billion AT1 capital in place for 2015, the Group's low point CET1 ratio increased from 5.5% to 6.7%, meeting the CET1 ratio hurdle rate.</li> </ul>
	<ul style="list-style-type: none"> <li>The Group's modelled leverage ratio under the adverse scenario is projected as 3.6% on a fully loaded Basel 3 basis and 4.2% under the PRA transitional definition for leverage ratio as at</li> </ul>		<ul style="list-style-type: none"> <li>Tier 1 leverage rate was projected to be 2.7% in 2017, which increased to 2.9% after the management actions, below the 3% leverage hurdle rate.</li> </ul>

	<p>31 December 2018. The low point occurs in 2017 with a stress leverage ratio of 3.5% on a fully loaded Basel 3 basis as at 31 December 2016 and 4.2% under the PRA transitional definition.</p>		<ul style="list-style-type: none"> <li>The stress was based on an end of 2015 starting balance sheet position. Since then, the Group has taken actions to strengthen its capital position. As a result, the Group now has a revised capital plan that brings it back over the thresholds.</li> </ul>
<p>What does this mean?</p>	<ul style="list-style-type: none"> <li>The 2016 EBA and BoE stress test results demonstrate that the Group has made good progress in transforming the balance sheet to being safe and sustainable. However, the legacy issues still heavily impact the Group's performance.</li> <li>Rebuilding the capital strength remains one of the Group's core strategic priorities. During 2016, RBS narrowed the range of uncertainty around its capital and leverage position by addressing a number of legacy issues including recording additional provisions of £5.9 billion for conduct and litigation costs. RBS also continued to de-risk its balance sheet.</li> <li>In August 2016 the Group successfully issued an additional £2 billion AT1 capital, bolstering the Group's capital position and leverage ratio.</li> </ul>		

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**Business review** **Capital and risk management****Capital risk\*** continued

## Capital sufficiency: gone concern view

The Group will be required to hold sufficient capital and other loss absorbing instruments such that, in the event of failure, there can be an orderly resolution that minimises any adverse impact on financial stability whilst preventing public funds being exposed to loss.

In November 2016, the BoE published its policy statement on its approach to setting MREL.

MREL will be set by the BoE on a case-by-case basis but it has stated that it expects institutions that are G-SIBs and subject to a bail-in resolution strategy, such as the Group, to meet interim MREL requirements from 1 January 2019 and end state MREL requirements from 1 January 2022 as follows:

Interim MREL	
1 January 2019	The minimum requirements set out in the FSB total loss absorbing capacity standard being the higher of: <ul style="list-style-type: none"> <li>• 16% of the Group's RWAs; and</li> <li>• 6% of the Group's leverage exposures</li> </ul>
1 January 2020	The higher of: <ul style="list-style-type: none"> <li>• The sum of two times the Group's Pillar 1 requirement and one times the Group's Pillar 2A add-ons; and</li> <li>• Two times the applicable leverage ratio requirement for the Group</li> </ul>
End state MREL	
1 January 2022	The higher of: <ul style="list-style-type: none"> <li>• Two times the sum of the Group's Pillar 1 requirement and Group's Pillar 2A add-ons; and</li> <li>• The higher of: <ul style="list-style-type: none"> <li>○ Two times the applicable leverage ratio requirement for the Group; and</li> </ul> </li> </ul>

o 6.75% of the Group's leverage exposure

The BoE is intending to review its general approach to the calibration of MREL before the end of 2020 prior to setting end-state MRELS.

MREL may consist of capital and other loss absorbing instruments. In order for liabilities to be eligible for MREL, a number of strict conditions will be set by the BoE including the ability for the BoE to apply its stabilisation powers to those liabilities. In addition, liabilities must have an effective remaining maturity (taking account of any rights of early repayment to investors) of greater than one year.

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## Business review **Capital and risk management**

### **Capital risk\*** continued

On the basis of the BoE policy statement, the Group expects to issue between £3 billion and £5 billion of MREL compliant senior debt from the single resolution entity (RBSG) each year to meet this requirement.

In order that there is sufficient loss absorbing capacity pre-positioned across the Group, the proceeds of externally issued MREL will be downstreamed to material operating subsidiaries in the form of capital or other subordinated claims. This ensures that internal MREL will absorb losses before operating liabilities within operating subsidiaries.

Although the BoE continue to develop its approach to the calibration of MREL within banking groups, the BoE policy statement sets out the framework that it will use to determine the distribution of MREL within banking groups. Under this framework, the BoE will set individual MRELS for all institutions within the Group and may also set individual MRELS for entities within the Group that are important from a resolution perspective.

The Group is not planning to downstream the proceeds of external MREL issuance prior to the completion of legal entity and business realignment required to implement ring-fencing.

### **Regulatory changes that may impact capital requirements**

The Group faces a number of changes in prudential regulation that may adversely impact the amount of capital it must hold and consequently may increase funding costs and reduce return on equity. The nature and timing of implementation of a number of these changes is not currently final.

In 2017, the UK, EU and BCBS are expected to further develop prudential regulation including the approach to calculating credit risk and operational risk RWAs, additional details on the MREL framework and a review of the leverage ratio framework.

Regulatory changes are actively monitored by the Group including engagement with industry associations and regulators and participation in quantitative impact studies. Monitoring the changing regulatory landscape forms a fundamental part of capital planning and management of its business.

The Group believes that its strategy to focus on simpler, lower risk activities within a more resilient recovery and resolution framework will enable it to manage the impact of these changes.

Key prudential regulatory developments that have been published and may impact the Group are set out in the following table.

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**Business review** Capital and risk management**Capital risk\*** continued

## Summary of potential changes to regulation that may impact the Group's capital requirements

Area of development	Actual or potential key changes that might impact the Group's capital requirements	Source of changes
Capital adequacy buffers	<ul style="list-style-type: none"> <li>A new systemic risk buffer will apply to the RBS ring-fenced bank sub-group from 1 January 2019.</li> <li>The buffer will be set between 0% and 3%.</li> </ul>	<ul style="list-style-type: none"> <li>Statement of Policy published by the PRA in December 2016.</li> </ul>
Credit risk RWAs	<ul style="list-style-type: none"> <li>Restriction in the scope of using internal models.</li> <li>Avoidance of mechanistic reliance on external ratings.</li> <li>For model-based RWAs, potential change to capital floors based on the standardised approach.</li> <li>Potential amendment of risk weights for securitisation exposures.</li> <li>Revision to UK residential mortgage risk weights.</li> </ul>	<ul style="list-style-type: none"> <li>Mostly relate to consultations published by the BCBS.</li> <li>Mortgage risk weights changes proposed by the PRA for 31 March 2019.</li> </ul>
Counterparty credit risk RWAs	<ul style="list-style-type: none"> <li>Change to exposure amounts under the standardised approach.</li> <li>Increase in the number of risk factors captured in the calculation of the counterparty valuation adjustment (CVA).</li> </ul>	<ul style="list-style-type: none"> <li>The standardised approach relates to the CRR 2<sup>(1)</sup> proposal to amend regulation published by the European Commission.</li> <li>Changes to CVA relate to a consultation published by the BCBS.</li> </ul>
Market risk RWAs	<ul style="list-style-type: none"> <li>Change from value at risk to expected shortfall models.</li> <li>Implementation of a more risk-sensitive standardised approach.</li> <li>Inclusion of risk of market illiquidity.</li> </ul>	<ul style="list-style-type: none"> <li>Relates to the CRR 2<sup>(1)</sup> proposal to amend regulation published by the European Commission.</li> </ul>
Operational risk RWAs	<ul style="list-style-type: none"> <li>Incorporation of bank-specific loss data into the calculation.</li> </ul>	<ul style="list-style-type: none"> <li>Consultation published by the BCBS.</li> </ul>

Leverage ratio	<ul style="list-style-type: none"> <li>• Changes to the design and calibration of the framework with a focus on derivative exposures and margining.</li> <li>• Recalibration of the UK leverage ratio framework to offset exclusion of central bank reserves from the calculation.</li> </ul>	<ul style="list-style-type: none"> <li>• Relates to the CRR 2<sup>(1)</sup> proposal to amend regulation published by the European Commission.</li> <li>• Statements made by the FPC and PRA.</li> </ul>
Large exposure framework	<ul style="list-style-type: none"> <li>• Changes to the design and calibration of the capital base and large exposure limit.</li> </ul>	<ul style="list-style-type: none"> <li>• Relates to the CRR 2<sup>(1)</sup> proposal to amend regulation published by the European Commission.</li> </ul>

Note:

(1) CRR 2 relates to the European Commission publication on 23 November 2016 to amend the Capital Requirements Regulation. Additional amendments were proposed to amend the Capital Requirements Directive and Banking Recovery and Resolution Directive.

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## Business review **Capital and risk management**

### **Capital risk\*** continued

#### **Capital management**

Capital management is the process by which the Group ensures that it has sufficient capital and other loss absorbing instruments to operate effectively including meeting minimum regulatory requirements, operating within Board approved risk appetite, maintaining its credit rating and supporting its strategic goals.

Capital management is critical in supporting the Group's business and is enacted through an end to end framework across the Group, its businesses and the legal entities on which it operates.

The key elements of the Group's capital management approach are set out below.

#### *Risk appetite*

Capital risk appetite is set by the Board, reflecting the Group's strategic objectives, current and future prudential regulatory requirements and market expectations.

It is expressed as a set of target ratios for CET1 and leverage under both normal and stressed financial conditions. Capital risk appetite is set at various levels including for the Group and its businesses. Performance against risk appetite is regularly monitored.

#### *Capital planning*

Capital planning is integrated into the Group's wider annual budgeting process and is assessed and updated at least monthly. Regular returns are submitted to the PRA which include a two year rolling forward view.

- Capital plans are produced for the Group, its key operating entities and its businesses over a five year planning horizon.

#### **Produce capital plans**

- Shorter term forecasts are developed frequently in response to actual performance, changes in internal and external business environment and to manage risks and opportunities.



- i**

**Assess**

  - Capital plans are developed to maintain capital of sufficient quantity and quality to support the Group's business and strategic plans over the planning horizon within approved risk appetite and minimum regulatory requirements.
- capital**

**adequacy**

  - Capital resources and capital requirements are assessed across a defined planning horizon.
  - Impact assessment captures input from across the Group including from businesses.
- i**

**Inform**

  - Capital planning informs potential capital actions including managing capital through buy backs or through new issuance.
- capital**

**actions**

  - Decisions on capital actions will be influenced by strategic and regulatory requirements, the cost and prevailing market conditions.
  - As part of capital planning, the Group will monitor its portfolio of capital issuance and assess the optimal blend and most cost effective means of financing.

Capital planning is one of the tools that the Group uses to monitor and manage the risk of excessive leverage.

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## Business review **Capital and risk management**

### Capital risk\* continued

#### Stress testing

Stress testing is a key risk management tool used by the Group and is a fundamental component of the Group's approach to capital management.

Stress testing is used to quantify, evaluate and understand the potential impact on the financial strength of the Group, including its capital position, given specified changes to risk factors. Stress testing includes:

- Scenario testing: examines the impact of a hypothetical future state of the world to define changes in risk factors affecting the Group; and
- Sensitivity testing: examining the impact of an incremental change to one or more risk factors.

The process for stress testing consists of four broad stages:

- |  |  |
|--|--|
| <p>Define<br/>scenarios<br/><br/>i</p> | <ul style="list-style-type: none"> <li>• Identify RBS specific vulnerabilities and risks.</li> <li>• Define and calibrate scenarios to examine risks and vulnerabilities.</li> <li>• Formal governance process to agree scenarios.</li> </ul>    |
| <p>Assess impact<br/><br/><br/>i</p>   | <ul style="list-style-type: none"> <li>• Translate scenarios into risk drivers.</li> <li>• Assess impact to positions, income and costs.</li> <li>• Impact assessment captures input from across the Group including from businesses.</li> </ul> |
| <p>Calculate<br/>results and</p>       | <ul style="list-style-type: none"> <li>• Aggregate impacts into overall results.</li> <li>• Results from part of risk management process.</li> </ul>   |

assess

- Scenario results used to inform the bank's business and capital plans.

implications

i

Develop and

- Scenario results analysed by subject matter experts and appropriate management actions are developed.

agree

management

- Scenario results and management actions are reviewed and agreed by senior management through executive committees including ERF, BRC and the Board.

actions

\*unaudited

**Business review** **Capital and risk management**

**Capital risk\*** **continued**

Stress testing is used widely across the Group; key areas are summarised in the diagram below:

Specific areas that involve capital management include:

- 1) *Strategic financial and capital planning*: through assessing the impact of sensitivities and scenarios on the capital plan and capital ratios.
- 2) *Risk appetite*: through gaining a better understanding of the drivers of and the underlying risks associated with risk appetite.
- 3) *Risk identification*: through a better understanding of the risks that could potentially impact the Group's financial strength and capital position.
- 4) *Risk mitigation*: through identifying actions that can be taken to mitigate risks or could be taken in the event of adverse changes to the business or economic environment. Risk mitigation is substantially supplemented through the Group's recovery plan.

The Group also undertakes regular reverse stress testing which examines circumstances that can lead to specific, defined business outcomes such as business failure. Reverse stress testing allows the Group to examine potential vulnerabilities in its business model more fully.

#### *Internal assessment of capital adequacy*

The Group conducts an annual internal assessment of its material risks and evaluates how much capital is required to cover these risks. This is referred to as the Internal Capital Adequacy Assessment Process (ICAAP). The ICAAP is approved by the Board and submitted to the PRA.

The ICAAP consists of a point in time capital assessment of the Group's exposures and risks at the financial year end and a forward looking stress capital assessment.

The ICAAP is used by the Group to form a view of capital adequacy separately to the regulatory minimum requirements. The ICAAP is used by the PRA to make an assessment of bank-specific capital requirements through the Pillar 2 framework.

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## **Business review** **Capital and risk management**

### **Capital risk\*** *continued*

#### *Capital allocation*

The Group has mechanisms to allocate capital across its legal entities and businesses that aim to optimise the utilisation of capital resources taking into account applicable regulatory requirements, strategic and business objectives and risk appetite.

The framework for allocating capital is approved by the Asset and Liability Committee.

#### *Governance*

Capital management is subject to substantial review and governance across the Group including capital management policies that are approved by the Asset and Liability Committee or Board Risk Committee

The Board approves the Group's capital plans, including its key legal entities and businesses, and including the results of the stress tests relating to those capital plans.

#### *Recovery and resolution planning*

The Group maintains a recovery plan that sets out credible recovery options that could be implemented in the event of a severe stress to restore its business to a stable and sustainable condition, focussing on addressing the Group's capital and liquidity position.

The recovery plan sets out a range of triggers that activate the implementation of the recovery plan and sets out the operational plan for its implementation.

The recovery plan is a key component of the overall risk management of the Group including the framework for managing its capital.

The recovery plan is prepared and updated annually and approved by the Board. The recovery plan is assessed for appropriateness on an ongoing basis, and is maintained in line with regulatory requirements.

Resolution is implemented if the Group fails and the appropriate regulator places the Group into resolution. Resolution is owned and implemented by the appropriate regulatory authority and the Group has a multi-year programme in place to develop resolution capability and meet regulatory requirements.

The Group is working with global regulators to ensure that the Group is compliant with the principles of resolution planning, demonstrating the process by which the Group and relevant regulatory bodies can develop a set of actions that would be taken to manage the failure of the Group or one of its significant legal entities in an orderly manner.

### Ring-fencing

As part of the response to the 2008 financial crisis the UK Government's Independent Commission on Banking report recommended that banks separate their retail and investment banking operations, helping to mitigate against the risk of the investment bank division running into financial difficulty.

Primary legislation and FCA/PRA regulations have been issued which must be complied with by 1 January 2019. For more details on ring-fencing, refer to page 172.

\*unaudited





**Business review** Capital and risk management**Capital risk\*** continued**Measurement**

## Capital and leverage: Key ratios

Capital, RWAs and risk asset ratios, on the basis of end-point Capital Requirements Regulation (CRR) and transitional rules, calculated in accordance with PRA definitions, are set out below.

	2016		2015	
	End-point CRR basis (1) £bn	PRA transitional basis £bn	End-point CRR basis (1) £bn	PRA transitional basis £bn
<b>Capital</b>				
CET1	30.6	30.6	37.6	37.6
Tier 1	34.7	40.4	39.6	46.3
Total	43.8	52.3	47.6	60.0
<b>RWAs</b>				
Credit risk				
- non-counterparty	162.2	162.2	166.4	166.4
- counterparty	22.9	22.9	23.4	23.4
Market risk	17.4	17.4	21.2	21.2
Operational risk	25.7	25.7	31.6	31.6
Total RWAs	228.2	228.2	242.6	242.6
<b>Risk asset ratios</b>	%	%	%	%
CET1	13.4	13.4	15.5	15.5
Tier 1	15.2	17.7	16.3	19.1
Total	19.2	22.9	19.6	24.7
<b>Leverage</b>	2016		2015	
Tier 1 capital (£bn)	£34.7bn	£40.4bn	39.6	46.3
Leverage exposure (£bn)	£683.3bn	£683.3bn	702.5	702.5
Leverage ratio (%)	5.1%	5.9%	5.6%	6.6%
Average Tier 1 capital (£bn) (2)	£38.0bn	£43.7bn		
Average leverage exposure (£bn) (2)	£712.1bn	£712.1bn		
Average leverage ratio (%) (2)	5.3%	6.1%		

Notes:

- (1) CRR as implemented by the Prudential Regulation Authority in the UK, with effect from 1 January 2014. All regulatory adjustments and deductions to CET1 have been applied in full for both bases with the exception of unrealised gains on available-for-sale securities which has been included from 2015 under the PRA transitional basis.
- (2) Based on 3 month average of month end leverage exposure and Tier 1 Capital.

General:

From 1 January 2015, RBS has been required to meet at least 56% of its Pillar 2A capital requirement with CET1 capital and the balance with Additional Tier 1 and/or Tier 2 capital. The Pillar 2A capital requirement is the additional capital that RBS must hold, in addition to meeting its Pillar 1 requirements in order to comply with the PRA's overall financial adequacy rule.

Measures in relation to end-point CRR basis, including RWAs, are based on the current interpretation, expectations, and understanding, of the CRR requirements, as well as further regulatory clarity and implementation guidance from the UK and EU authorities (end-point CRR basis). The actual end-point CRR impact may differ when the final technical standards are interpreted and adopted.

Capital base:

- (1) Own funds are based on shareholders' equity.
- (2) The adjustment arising from the application of the prudent valuation requirements to all assets measured at fair value, has been included in full. Additional valuation adjustments relating to unearned credit spreads on exposures under the advanced internal ratings approach has been included in the determination of the expected loss amount deducted from CET1.
- (3) Where the deductions from AT1 capital exceed AT1 capital, the excess is deducted from CET1 capital.
- (4) Insignificant investments in equities of other financial entities (net): long cash equity positions are considered to have matched maturity with synthetic short positions if the long position is held for hedging purposes and sufficient liquidity exists in the relevant market. All the trades are managed and monitored together within the equities business.
- (5) Based on our current interpretations of the Commission Delegated Regulation issued in December 2013 on credit risk adjustments, RBS's standardised latent provision has been reclassified to specific provision and is not included in Tier 2 capital.

RWAs:

- (1) Current securitisation positions are shown as risk-weighted at 1,250%.
- (2) RWA uplifts include the impact of credit valuation adjustments and asset valuation correlation on large financial sector entities.
- (3) RWAs reflect implementation of the full internal model method suite, and include methodology changes that took effect immediately on CRR implementation.
- (4) Counterparties which meet the eligibility criteria under CRR are exempt from the credit valuation adjustments volatility charges.
- (5) The CRR final text includes a reduction in the risk-weight relating to small and medium-sized enterprises.

\*unaudited

## Business review Capital and risk management

<b>Capital risk continued</b>				
<b>Capital and leverage: Capital resources</b>				
	2016		2015*	
	PRA		PRA	
	End-point	transitional	End-point	transitional
	CRR	CRR	CRR	CRR
	basis (1)	basis (1)	basis (1)	basis(1)
	£m	£m	£m	£m
<b>Shareholders' equity (excluding non-controlling interests)</b>				
Shareholders' equity	48,609	48,609	53,431	53,431
Preference shares - equity	(2,565)	(2,565)	(3,305)	(3,305)
Other equity instruments	(4,582)	(4,582)	(2,646)	(2,646)
	41,462	41,462	47,480	47,480
<b>Regulatory adjustments and deductions</b>				
Own credit	(304)	(304)	(104)	(104)
Defined benefit pension fund adjustment	(208)	(208)	(161)	(161)
Cash flow hedging reserve	(1,030)	(1,030)	(458)	(458)
Deferred tax assets	(906)	(906)	(1,110)	(1,110)
Prudential valuation adjustments	(532)	(532)	(381)	(381)
Goodwill and other intangible assets	(6,480)	(6,480)	(6,537)	(6,537)
Expected losses less impairments	(1,371)	(1,371)	(1,035)	(1,035)
Other regulatory adjustments	(8)	(8)	(86)	(64)
	(10,839)	(10,839)	(9,872)	(9,850)
<b>CET1 capital</b>	<b>30,623</b>	<b>30,623</b>	<b>37,608</b>	<b>37,630</b>
<b>AT1 capital</b>				
Eligible AT1	4,041	4,041	1,997	1,997
Qualifying instruments and related share premium subject to phase out	—	5,416	—	5,092
Qualifying instruments issued by subsidiaries and held by third parties	—	339	—	1,627
<b>AT1 capital</b>	<b>4,041</b>	<b>9,796</b>	<b>1,997</b>	<b>8,716</b>
<b>Tier 1 capital</b>	<b>34,664</b>	<b>40,419</b>	<b>39,605</b>	<b>46,346</b>
<b>Qualifying Tier 2 capital</b>				
Qualifying instruments and related share premium	6,893	7,066	5,745	6,265

Qualifying instruments issued by subsidiaries and held by third parties	2,268	4,818	2,257	7,354
Tier 2 capital	9,161	11,884	8,002	13,619
Total regulatory capital	43,825	52,303	47,607	59,965

Note:

(1) CRR as implemented by the Prudential Regulation Authority in the UK, with effect from 1 January 2014. All regulatory adjustments and deductions to CET1 have been applied in full for the end-point CRR basis with the exception of unrealised gains on available-for-sale securities which has been included from 2015 for the PRA transitional basis.

(2) The Group's Tier 1 grandfathering cap is set at £5.8 billion for 2016 (2015 - £6.7 billion).

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\*unaudited

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Business review **Capital and risk management****Capital risk\*** continued

The table below analyses the movement in end-point CRR CET1, AT1 and Tier 2 capital for the year.

	CET1	AT1	Tier 2	Total
	£m	£m	£m	£m
<b>At 1 January 2016</b>	37,608	1,997	8,002	47,607
Loss for the year	(6,955)	—	—	(6,955)
Own credit	(200)	—	—	(200)
Share capital and reserve movements in respect of employee share schemes	208	—	—	208
Ordinary shares issued	215	—	—	215
Foreign exchange reserve	1,214	—	—	1,214
Available-for-sale reserves	(69)	—	—	(69)
Goodwill and intangibles deduction	57	—	—	57
Deferred tax assets	204	—	—	204
Prudential valuation adjustments	(151)	—	—	(151)
Expected loss over impairment provisions	(336)	—	—	(336)
Capital instruments issued/(matured)	—	2,044	—	2,044
Net dated subordinated debt/grandfathered instruments	—	—	(826)	(826)
Foreign exchange movements	—	—	1,985	1,985
Other movements	(1,172)	—	—	(1,172)
<b>At 31 December 2016</b>	30,623	4,041	9,161	43,825

## Leverage exposure

The leverage exposure is based on the CRR Delegated Act.

	End-point CRR basis	
	2016	2015
	£bn	£bn
<b>Leverage</b>		
Derivatives	247.0	262.5
Loans and advances	340.3	327.0
Reverse repos	41.8	39.9
Other assets	169.6	186.0

Total assets	798.7	815.4
Derivatives		
- netting	(241.7)	(258.6)
- potential future exposures	65.3	75.6
Securities financing transactions gross up	2.3	5.1
Undrawn commitments (analysis below)	58.6	63.5
Regulatory deductions and other adjustments	0.1	1.5
Leverage exposure	683.3	702.5
Tier 1 capital	34.7	39.6
Leverage ratio %	5.1	5.6
Average leverage exposure	712.1	
Average Tier 1 capital	38.0	
Average leverage ratio %	5.3	
UK leverage ratio %	5.6	

Note:

(1) The UK leverage ratio excludes central bank claims from the leverage exposure where deposits held are denominated in the same currency and of contractual maturity that is equal or longer than that of the central bank claims.

\*unaudited



**Business review** Capital and risk management**Capital risk\*** continued

	2016	2015
	£bn	£bn
<i>Weighted undrawn commitments</i>		
The table below provides a breakdown of weighted undrawn commitments.		
Unconditionally cancellable credit cards	2.4	2.4
Other Unconditionally cancellable items	7.7	7.2
Unconditionally cancellable items (1)	10.1	9.6
Undrawn commitments <1 year which may not be cancelled	1.8	0.6
Other off-balance sheet items with 20% CCF	0.9	1.4
Items with a 20% CCF	2.7	2.0
Revolving credit risk facilities	27.2	25.3
Term loans	3.1	4.3
Mortgages	0.1	5.9
Other undrawn commitments > 1 year which may not be cancelled & off-balance sheet items with 50% CCF	3.3	5.3
Items with a 50% CCF	33.7	40.8
Items with a 100% CCF	12.1	11.1
Total	58.6	63.5

Note:

(1) Based on a 10% credit conversion factor (CCF).

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## Business review **Capital and risk management**

### Capital risk\* continued

#### Loss absorbing capital

RBS's capital components and estimated loss absorbing capital (LAC) at 31 December 2016 based on current regulatory interpretations are set out below. For details regarding regulatory developments in relation to MREL requirements, refer to page 239. The roll-off profile and average spread relating to senior debt and Tier 2 instruments is set out on the next page.

The following table illustrates the components of estimated LAC in RBSG and operating subsidiaries.

	2016				2015			
	Par value (1) £bn	Balance sheet value £bn	Regulatory value (2) £bn	LAC value (3) £bn	Par value (1) £bn	Balance sheet value £bn	Regulatory value (2) £bn	LAC value (3) £bn
CET1 capital (4)	30.6	30.6	30.6	30.6	37.6	37.6	37.6	37.6
Tier 1 capital: end-point CRR compliant AT1								
of which: RBSG (holdco)	4.0	4.0	4.0	4.0	2.0	2.0	2.0	2.0
of which: RBSG operating subsidiaries (opcos)	—	—	—	—	—	—	—	—
	4.0	4.0	4.0	4.0	2.0	2.0	2.0	2.0
Tier 1 capital: non end-point CRR compliant								
of which: holdco	5.5	5.6	5.5	4.0	6.0	6.0	5.9	4.6
of which: opcos	0.3	0.3	0.3	0.3	2.5	2.5	2.5	0.3
	5.8	5.9	5.8	4.3	8.5	8.5	8.4	4.9
Tier 2 capital: end-point CRR compliant								
of which: holdco	6.9	7.0	6.9	5.3	5.8	5.9	5.7	4.4
of which: opcos	6.0	6.4	4.0	5.6	5.1	5.5	3.8	5.5
	12.9	13.4	10.9	10.9	10.9	11.4	9.5	9.9

Tier 2 capital: non end-point CRR compliant									
of which: holdco	0.4	0.4	0.2	0.1	0.3	0.3	0.2	0.1	
of which: opcos	2.5	2.7	2.1	2.1	3.3	3.6	3.0	2.9	
	2.9	3.1	2.3	2.2	3.6	3.9	3.2	3.0	
Senior unsecured debt securities issued by:									
RBSG holdco	6.9	6.8	—	5.0	4.9	5.0	—	2.9	
RBSG opcos	14.8	15.0	—	—	17.7	18.1	—	—	
	21.7	21.8	—	5.0	22.6	23.1	—	2.9	
Total	77.9	78.8	53.6	57.0	85.2	86.5	60.7	60.3	
RWAs				228.2				242.6	
Leverage exposure				683.3				702.5	
LAC as a ratio of RWAs (4)				24.9%				24.9%	
LAC as a ratio of leverage exposure				8.3%				8.6%	

## Notes:

- (1) Par value reflects the nominal value of securities issued.
- (2) Regulatory capital instruments issued from operating companies are included in the transitional LAC calculation, to the extent they meet the MREL criteria.
- (3) LAC value reflects RBS's interpretation of the Bank of England's policy statement on the minimum requirements for own funds and eligible liabilities (MREL), published in November 2016. MREL policy and requirements remain subject to further potential development, as such RBS estimated position remains subject to potential change. Liabilities excluded from LAC include instruments with less than one year remaining to maturity, structured debt, operating company senior debt, and other instruments that do not meet the MREL criteria. Includes Tier 1 and Tier 2 securities prior to incentive to redeem.
- (4) CRD IV capital buffers met by CET1 in addition to MREL requirements: being 3.5% in 2017 based on a capital conservation buffer of 2.5% and G-SIB requirement of 1.0%, and 4.0% in 2016 based on a capital conservation buffer of 2.5% and a G-SIB requirement of 1.5%. Excludes consideration of any additional management buffer.
- (5) Corresponding shareholders' equity was £48.6 billion (2015 - £53.4 billion).
- (6) Regulatory amounts reported for AT1, Tier 1 and Tier 2 instruments are before grandfathering restrictions imposed by CRR.

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## Business review Capital and risk management

## Capital risk\* continued

## Roll-off profile

Based on current guidance, RBS anticipates issuing senior bonds from its holding company to ensure LAC classification under MREL proposals. The following table illustrates the roll-off profile and weighted average spreads of RBS's major wholesale funding programmes.

Senior debt roll-off profile (1)							
	As at and for						
	year ended	Roll-off profile					
	31 December 2016	H1 2017	H2 2017	2018	2019	2020 & 2021	2022 & later
RBSG							
- amount (£m)	6,832	371	449	83	1,413	2	4,514
- weighted average rate spread (bps)	220	128	190	172	218	162	231
RBS plc							
- amount (£m)	14,950	4,404	1,168	1,495	2,468	3,460	1,955
- weighted average rate spread (bps)	121	69	106	143	244	186	98
RBS N.V.							
- amount (£m)	47	4	8	24	—	4	7
- weighted average rate spread (bps)	92	10	43	125	—	5	136
Securitisation							
- amount (£m)	1,481	—	—	—	—	—	1,481
- weighted average rate spread (bps)	42	—	—	—	—	—	42
Covered bonds							
- amount (£m)	3,935	—	—	905	—	1,896	1,134
- weighted average rate spread (bps)	191	—	—	137	—	150	306
Total notes issued (£m)	27,245	4,779	1,625	2,507	3,881	5,362	9,091
Weighted average spread	159	74	128	142	235	174	174
Tier 2 capital instruments roll-off profile (2)							

RBSG (£m)	7,404	87	—	290	888	—	6,139
RBS plc (£m)	6,584	3,901	138	2,020	38	—	487
NWB Plc (£m)	1,207	741	—	—	—	376	90
RBS N.V. (£m)	1,226	—	—	418	298	12	498
UBI DAC	76	—	—	—	—	—	76
Total Tier 2 capital (£m)	16,497	4,729	138	2,728	1,224	388	7,290

## Notes:

- (1) Based on final contractual instrument maturity.
- (2) Based on first call date of instrument.
- (3) The weighted average spread reflects the average net funding cost to RBS. This is calculated as the difference between the issuing coupon and the equivalent hedging rate.

\*unaudited

**Business review** Capital and risk management**Capital risk\*** continued

## Risk-weighted assets

The table below analyses the movement in credit risk RWAs on the end-point CRR basis during the year, by key drivers.

	Credit risk RWAs		Total £bn
	Non-counterparty £bn	Counterparty £bn	
<b>At 1 January 2016</b>	166.4	23.4	189.8
Foreign exchange movement	10.1	1.4	11.5
Business movements	(10.5)	(2.4)	(12.9)
Risk parameter changes (1)	(4.5)	0.5	(4.0)
Model updates	0.7	—	0.7
<b>At 31 December 2016</b>	162.2	22.9	185.1

Note:

(1) PD model changes relating to counterparty risks are included with risk parameter changes in line with EBA Pillar 3 Guidelines issued in December 2016.

The table below analyses the movement in market and operational risk RWAs on the end-point CRR basis during the year.

	Market risk RWAs			Operational risk	
	NatWest Markets £bn	Other £bn	Total £bn	RWAs £bn	Total £bn
<b>At 1 January 2016</b>	13.8	7.4	21.2	31.6	52.8
Business and market movements	(2.2)	(1.6)	(3.8)	(5.9)	(9.7)
<b>At 31 December 2016</b>	11.6	5.8	17.4	25.7	43.1

**Key points**

- RWAs decreased by £14.4 billion to £228.2 billion primarily as result of run down of Capital



Resolution and the reduction in operational risk (£5.9 billion) partly offset by adverse exchange rate movements (£11.5 billion) as sterling weakened against all major currencies.

- The foreign exchange movement occurred primarily in Capital Resolution (£4.2 billion), Ulster Bank RoI (£2.6 billion) Commercial Banking (£2.1 billion) and NatWest Markets (£1.2 billion).
- The annual operational risk recalculation resulted in a decrease of £2.0 billion and a further £3.9 billion reduction relating to the removal of the Citizens related element following PRA approval.
- Growth in UK lending, both new and organic, and the transfer of Northern Ireland loans from UK PBB were the key contributors to the increase in Commercial Banking.
- NatWest Markets RWAs increased by £2.1 billion principally due to business movements and the impact of the weakening of sterling.
- Capital Resolution RWAs continued to decrease in line with risk reduction strategy (£14.5 billion) with the majority of the movement seen in Markets (£4.9 billion), primarily derivative mitigation activities and terminations, and disposals and run-off in Global Transactions Services (£3.1 billion), shipping (£1.7 billion) and legacy loan portfolio (£2.3 billion).
- The Central items decrease of £7.1 billion is significantly driven by the operational risk reduction relating to Citizens.

\*unaudited

**Business review** [Capital and risk management](#)

Capital risk\* [continued](#)

[RWAs by segment](#)

The chart below illustrates the concentration of risk-weighted assets by segment.

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## Business review Capital and risk management

## Capital risk\* continued

The table below analyses the movement in end-point CRR RWAs by segment during the year.

	Ulster								Central	
	Bank	Commercial	Private		NatWest	Capital			items	
Total RWAs	UK PBB £bn	Rol £bn	Banking £bn	Banking £bn	RBSI £bn	Markets £bn	Resolution £bn	W&G £bn	& other £bn	Total £bn
At 1 January 2016	33.3	19.4	72.3	8.7	8.3	33.1	49.0	9.9	8.6	242.6
Foreign exchange movement	—	2.6	2.1	—	0.6	1.2	4.2	—	0.8	11.5
Business movements	—	(1.8)	4.1	—	0.6	1.2	(18.1)	(0.2)	(8.3)	(22.5)
Risk parameter changes (1)	(1.0)	(2.1)	(0.2)	—	—	0.1	(0.9)	—	0.1	(4.0)
Methodology changes	0.2	—	—	(0.1)	—	(0.4)	0.2	—	—	(0.1)
Model updates (2)	0.2	—	0.2	—	—	—	0.1	(0.1)	0.3	0.7
At 31 December 2016	32.7	18.1	78.5	8.6	9.5	35.2	34.5	9.6	1.5	228.2
Credit risk										
- non-counterparty	24.8	16.9	72.0	7.5	8.8	5.5	18.2	8.2	0.3	162.2
- counterparty	—	0.1	—	—	—	14.1	8.7	—	—	22.9
Market risk	—	—	—	—	—	11.6	4.8	—	1.0	17.4
Operational risk	7.9	1.1	6.5	1.1	0.7	4.0	2.8	1.4	0.2	25.7
Total RWAs	32.7	18.1	78.5	8.6	9.5	35.2	34.5	9.6	1.5	228.2

## Notes:

(1) Risk parameter changes relate to changes in credit quality metrics of customers and counterparties such as probability of default (PD) and loss given default (LGD) as well as IRB model changes relating to counterparty credit risk (in line with EBA Pillar 3 Guidelines).

(2) Credit risk models were updated during the year including LGD model for quasi governments and PD model for banks.

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## Business review **Capital and risk management**

### Liquidity and funding risk

#### Definition

Liquidity and funding risk arises when RBS is unable to meet its financial obligations, including financing wholesale maturities or customer deposit withdrawals, as and when they fall due.

All the quantitative disclosures in this section are audited except for those in Liquidity metrics and Behavioural maturity.

#### Key developments in 2016

##### Liquidity position:

- The liquidity portfolio of £164 billion covered total wholesale funding, including derivative collateral, by more than two times. The liquidity portfolio increased by £8 billion in the year driven by secondary liquidity, as the volume of mortgage assets placed into the Discount Window Facility (DWF) increased during 2016.
- The regulatory liquidity coverage ratio (LCR) metric decreased to 123% at 31 December 2016 from 136% at the prior year end, driven by Capital Resolution run down and by UK PBB and Commercial Banking lending growth.
- Internal stressed outflow coverage (SOC) was 139% at 31 December 2016, down from 227% in 2015, primarily due to a change in approach that restricts reliance on DWF assets.

##### Funding position:

- Net stable funding ratio (NSFR) remained broadly unchanged from the prior year at 121%. This is comfortably above the minimum target of 100% and reflects RBS's funding strategy to rely on stable customer deposits.
- Loan:deposit ratio was 91% at the end of 2016, a 2% increase from the prior year, driven by Capital Resolution running down more deposits than loans.

#### Sources of liquidity and funding

Liquidity and funding risks arise through the maturity transformation role that banks perform. It is dependent on RBS specific factors such as maturity profile, composition of sources and uses of funding and the quality and size of the liquidity portfolio. Broader market factors, such as wholesale market conditions and depositor and investor behaviour, are also contributing factors.

RBS's primary funding sources are as follows:

Type	Description
Customer deposits	PBB and CPB deposit taking franchises.
Wholesale markets	Short-term (less than 1 year) unsecured money markets and secured repo market funding.
Term debt	Issuance of long-term (more than 1 year) unsecured and secured debt securities.

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## Business review **Capital and risk management**

### Liquidity and funding risk *continued*

RBS may access various funding facilities offered by central banks from time to time. The use of such facilities can be both part of a wider strategic objective to support initiatives to help stimulate economic growth or as part of the broader liquidity management and funding strategy. Usage and repayment of available central bank facilities will fit within the overall liquidity risk appetite and concentration limits.

### Policy, framework and governance

The key elements of the liquidity and funding framework within RBS are as follows:

Type	Description
Risk appetite	Meeting regulatory and set internal risk limits for liquidity and funding.
Policies	How we manage liquidity and funding across RBS.
Governance	Management oversight and three lines of defence.

Internal liquidity and funding policies are designed to ensure that RBS:

- Has a clearly stated liquidity and funding risk tolerance:* The liquidity and funding risk tolerance forms part of RBS's bank-wide risk appetite statement, which is overseen by the Board Risk Committee and approved by the RBS Board. The risk appetite statement defines key metrics, risk trigger levels and capacity for liquidity and funding management within RBS. The Board also sets the appetite for funding risk to ensure that stable sources of funding are used to fund RBS's core assets. RBS monitors its liquidity positions against these risk tolerances on a daily basis. In setting risk limits the Board considers the nature of RBS's activities, overall risk appetite, market best practice and regulatory compliance.
- Has in place strategies, policies and practices to ensure that RBS maintains sufficient liquidity:* the risk management framework determines the sources of liquidity risks and the steps that can be taken when these risks exceed certain monitored limits. These steps include when and how to use the liquid asset portfolio, and other balance sheet actions that can be undertaken. The Asset and Liability Management Committee (ALCo), and by delegation the ALCo Technical Committee, oversees the implementation of liquidity and funding management across RBS within set risk appetite.
- Incorporates liquidity costs, benefits and risks in product pricing and performance management:* RBS uses internal funds transfer pricing to ensure liquidity costs are reflected in the measurement of business performance, and to correctly incentivise the business to source the most appropriate mix of funding.





## Business review **Capital and risk management**

### Liquidity and funding risk **continued**

#### Regulatory oversight and liquidity framework\*

RBS operates across multiple jurisdictions and is subject to a number of regulatory regimes, with the key metrics being:

Ratio	Exposure type	Description
Liquidity coverage ratio	Liquidity profile	Coverage of 30 day net cash outflows in stress - effective from 1 October 2015.
Net stable funding ratio	Structural funding profile	Required and available stable funding sources less than and greater than 1 year timeline. Effective from 1 January 2018.

The principal regulator, the PRA, has a comprehensive set of liquidity regulations which implement the Capital Requirements Directive (CRD) IV liquidity regime in the UK. To comply with the PRA regulatory framework, RBS undertakes the following:

Activity	Description
Individual Liquidity Adequacy Assessment Process (ILAAP)	An ongoing exercise to comply with best practice and regulatory standards for liquidity management.
L-SREP	An annual Liquidity Supervisory Review and Evaluation Process (L-SREP) with the PRA, that involves a comprehensive review of the RBS ILAAP, liquidity policies and risk management framework. This results in the settings of the Individual Liquidity Guidance, which influences the size and overall composition of the liquidity portfolio.

#### Regulatory developments

LCR is being introduced on a phased basis and UK banks are initially required to maintain a minimum 90% LCR by 1 January 2017, rising to 100% by 1 January 2018.

The Basel Committee on Banking Supervision (BCBS) published its final recommendations for implementation of the NSFR in October 2014. The proposal included an implementation date of 1 January 2018, by which time banks are expected to meet and maintain an NSFR ratio of 100%. The European Commission (EC) is due to submit a legislative proposal to the European Parliament during 2017 for implementing the NSFR in the European Union (EU). In the meantime, RBS uses the definitions from the BCBS guidelines, and its own internal interpretations, to calculate the NSFR.

### Measurement, monitoring and contingency planning

In implementing the liquidity risk management framework, a suite of tools are used to monitor, limit and stress test the risks within the balance sheet. Set limits control the amount and composition of funding sources, asset and liability mismatches and funding concentrations, in addition to the level of liquidity risk.

\*unaudited

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## Business review **Capital and risk management**

### Liquidity and funding risk **continued**

Liquidity risks are reviewed at significant legal entity and business levels daily, with performance reported to ALCos at least monthly.

Any breach of internal metric limits will set in motion a series of actions and escalations outlined under the RBS Recovery Plan (refer to page 245), which covers all legal entities within the Group. The plan sets out credible recovery options that could be implemented in the event of a severe stress to restore the business to a stable and sustainable position, focussing on addressing the bank's capital and liquidity position.

Two significant legal entities, RBS Securities Inc and The Royal Bank of Scotland International Limited, have been requested by local regulators to maintain separate recover plans to address specific liquidity risks. These plans will be aligned to the 2017 RBS Recovery Plan to ensure they operate consistently in the event of a stress scenario.

### Stress testing\*

Under the liquidity risk management framework RBS maintains the ILAAP, a component of which is an assessment of net stressed liquidity outflows. RBS considers a range of extreme but plausible stress scenarios on cash flows, liquidity resources, profitability, solvency, asset encumbrance and survival horizon.

Type	Description
Idiosyncratic scenario	The market perceives RBS to be suffering from a severe stress event which results in an immediate assumption of increased credit risk or concerns over solvency.
Market-wide scenario	A market stress event affecting all participants in a market through contagion, counterparty failure and other market risks. RBS is impacted under this scenario but no more severely than any other participants with equivalent exposure.
Combined scenario	This scenario models the combined impact of an idiosyncratic and market stress occurring at once. The combined scenario reflects the contingency that a severe name-specific event occurs at RBS in conjunction with a broader market stress, causing wider damage to the market and financial sector and severely impacting funding markets and assets.

RBS uses the most severe combination of these to set the internal stress testing scenario. The results of this enable the bank to set its internal liquidity risk appetite which complements the regulatory LCR requirement.

\*unaudited

## Business review **Capital and risk management**

### Liquidity and funding risk **continued**

#### Liquidity portfolio

The size of the portfolio is determined under the liquidity risk management framework with reference to RBS's liquidity risk appetite.

The majority of the portfolio is centrally managed by RBS Treasury, ring-fenced from the NatWest Markets trading book, and is the ultimate responsibility of the RBS Treasurer. This portfolio is held in the PRA regulated UK Domestic Liquidity Subgroup (UK DoLSub) comprising RBS's five licensed deposit taking UK banks: The Royal Bank of Scotland plc, National Westminster Bank Plc, Ulster Bank Limited, Coutts & Co and Adam & Company PLC.

Two of RBS's significant operating subsidiaries, RBS N.V. and Ulster Bank Ireland DAC, hold locally managed portfolios that comply with local regulations that may differ from PRA rules.

The UK DoLSub liquidity portfolio accounted for 96% of the total liquidity portfolio; this portion is available to meet liquidity needs as they arise across RBS. The remaining liquidity reserves are held within non-UK bank subsidiaries for local use.

Separate from the liquidity portfolio, RBS holds high quality assets to meet payment systems collateral requirements; these are managed by RBS Treasury.

RBS categorises its liquidity portfolio, including its locally managed liquidity portfolios, into primary and secondary liquid assets:

- Primary liquid assets such as cash and balances at central banks, treasury bills and other high quality government and US agency bonds.
- Secondary liquid assets are eligible as collateral for local central bank liquidity facilities, but do not meet the core local regulatory definition. These assets include own-issued securitisations or whole loans that are retained on balance sheet and pre-positioned with a central bank so that they may be converted into additional sources of liquidity at very short notice.

RBS retains a prudent approach to setting the composition of the liquidity portfolio, which is subject to internal policies and limits over quality of counterparty, maturity mix and currency mix. The liquidity value of

the portfolio is determined with reference to current market prices and the haircuts necessary to generate cash from the asset.

<b>Liquidity risk</b>		
<b>Key metrics*</b>		
The table below sets out the key liquidity and related metrics monitored by RBS. Ratios are set out in order of tenor.		
	2016	2015
Liquidity portfolio	£164bn	£156bn
Liquidity coverage ratio (1)	123%	136%
Stressed outflow coverage (2)	139%	227%
Net stable funding ratio (3)	121%	121%
Loan:deposit ratio	91%	89%

Notes:

(1) On 1 October 2015 the LCR became the PRA's primary regulatory liquidity standard. It is a Pillar 1 metric to which the PRA apply Pillar 2 add-ons. UK banks are required to meet a minimum standard of 90% from 1 January 2017, rising to 100% by 1 January 2018. The published LCR excludes Pillar 2 add-ons. RBS calculates the LCR using its own interpretations of the EU LCR Delegated Act, which may change over time and may not be fully comparable with those of other financial institutions.

(2) RBS's liquidity risk appetite is measured by reference to the liquidity portfolio as a percentage of stressed contractual and behavioural outflows under the worst of three severe stress scenarios of a market-wide stress, an idiosyncratic stress and a combination of both in RBS's ILAAP. This assessment is performed in accordance with PRA guidance.

(3) BCBS issued its final recommendations for the implementation of the net stable funding ratio in October 2014, proposing an implementation date of 1 January 2018. Pending further guidelines from the EU and the PRA, RBS uses the definitions and proposals from the BCBS paper and internal interpretations, to calculate the NSFR. Consequently RBS's ratio may change over time and may not be comparable with those of other financial institutions.

\*unaudited



## Business review Capital and risk management

## Liquidity and funding risk continued

## Liquidity portfolio

The table below shows the liquidity portfolio by product, liquidity value and by carrying value. Liquidity value is lower than carrying value as it is stated after discounts applied by the Bank of England and other central banks to instruments, within the secondary liquidity portfolio, eligible for discounting.

	Liquidity value									
	2016					2015				
	31 December			Average		31 December			Average	
	UK			UK		UK			UK	
	DoLSub (1)	Other	Total	DoLSub (1)	Total	DoLSub (1)	Other	Total	DoLSub (1)	Total
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Cash and balances at central banks	66,598	2,542	69,140	56,772	59,489	67,790	1,611	69,401	67,294	69,736
Central and local government bonds										
AAA rated governments	3,936	1,331	5,267	3,692	4,539	3,201	1,098	4,299	4,069	5,263
AA- to AA+ rated governments and US agencies	19,348	1,244	20,592	18,757	21,106	18,238	3,216	21,454	11,462	22,546
Below AA rated governments	—	237	237	—	—	—	—	—	—	46
Local government	—	—	—	—	—	—	—	—	—	12
	23,284	2,812	26,096	22,449	25,645	21,439	4,314	25,753	15,531	27,867
Primary liquidity	89,882	5,354	95,236	79,221	85,134	89,229	5,925	95,154	82,825	97,603
Secondary liquidity (2)	68,007	683	68,690	65,588	66,774	59,201	1,369	60,570	54,131	57,654
Total liquidity value	157,889	6,037	163,926	144,809	151,908	148,430	7,294	155,724	136,956	155,257

Total carrying value	184,136	6,209	190,345				181,240	7,494	188,734		
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## Notes:

(1) The PRA regulated UK DoLSub comprising RBS's five licensed deposit-taking UK banks: The Royal Bank of Scotland plc, National Westminster Bank Plc, Ulster Bank Limited, Coutts & Co and Adam & Company PLC. In addition, certain of RBS's significant operating subsidiaries, RBS N.V. and Ulster Bank Ireland DAC, hold managed portfolios that comply with local regulations that may differ from PRA rules.

(2) Comprises assets eligible for discounting at the Bank of England and other central banks.

The table below shows the liquidity value of the liquidity portfolio by currency.					
	GBP	USD	EUR	Other	Total
Total liquidity portfolio	£m	£m	£m	£m	£m
2016	128,614	9,582	24,833	897	163,926
2015	110,289	20,861	24,574		+55,724

## Business review **Capital and risk management**

### Liquidity and funding risk *continued*

#### Funding risk

The composition of RBS's balance sheet is a function of the broad array of product offerings and markets served by its core businesses. The structural composition of the balance sheet is augmented as needed through active management of both asset and liability portfolios. The objective of these activities is to optimise the liquidity profile, while ensuring adequate coverage of all cash requirements under extreme stress conditions.

RBS's asset and liability types broadly match. Customer deposits provide more funding than customer loans utilise; repurchase agreements are largely covered by reverse repurchase agreements; interbank lending and funding largely nets off and this gap has narrowed over the past five years; and derivative assets are largely netted against derivative liabilities.

#### Key funding metrics

The table below summarises the key funding metrics.

	Short-term wholesale funding (1)		Total wholesale funding		Net inter-bank funding (2)		
	Excluding derivative collateral	Including derivative collateral	Excluding derivative collateral	Including derivative collateral	Deposits	Loans (3)	Net inter-bank funding
	£bn	£bn	£bn	£bn	£bn	£bn	£bn
2016 total	13.9	34.6	59.3	80.0	12.6	(10.6)	2.0
2015 total	17.2	37.6	58.7	79.1	7.7	(7.3)	0.4

Notes:

- (1) Short-term wholesale funding is funding with a residual maturity of less than one year.
- (2) Excludes derivative cash collateral.
- (3) Primarily short-term balances.



## Business review Capital and risk management

## Liquidity and funding risk continued

Funding sources						
The table below shows the carrying values of the principal funding sources.						
	2016			2015		
	Short-term	Long-term		Short-term	Long-term	
	less than	more than		less than	more than	
	1 year	1 year	Total	1 year	1 year	Total
By product	£m	£m	£m	£m	£m	£m
Deposits by banks						
Derivative cash collateral	20,674	—	20,674	20,367	—	20,367
Other deposits (1)	6,130	6,513	12,643	7,336	359	7,695
	26,804	6,513	33,317	27,703	359	28,062
Debt securities in issue						
Commercial paper and certificates of deposit	3,205	3	3,208	742	202	944
Medium-term notes	3,388	15,233	18,621	6,639	15,540	22,179
Covered bonds	96	3,839	3,935	2,171	3,414	5,585
Securitisations	—	1,481	1,481	4	2,438	2,442
	6,689	20,556	27,245	9,556	21,594	31,150
Subordinated liabilities	1,062	18,357	19,419	323	19,524	19,847
Notes issued	7,751	38,913	46,664	9,879	41,118	50,997
Wholesale funding	34,555	45,426	79,981	37,582	41,477	79,059
Customer deposits						
Derivative cash collateral (2)	11,487	—	11,487	10,373	—	10,373
Financial institution deposits	52,292	668	52,960	45,134	1,226	46,360
Personal deposits	162,958	1,877	164,835	154,066	3,212	157,278
Corporate deposits	123,495	1,095	124,590	130,514	1,466	131,980
Total customer deposits	350,232	3,640	353,872	340,087	5,904	345,991
Total funding excluding repos	384,787	49,066	433,853	377,669	47,381	425,050
Total repos	32,335	—	32,335	37,378	—	37,378
Total funding including repos	417,122	49,066	466,188	415,047	47,381	462,428

## Notes:

(1) Includes £1.3 billion (2015 - £0.7 billion) relating to RBS's participation in central bank financing operations under the European Central Bank's Targeted Long Term Refinancing Operations.

(2) Cash collateral includes £10,002 million (2015 - £9,504 million) from financial institutions.

Repos		
The table below analyses repos by counterparty type.		
	2016	2015
	£m	£m
Financial institutions		
- central and other banks	5,239	10,266
- other financial institutions	25,652	20,130
Other corporate	1,444	6,982
Total	32,335	37,378

## Key point

- Reverse repos at 31 December 2016 were £41.8 billion (2015 - £39.9 billion). Fair value of securities received as collateral for reverse repos was £41.8 billion (2015 - £39.8 billion), of which £30.5 billion (2015 - £29.0 billion) had been rehypothecated for RBS's own transactions, in line with normal market practice.

**Business review** Capital and risk management

<b>Liquidity and funding risk continued</b>									
<b>Loan:deposit ratios and funding surplus/(gap)</b>									
The table below shows loans and advances to customers, customer deposits, loan:deposit ratios (LDR) and funding surplus/(gap).									
	2016				2015*				
	Loans and advances to customers (1)	Customer deposits (2)	LDR (%)	Funding surplus/(gap) (3)	Loans and advances to customers (1)	Customer deposits (2)	LDR (%)	Funding surplus/(gap) (3)	
	£m	£m	%	£m	£m	£m	%	£m	
UK PBB	132,107	145,826	91	13,719	119,705	137,840	87	18,135	
Ulster Bank Rol	18,930	16,109	117	(2,821)	16,673	13,102	127	(3,571)	
Commercial Banking	100,069	97,886	102	(2,183)	91,286	88,859	103	(2,427)	
Private Banking	12,157	26,560	46	14,403	11,193	23,084	48	11,891	
RBSI	8,774	25,176	35	16,402	7,337	21,264	35	13,927	
NatWest Markets	17,417	8,384	nm	(9,033)	16,076	5,674	nm	(10,402)	
Capital Resolution	12,767	9,499	134	(3,268)	23,632	26,006	91	2,374	
W&G	20,546	24,166	85	3,620	20,016	24,085	83	4,069	
Central items & other	256	266	nm	10	416	3,272	nm	2,856	
Disposal groups	—	—	—	—	1,639	2,805	58	1,166	
	323,023	353,872	91	30,849	307,973	345,991	89	38,018	

## Notes:

- (1) Excludes reverse repo agreements and net of impairment provisions.
- (2) Excludes repo agreements.
- (3) Calculated as customer deposits less loans and advances to customers.
- (4) nm = not meaningful.

## Key points

- The loan:deposit ratio was 91%, up from 89% at the end of 2015 as loans grew more than deposits.
- Loan growth was driven by mortgage lending in UK PBB and corporate lending in Commercial Banking.
- Deposit growth continued in 2016, particularly in UK PBB, Commercial Banking, Private Banking and RBSI. These increases were partially offset by deposit reductions in Capital Resolution as the business continued to run down, and the sale of the International Private Banking business.

\*unaudited



## Business review Capital and risk management

Liquidity and funding risk continued										
The table below shows RBS's principal funding sources.										
By currency	2016					2015				
	GBP £m	USD £m	EUR £m	Other £m	Total £m	GBP £m	USD £m	EUR £m	Other £m	Total £m
Deposits by banks	11,143	2,423	17,827	1,924	33,317	5,301	3,570	17,651	1,540	28,062
Debt securities in issue										
Certificates of deposit (CDs)	1,401	—	1,807	—	3,208	892	50	2	—	944
Medium-term notes (MTNs)	1,457	6,549	9,512	1,103	18,621	2,695	5,744	11,754	1,986	22,179
Covered bonds	1,134	—	2,801	—	3,935	1,079	—	4,506	—	5,585
Securitisations	175	302	1,004	—	1,481	403	713	1,326	—	2,442
	4,167	6,851	15,124	1,103	27,245	5,069	6,507	17,588	1,986	31,150
Subordinated liabilities	962	12,367	5,176	914	19,419	1,028	12,848	4,963	1,008	19,847
Wholesale funding	16,272	21,641	38,127	3,941	79,981	11,398	22,925	40,202	4,534	79,059
% of wholesale funding	20%	27%	48%	5%	100%	14%	29%	51%	6%	100%
Customer deposits	299,693	17,791	33,144	3,244	353,872	282,152	20,912	35,680	7,247	345,991
Total funding excluding repos	315,965	39,432	71,271	7,185	433,853	293,550	43,837	75,882	11,781	425,050
% of total funding	73%	9%	16%	2%	100%	69%	10%	18%	3%	100%

## Notes issued - residual maturity profile by note type

The table below shows RBS's debt securities in issue and subordinated liabilities by residual maturity.

2016	Debt securities in issue							
	Commercial paper and CDs	MTNs	Covered bonds	Securitisations	Total	Subordinated liabilities	Total notes	Total notes
							in issue	in issue
	£m	£m	£m	£m	£m	£m	£m	%

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Less than 1 year	3,205	3,388	96	—	6,689	1,062	7,751	17
1-3 years	3	4,937	871	—	5,811	2,814	8,625	18
3-5 years	—	3,323	1,883	—	5,206	483	5,689	12
More than 5 years	—	6,973	1,085	1,481	9,539	15,060	24,599	53
Total including disposal groups	3,208	18,621	3,935	1,481	27,245	19,419	46,664	100
<b>2015</b>								
Less than 1 year	742	6,639	2,171	4	9,556	323	9,879	20
1-3 years	202	5,567	758	—	6,527	2,801	9,328	18
3-5 years	—	6,203	1,627	—	7,830	317	8,147	16
More than 5 years	—	3,770	1,029	2,438	7,237	16,406	23,643	46
Total	944	22,179	5,585	2,442	31,150	19,847	50,997	100

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## Business review **Capital and risk management**

### Liquidity and funding risk *continued*

#### Maturity analysis

The contractual maturity of balance sheet assets and liabilities reflects the maturity transformation role banks perform, lending long-term but obtaining funding predominantly through short-term liabilities such as customer deposits. In practice, the behavioural profiles of many liabilities exhibit greater stability and longer maturity than the contractual maturity. This is particularly true of many types of retail and corporate deposits which, despite being repayable on demand or at short notice, have demonstrated very stable characteristics even in periods of acute stress. In its analysis to assess and manage asset and liability maturity gaps RBS determines the expected customer behaviour through qualitative and quantitative techniques, incorporating observed customer behaviours over long periods of time. This analysis is subject to governance through ALCos down to a segment level.

Behavioural analysis*																
Contractual maturity analysis and net behavioural funding surplus/(gap) are set out below.																
Behavioural maturity					Contractual maturity											
Net surplus/(gap)					Net surplus/(gap)				Loans to customers				Customer accounts			
Less than		Greater than			Less than		Greater than		Less than		Greater than		Less than		Greater than	
1 year	1-5 years	5 years	Total	1 year	1-5 years	5 years	Total	1 year	1-5 years	5 years	Total	1 year	1-5 years	5 years	Total	
£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn
UK																
PBB	3	(3)	14	14	132	(27)	(91)	14	12	29	91	132	144	2		—146
UB Rol	—	(3)	—	(3)	14	(5)	(12)	(3)	1	6	12	19	15	1		—16
CB	(9)	22	(15)	(2)	60	(42)	(20)	(2)	38	42	20	100	98	—		—98
PB	1	2	12	15	22	(4)	(3)	15	5	4	3	12	27	—		—27
RBSI	2	7	7	16	21	(2)	(3)	16	4	2	3	9	25	—		—25
NWM																
(1)	3	(12)	—	(9)	(7)	(2)	—	(9)	15	2	—	17	8	—		—8
CR (2)	—	—	(3)	(3)	2	(2)	(3)	(3)	7	3	3	13	9	1		—10
W&G	1	—	2	3	20	(7)	(10)	3	4	7	10	21	24	—		—24
Total	1	13	17	31	264	(91)	(142)	31	86	95	142	323	350	4		—354
<b>2015</b>																
UK	8	1	9	18	123	(24)	(81)	18	12	27	81	120	135	3		—138

PBB																
UB Rol	3	(4)	(3)	(4)	11	(4)	(11)	(4)	1	5	11	17	12	1		—13
CB	5	15	(22)	(2)	55	(37)	(20)	(2)	34	37	20	91	89		—	—89
PB	1	3	8	12	18	(4)	(2)	12	5	4	2	11	23		—	—23
RBSI	1	5	8	14	19	(3)	(2)	14	2	3	2	7	21		—	—21
NWM (1)	(3)	(7)		—(10)	(9)	(1)		—(10)	14	2		—16	5	1		— 6
CR (2)	4	(1)	(1)	2	13	(6)	(5)	2	12	7	5	24	25	1		—26
W&G	1	2	1	4	20	(7)	(9)	4	4	7	9	20	24		—	—24
Central	4		—	— 4	4		—	— 4	2		—	— 2	6		—	— 6
Total	24	14		—38	254	(86)	(130)	38	86	92	130	308	340	6		—346

Notes:

- (1) NatWest Markets
- (2) Capital Resolution

### Key points

- The net customer funding surplus has decreased by £7 billion during 2016 to £31 billion, driven by loan growth in addition to deposit rundown in Capital Resolution, partially offset by underlying deposit growth.
- Customer deposits and customer loans are broadly matched from a behavioural perspective.
- The net funding surplus in 2016 is concentrated in the longer dated buckets, reflecting the stable characteristics of customer deposits and lending that is behaviourally shorter dated.

\*unaudited



## Business review Capital and risk management

### Liquidity and funding risk continued

#### Contractual maturity

The following table shows the residual maturity of financial instruments, based on contractual date of maturity. Held-for-trading (HFT) assets and liabilities have been excluded from the maturity analysis in view of their short-term nature and are shown in total in the table below. Hedging derivatives are included within the relevant maturity bands.

2016	Other than held-for-trading									HFT	Total
	Less than 1 month	1-3 months	3-6 months	6 months	Subtotal	1-3 years	3-5 years	More than 5 years	Total excluding HFT		
				-1 year				5 years			
	£m	£m	£m	£m	£m	£m	£m	£m	£m		
Cash and balances at central banks	74,250	—	—	—	74,250	—	—	—	74,250	—	74,250
Bank reverse repos	1,543	197	—	—	1,740	—	—	—	1,740	11,120	12,860
Customer reverse repos	338	1,362	641	—	2,341	—	—	—	2,341	26,586	28,927
Loans to banks	9,521	237	655	38	10,451	46	—	1	10,498	6,780	17,278
Loans to customers	33,832	8,042	9,314	18,876	70,064	52,954	42,690	139,811	305,519	17,504	323,023
Personal	4,341	2,476	3,332	6,513	16,662	20,212	17,050	111,628	165,552	340	165,892
Corporate	25,112	4,859	4,475	7,243	41,689	28,338	24,222	26,148	120,397	3,702	124,099
Financial institutions (excluding banks)	4,379	707	1,507	5,120	11,713	4,404	1,418	2,035	19,570	13,462	33,032
Debt securities	1,911	2,279	3,016	3,138	10,344	10,103	7,356	20,215	48,018	24,504	72,522
Equity shares	—	—	—	—	—	—	—	537	537	166	703
Settlement balances	5,526	—	—	—	5,526	—	—	—	5,526	—	5,526
Derivatives	455	—	—	1,178	1,633	2,319	531	306	4,789	242,192	246,981

Total financial assets												
excluding disposal groups	127,376	12,117	13,626	23,230	176,349	65,422	50,577	160,870	453,218	328,852	782,070	
Disposal groups	13	—	—	—	13	—	—	—	13	—	13	
Total financial assets	127,389	12,117	13,626	23,230	176,362	65,422	50,577	160,870	453,231	328,852	782,083	
Bank repos	917	197	—	—	1,114	—	—	—	1,114	4,125	5,239	
Customer repos	3,910	—	—	—	3,910	—	—	—	3,910	23,186	27,096	
Deposits by banks	5,632	462	31	2	6,127	1,284	5,000	150	12,561	20,756	33,317	
Customer accounts	324,109	5,785	3,665	4,485	338,044	2,846	167	37	341,094	12,778	353,872	
Personal	155,417	2,971	1,689	2,881	162,958	1,877	—	—	164,835	—	164,835	
Corporate	119,156	1,759	1,493	758	123,166	769	98	34	124,067	2,008	126,075	
Financial institutions												
(excluding banks)	49,536	1,055	483	846	51,920	200	69	3	52,192	10,770	62,962	
Debt securities in issue	1,061	1,040	2,170	1,987	6,258	5,586	4,808	8,979	25,631	1,614	27,245	
Settlement balances	3,645	—	—	—	3,645	—	—	—	3,645	—	3,645	
Short positions	—	—	—	—	—	—	—	—	—	—	—	22,077
Derivatives	—	205	405	—	610	1,329	584	1,534	4,057	232,418	236,475	
Subordinated liabilities	684	162	115	101	1,062	2,814	483	15,060	19,419	—	19,419	
Other liabilities	2,028	—	—	—	2,028	—	—	—	2,028	—	2,028	
Total financial liabilities	341,986	7,851	6,386	6,575	362,798	13,859	11,042	25,760	413,459	316,954	730,413	

## Business review Capital and risk management

Liquidity and funding risk continued											
2015	Other than held-for-trading									HFT	Total
	Less than 1 month	1-3 months	3-6 months	6 months - 1 year	Subtotal	1-3 years	3-5 years	More than 5 years	Total excluding HFT		
	£m	£m	£m	£m	£m	£m	£m	£m	£m		
Cash and balances											
at central banks	79,939	—	—	—	79,939	—	—	—	79,939	—	79,939
Bank reverse repos	535	748	—	—	1,283	—	—	—	1,283	11,069	12,352
Customer reverse repos	26	—	—	—	26	—	—	—	26	27,532	27,558
Loans to banks	7,425	217	17	27	7,686	—	21	1	7,708	11,295	19,003
Loans to customers	34,439	8,039	8,501	17,243	68,222	50,822	41,151	130,219	290,414	17,559	307,973
Personal	5,875	2,575	3,277	5,805	17,532	19,113	15,640	99,778	152,063	35	152,098
Corporate	23,976	4,932	4,072	7,699	40,679	26,460	24,046	28,126	119,311	4,644	123,955
Financial institutions											
(excluding banks)	4,588	532	1,152	3,739	10,011	5,249	1,465	2,315	19,040	12,880	31,920
Debt securities	3,246	2,766	5,662	2,866	14,540	7,199	6,932	17,988	46,659	35,857	82,516
Equity shares	—	—	—	—	—	—	—	725	725	660	1,385
Settlement balances	4,116	—	—	—	4,116	—	—	—	4,116	—	4,116
Derivatives	484	—	—	1,106	1,590	1,571	433	231	3,825	258,719	262,544
Total financial assets	130,210	11,770	14,180	21,242	177,402	59,592	48,537	149,164	434,695	362,691	797,386



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Bank repos	609	—	—	—	609	—	—	—	609	9,657	10,266
Customer repos	1,542	—	—	—	1,542	—	—	—	1,542	25,570	27,112
Deposits by banks	6,023	536	30	739	7,328	—	—	265	7,593	20,469	28,062
Customer accounts	315,641	5,101	4,023	4,455	329,220	4,372	427	61	334,080	11,911	345,991
Personal	145,786	3,131	1,826	3,323	154,066	3,199	13	—	157,278	—	157,278
Corporate	126,306	1,314	1,689	830	130,139	786	364	57	131,346	1,503	132,849
Financial institutions (excluding banks)	43,549	656	508	302	45,015	387	50	4	45,456	10,408	55,864
Debt securities in issue	442	3,410	1,523	2,727	8,102	5,666	7,513	5,986	27,267	3,883	31,150
Settlement balances	3,397	—	—	—	3,397	—	—	—	3,397	—	3,397
Short positions	—	—	—	—	—	—	—	—	—	20,809	20,809
Derivatives	—	144	291	—	435	605	413	1,150	2,603	252,130	254,733
Subordinated liabilities	4	162	88	69	323	2,801	317	16,406	19,847	—	19,847
Other liabilities	1,886	—	—	—	1,886	—	—	—	1,886	—	1,886
Total financial liabilities	329,544	9,353	5,955	7,990	352,842	13,444	8,670	23,868	398,824	344,429	743,253

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**Business review** Capital and risk management**Liquidity and funding risk** continued**Encumbrance**

RBS evaluates the extent to which assets can be financed in a secured form (encumbrance), but certain asset types lend themselves more readily to encumbrance. The typical characteristics that support encumbrance are an ability to pledge those assets to another counterparty or entity through operation of law without necessarily requiring prior notification, homogeneity, predictable and measurable cash flows, and a consistent and uniform underwriting and collection process. Retail assets including residential mortgages, credit card receivables and personal loans display many of these features.

RBS categorises its assets into three broad groups; assets that are:

- Already encumbered and used to support funding currently in place via own asset securitisations, covered bonds and securities repurchase agreements.
- Pre-positioned with central banks as part of funding schemes and those encumbered under such schemes.
- Not currently encumbered. In this category, RBS has in place an enablement programme which seeks to identify assets which are capable of being encumbered and to identify the actions to facilitate such encumbrance whilst not impacting customer relationships or servicing.

Balance sheet encumbrance										
	Encumbered as a result of transactions with				Pre-positioned		Unencumbered assets not pre-positioned			
	counterparties other than central banks				encumbered		with central banks			
	Covered		Repos &		assets held					
	bonds &	Derivatives	similar	Total	at	Readily	Other	Cannot	Total	Total
	securitisations		(2)	(3)	banks	available	available	be used		
	(1) £bn	£bn	£bn	£bn	£bn	(5) £bn	(6) £bn	(7) £bn	£bn	£bn
2016										
Cash and balances										
at central banks	—	—	4.0	4.0	—	70.2	0.1	—	70.3	74.3

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Loans and advances											
- banks	1.2	6.7	0.7	8.6		8.1	0.5	0.1	8.7	17.3	
- residential mortgages											
- UK	10.1			10.1	97.9	19.8	9.5		29.3	137.3	
- Irish	7.1			7.1	1.5	5.7		0.1	5.8	14.4	
- US	0.3			0.3						0.3	
- credit cards						4.0	0.3		4.3	4.3	
- personal loans						6.2	3.3		9.5	9.5	
- other	0.1	17.0		17.1	6.1	5.9	105.6	22.5	134.0	157.2	
Reverse repos									41.8	41.8	
Debt securities		2.8	35.4	38.2		33.2	0.8	0.3	34.3	72.5	
Equity shares			0.1	0.1		0.3	0.2	0.1	0.6	0.7	
Settlement balances								5.5	5.5	5.5	
Derivatives								247.0	247.0	247.0	
Intangible assets								6.5	6.5	6.5	
PP&E							3.1	1.5	4.6	4.6	
Deferred tax								1.8	1.8	1.8	
Other assets								3.7	3.7	3.7	
	18.8	26.5	40.2	85.5	105.5	153.4	123.4	330.9	607.7	798.7	

For the notes to this table refer to the following page.

## Business review Capital and risk management

Liquidity and funding risk continued										
	Encumbered as a result of transactions with counterparties other than central banks				Pre-positioned & encumbered assets held at central banks (4)		Unencumbered assets not pre-positioned with central banks			
	Covered bonds & securitisation (1)	Derivatives (2)	Repos & similar (2)	Total (2)		Readily available (5)	Other available (6)	Cannot be used (7)	Total (8)	Total (9)
2015	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn
Cash and balances at central banks	—	—	2.5	2.5	—	77.3	0.1	—	77.4	79.9
Loans and advances										
- banks	1.5	11.0	0.4	12.9	—	4.3	1.3	0.5	6.1	19.0
- residential mortgages										
- UK	15.2	—	—	15.2	81.3	18.6	8.4	—	27.0	123.5
- Irish	7.4	—	—	7.4	1.2	4.0	—	0.1	4.1	12.7
- credit cards	—	—	—	—	—	4.4	0.2	—	4.6	4.6
- personal loans	—	—	—	—	—	6.0	5.1	—	11.1	11.1
- other	0.8	17.2	0.4	18.4	8.3	8.9	98.4	22.1	129.4	156.1
Reverse repos	—	—	—	—	—	—	—	—	39.9	39.9
Debt securities	—	2.9	31.9	34.8	—	47.2	0.5	—	47.7	82.5
Equity shares	—	—	—	—	—	0.8	0.2	0.4	1.4	1.4
Settlement balances	—	—	—	—	—	—	—	—	4.1	4.1
Derivatives	—	—	—	—	—	—	—	—	262.5	262.5
Intangible assets	—	—	—	—	—	—	—	—	6.5	6.5
PP&E	—	—	0.3	0.3	—	—	3.1	1.1	4.2	4.5

Deferred tax	—	—	—	—	—	—	—	—	2.6	2.6	2.6
Other assets	—	—	—	—	—	—	—	—	4.5	4.5	4.5
	24.9	31.1	35.5	91.5	90.8	171.5	117.3	344.3	633.1	815.4	

## Notes:

- (1) Covered bonds and securitisations include securitisations, conduits and covered bonds.
- (2) Repos and other secured deposits, cash, coin and nostro balance held with the Bank of England as collateral against deposits and notes in circulation are included here rather than within those positioned at the central bank as they are part of normal banking operations.
- (3) Total assets encumbered as a result of transactions with counterparties other than central banks are those that have been pledged to provide security and are therefore not available to secure funding or to meet other collateral needs.
- (4) Assets pre-positioned at the central banks include loans provided as security as part of funding schemes and those encumbered under such schemes.
- (5) Readily available for encumbrance: including assets that have been enabled for use with central banks but not pre-positioned; cash and high quality debt securities that form part of RBS's liquidity portfolio and unencumbered debt securities.
- (6) Other assets that are capable of being encumbered are those assets on the balance sheet that are available for funding and collateral purposes but are not readily realisable in their current form. These assets include loans that could be prepositioned with central banks but have not been subject to internal and external documentation review and diligence work.
- (7) Cannot be used includes:
- (a) Derivatives, reverse repurchase agreements and trading related settlement balances.
- (b) Non-financial assets such as intangibles, prepayments and deferred tax.
- (c) Loans that cannot be pre-positioned with central banks based on criteria set by the central banks, including those relating to date of origination and level of documentation.
- (d) Non-recourse invoice financing balances and certain shipping loans whose terms and structure prohibit their use as collateral.
- (8) In accordance with market practice, RBS employs securities recognised on the balance sheet, and securities received under reverse repo transactions as collateral for repos. Secured derivative liabilities reflect net positions that are collateralised by balance sheet assets.



## **Business review** **Capital and risk management**

### **Business risk\***

#### **Definition and sources of risk**

Business risk arises as a result of RBS's exposure to the macro-environment, to the competitive environment, and to technological changes. In addition, internal factors such as volatility in sales volumes, and input costs, and other operational risks such as RBS's ability to assess the business operating environment, or to execute its chosen strategy, contribute to business risk.

#### **Key developments in 2016**

The Board has ultimate responsibility for business risk and for approving strategic plans, initiatives and changes to strategic direction.

RBS's strategic planning process is managed by Strategy and Corporate Development. The Risk and Finance functions are key contributors to strategic planning.

Responsibility for the day-to-day management of business risk lies primarily with the franchises, with oversight by the Finance function. The franchises are responsible for delivery of their business plans and the management of such factors as pricing, sales volumes, marketing expenditure and other factors that can introduce volatility into earnings.

Business risk is identified and managed at the product and transaction level. Estimated revenue, costs and capital are key considerations in the design of any new product or in any new investment decision.

Business risk is reported, assessed and challenged at every

governance level within the organisation. Each franchise monitors its financial performance relative to plans and reports this on a regular basis to the finance directors of each franchise.

RBS operates a monthly rolling forecasting process to identify projected changes in, or risks to, key financial metrics, and ensures appropriate actions are taken.

RBS continued to reduce its business risk profile by implementing its strategic plan to shift the business mix towards the UK and retail and commercial banking segments, with higher risk activities in NatWest Markets and Capital Resolution curtailed through disposals and run-downs.

RBS also continued with its simplification and cost reduction programmes.

Market conditions have become more volatile following the EU referendum result, and RBS has been closely monitoring and assessing the operating environment and its impact on business risk.

\*unaudited



## **Business review** Capital and risk management

### **Reputational risk\***

#### **Definition and sources of risk**

Reputational risk can arise from the conduct of employees; activities of customers and the sectors and countries in which they operate; provision of products and transactions; as well as operations and infrastructure.

#### **Key developments in 2016**

Reputational risk has Board-level oversight reinforced by a Reputational Risk Policy. The Board Risk Committee and Board Sustainable Banking Committee are responsible for overseeing how RBS manages its reputation. The Board's oversight of reputational issues is supported by the senior RBS-wide Reputational Risk Forum (RRF) which opines on cases that represent a material reputational risk to the whole organisation. The RRF, which has delegated authority from the Executive Risk Forum (ERF), also acts as a central forum to review sector or theme-specific reputational risk acceptance positions, including Environmental, Social and Ethical risk positions.

RBS articulated its appetite for reputational risk through the implementation of a qualitative reputational risk appetite statement and framework. This has improved the identification, assessment and management of customers and issues that present a material reputational risk, resulting in a greater awareness and focus on the importance of this risk and an increase in the number of cases brought to franchise and RBS-wide Reputational Risk fora.

Reputational risk is mitigated through the policy and governance framework, with ongoing staff training to ensure early identification, assessment and escalation of material issues.

The most material threats to RBS's reputation continued to originate from historical and more recent conduct issues. As a result, RBS has been the subject of investigations and reviews by a number of its regulators, some of which have resulted in fines and public censure. Refer to the Litigation, investigations and reviews section of Note 31 on the consolidated accounts on page 459.

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## Business review **Capital and risk management**

### Conduct and regulatory risk\*

#### Definition

Conduct and regulatory risk is the risk that the behaviour of RBS and its staff towards customers, or in the markets in which it operates, leads to unfair or inappropriate customer outcomes and results in reputational damage, financial loss or both. The damage or loss may be the result of a failure to comply with (or adequately plan for changes to) relevant official sector policy, laws, regulations, or major industry standards, or of failing to meet customers' or regulators' expectations. All the disclosures in this section are unaudited.

#### Sources of risk

Conduct and regulatory risk exists across all stages of RBS's relationships with its customers, from the development of its business strategies, to post-sales processes. The activities through which conduct risk may arise are varied and include product design, marketing and sales, complaint handling, staff training, and handling of confidential Insider Information. Conduct risk also exists if RBS does not take effective action to prevent fraud, bribery and money laundering. Regulatory risk arises from the regulatory, business or operating environment and from RBS's response to it. As set out in the Litigation, investigations and reviews section in Note 30 on the consolidated accounts, RBS and certain members of staff are party to legal proceedings and are subject to investigation and other regulatory action in the UK, the US and other jurisdictions.

#### Key regulatory and conduct developments in 2016

RBS continued to remediate historical conduct issues, while also focusing its customer-facing businesses and support functions around the needs of its customers including the delivery of a number of regulatory change programmes. Conduct and litigation costs were £5.9 billion in 2016 compared with £3.6 billion in 2015.

- The remediation of PPI continued, with the FCA due to update on policy during the first quarter of 2017. Provisioning was increased by £601 million principally to cover the potential pushing back of the time bar.
- On 8 November, RBS announced it would be taking two steps in relation to the FCA's S166 review into GRG, firstly to implement a complaints process with independent third-party oversight for all customers in scope and secondly to provide an automatic refund of complex fees paid by in-scope SME customers. The FCA review is ongoing and the final report findings are awaited.

- RBS made a provision for the industry-wide review by the Central Bank of Ireland on the treatment of customers who were sold mortgages with a tracker interest rate or with a tracker interest rate entitlement.
- Following the outcome of the FCA's thematic review on Packaged Bank Accounts, NatWest was required to provide an attestation that it is compliant with FCA rules.
- The application of the revised Markets in Financial Instruments Directive and Regulation (MiFID II/MiFIR) was delayed by a year to January 2018, while UK and EU regulators published several consultations on its implementation.
- The Market Abuse Regime took effect from July 2016.
- The UK's Senior Managers and Certification regime was successfully implemented.
- Work continues on the UK's ring-fencing requirements.

\*unaudited

**Business review** [Capital and risk management](#)

**Conduct and regulatory risk\*** [continued](#)

The Conduct Risk Appetite Framework was established in 2015 and continues to be embedded across RBS.

The Conduct Risk Appetite Framework is divided into seven pillars, ensuring that conduct risk exposures are understood and managed in accordance with agreed risk appetite. The Conduct Risk Appetite Framework requires regular and consistent assessment through periodic Conduct Performance Assessment, reporting of risk exposures and the operating effectiveness of controls, across the businesses.

Product profitability and  
pricing structures are fair  
and transparent

Other activities undertaken to address regulatory risk included:

- Migration to simpler, principle-based policies with accountable executives identified and roles, accountabilities and responsibilities defined;
- Roll-out of RBS-wide policies, processes and strategic systems to identify and manage conflicts of interest better;
- Enhancement of the RBS-wide surveillance programme; and
- Significant investment in anti-money laundering controls, governance and training.

\*unaudited

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## Business review **Capital and risk management**

### Conduct and regulatory risk\* continued

#### Governance

RBS defines appropriate standards of conduct and drives adherence to those standards through its framework for managing conduct and regulatory risk. The Board and its senior committees receive updates on conduct risk exposures and action plans through regular reporting.

Key elements of the governance structure are set out below:

- The Conduct & Regulatory Affairs (C&RA) Executive Committee considers emerging material risks and issues, and implements Board and Executive Committee risk management policy decisions;
- The Financial Crime Accountable Executive Committee (accountable to the Executive Risk Forum) ensures that the customer businesses and the Services function fulfil strategic objectives by identifying and managing their financial crime risks effectively; and
- The Mandatory Change Advisory Committee, reports to the Bank-Wide Investment Committee, acting as the reception committee for reviewing externally mandated changes that may affect RBS. It also recommends appropriate responses, including change implementation activities. In doing so, it determines which businesses or functions own individual risks; and commissions and reviews impact assessments from customer businesses and functions.

Plans to merge parts of the C&RA function with Risk management were announced in December 2016 to take effect from 1 January 2017. The change is designed to take advantage of synergies across the risk, conduct and regulatory agendas. Regulatory Affairs will move to Corporate Governance & Secretariat, and Remediation and Complaints will move to Services' Chief Operating Office.

#### Controls and assurance

Under the Policy framework, there are 19 conduct risk policies. Each policy is designed to provide both high-level direction and RBS-wide requirements. The policies ensure RBS meets its regulatory obligations. They also provide the necessary clarity to staff on their conduct obligations.

RBS's Regulatory Affairs department separately oversees regulatory developments, interactions with regulators and regulatory approvals for individuals.



Assurance and monitoring activities are essential to measure the extent to which RBS manages its delivery of specific customer outcomes.

Risk assessments are used to identify material conduct risks and implement key controls across all business areas. The risk assessment process is designed to confirm that risks are effectively managed and prioritised, as well as ensure controls are tested.

Scenario analysis is used to assess the impact of extreme but plausible conduct risks including financial crime. The scenarios assess the exposures that could significantly affect RBS's financial performance or reputation and are an important component in the operational risk framework and capital model.

\*unaudited

## Business review **Capital and risk management**

### Conduct and regulatory risk\* **continued**

#### Risk appetite

The conduct risk appetite framework has now been embedded and the Conduct Performance Assessment, which forms part of it, facilitates a consistent approach across RBS for assessing conduct and regulatory risk.

Risk appetite statements, in line with RBS-wide risk appetite, articulate the levels of risk which franchises and functions must not exceed. Where businesses are operating outside of appetite, the problems are addressed through agreed risk mitigation plans.

#### Risk monitoring and measurement

The Board and senior RBS committees receive updates on conduct risk exposures and action plans through monthly reporting. The reporting is intended to be focused, forward-looking and action-oriented.

The most material conduct matters are reported to the appropriate committees, including the Board, the Group Audit Committee and Board Risk Committee.

An annual Money Laundering Reporting Officer's Report is submitted to the Board and the FCA. This covers RBS's Anti-Money Laundering (AML) framework and the operation and effectiveness of the systems and controls in place to comply with AML laws and regulations. In addition, it covers the systems and controls in place to prevent the financing of terrorism and to ensure compliance with sanctions as well as embargoes and export controls.

The Group Audit Committee is provided with a whistleblowing report on a biannual basis. It details cases by internal reporting categories based on the RBS definition of whistleblowing, which is contained within RBS's Speak Up policy.

The policy encompasses both the legislative definition contained within the Public Interest Disclosure Act 1998 and the regulatory definition within FCA and PRA regulations and guidance. It extends these to include conduct or behaviour which does not meet the expected bank standards documented in Our Code. The whistleblowing report identifies underlying trends and highlights the outcomes of investigations.

Each business within RBS has enhanced its use of management information by linking it to the risk appetite statement. This is required to help ensure appropriate customer outcomes are delivered and that the management information is compliant with the Basel Committee on Banking Supervision's principles for effective risk data aggregation and risk reporting.

### Risk mitigation

Information is communicated to each customer-facing business and function about regulatory developments and discussions with regulators. This helps identify and execute any required mitigating changes to strategy or to business models.

Early identification and effective management of changes in legislation and regulation are critical to the successful mitigation of conduct and regulatory risk. The effects of all changes are managed to ensure timely compliance readiness. Changes assessed as having a 'High' or 'Medium-High' impact are managed closely.

\*unaudited

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## Business review **Capital and risk management**

### Operational risk\*

#### Definition

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems, or external events. It arises from day-to-day operations and is relevant to every aspect of the business.

Operational risk may directly affect customers, lead to financial loss or damage RBS's reputation (for example, a major IT systems failure or fraudulent activity). There can also be a link between operational risk failures and conduct risk issues.

All the disclosures in this section are unaudited.

#### Sources of risk

Operational risk may arise from a failure to manage operations, systems, transactions and assets appropriately. This can take the form of human error, an inability to deliver change adequately or on time, the non-availability of technology services, or the loss of customer data. Fraud and theft are sources of operational risk, as is the impact of natural and man-made disasters. It can also arise from a failure to account for changes in law or regulations or to take appropriate measures to protect assets.

#### Key developments in 2016

During 2016, RBS's operational risk management framework was enhanced with improved links between risk appetite and risk exposures. This underpins an appropriate risk-based approach to operational risk management.

The year also saw a continued focus on the risks arising from the execution of major projects, including the Transformation programme, the restructuring of NatWest Markets (formerly CIB), preparations for the implementation of the Independent Commission on Banking's ring-fencing proposals, the planned divestment of Williams & Glyn, and the impact on RBS's control environment due to cost reduction measures. These are essential to the achievement of RBS's strategic objectives and, accordingly, Operational Risk continued to oversee these, ensuring the associated risks were assessed and understood with mitigating activity in place wherever possible.

There was also a continued strong focus on RBS's enhanced risk and control assessment methodology. This approach enhances understanding of the risk profile for the most critical products and services. As a core aspect of the Controls Transformation Programme, the new approach, building on design in 2015, continued to be rolled out and embedded across the organisation. A significant number of assessments were carried out during 2016 in order to identify and quantify the most material risks to key products and services. Refer to page 278 for further details.

\*unaudited

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## Business review **Capital and risk management**

### Operational risk\* continued

The external fraud threat environment across the industry continued to escalate in 2016, with this trend predicted to continue. RBS has put in place a collective bank-wide response plan to the increased threat. This aligns fraud prevention programmes across the bank with the objective of mitigating the customer and financial impacts of external fraud. The plan successfully delivered key strategic programmes in 2016 that enhanced RBS's fraud prevention and detection capabilities, enabling it to limit the impact of fraudulent activity on its customers. As a result RBS recorded an increase in its fraud detection rates in the second half of 2016. RBS is also supporting an industry-led education initiative in 2017-2018 which will offer advice to help the public protect themselves from preventable financial fraud. The initiative is led by Financial Fraud Action UK Ltd and is being delivered in conjunction with the Home Office, law enforcement and other banks.

The information and cyber security risk facing RBS continues to change in line with the constantly evolving threat environment in which it operates. Internal security improvement programmes continue to progress RBS-wide, developing new, and strengthening existing controls to protect RBS and its customers. RBS continuously develops and utilises pro-active threat management and intelligence processes to understand, manage and mitigate credible threats.

Throughout 2016 RBS has decommissioned a number of internet-facing websites thus reducing the attack surface visible to external parties such as hackers and fraudsters. Improvements have also been made to access controls for RBS systems. Internal training programmes continue to ensure all employees are fully aware of the constant threats facing RBS and remain vigilant to unauthorised attempts by internal or external parties to access systems and data.

### Risk governance

A strong Operational Risk management function is vital to support RBS's ambitions to serve its customers better. Improved management of operational risk against a defined appetite directly supports the strategic risk objective of improving stakeholder confidence and is vital for stability and reputational integrity.

The Operational Risk function, part of the second line of defence, undertakes a leadership role and is tasked with delivering a robust operational risk management framework and culture across RBS. The Director of Operational Risk reports to the Chief Risk Officer.

The Operational Risk function is responsible for the design, development, delivery and continuous improvement of the operational risk management framework. The Operational Risk Policy is incorporated into the RBS Policy Framework and provides direction for the consistent identification, assessment, management, monitoring and reporting of operational risk. Through a network of oversight teams, the function seeks to ensure the integrity of the framework, and manages overall operational risk profile against risk appetite.

\*unaudited

## Business review **Capital and risk management**

### Operational risk\* continued

The Operational Risk Executive Committee (OREC), which is a sub-committee of the Executive Risk Forum (ERF), acts on all operational risk matters. This includes reviewing operational risk exposure against risk appetite; identifying and assessing both current and emerging material operational risks; reviewing and monitoring the operational risk profile; and reviewing and approving material operational risk policy management framework changes.

### Controls and assurance

The Control Environment Certification (CEC) process is a half yearly self-assessment by the CEOs of RBS's customer-facing franchises and business units, as well as the heads of the bank's support and control functions. It gives an assessment on the adequacy and effectiveness of the internal control environment in a consistent and comparable manner, highlighting areas where targeted effort is needed to meet the standards required in order to create a safer and more secure bank for customers. It covers material risks and the key controls that underpin them, including financial, operational and compliance controls, as well as the supporting risk management frameworks.

The CEC outcomes, including forward-looking assessments for the next two half-yearly cycles and the progress made to improve the control environment, are reported to the Board, the Group Audit Committee and the Board Risk Committee (BRC). They are also shared with external auditors.

The CEC process helps to ensure compliance with the RBS Policy Framework, Sarbanes-Oxley 404 requirements concerning internal control over financial reporting (as referenced in the Compliance report section on page 150), and certain requirements of the UK Corporate Governance Code.

### Risk appetite

The operational risk appetite framework supports effective management of key operational risks. It expresses the level and types of operational risk the bank is willing to accept in order to achieve its strategic objectives and business plans.

RBS's operational risk appetite is expressed through a set of qualitative risk appetite statements and quantitative measures which are defined at an aggregate, bank-wide and individual business level. Appetite covers RBS's most material operational risks, defined by a materiality assessment, which in turn considers past, current and future risk exposures. Appetite exposures for all material risks are regularly reported to



business risk committees, the OREC, ERF and BRC.

The aggregation of operational risk appetite drives measurement of how effectively RBS is managing its material risks across the core components of the operational risk management framework. It provides for an aggregate view of risk appetite, risk and control profile, loss and event data management and control environment.

\*unaudited

## Business review **Capital and risk management**

### Operational risk\* continued

Above these sit an RBS-level operational risk appetite statement which encompasses the full range of operational risks. This drives the strategic risk measurement of stakeholder confidence and is reviewed annually by the ERF. The statement is supported by three simple measures: (i) the relationship between operational risk losses and RBS's gross income; (ii) metrics covering control environment performance; and (iii) the requirement for the material RBS-wide operational risks to be managed within risk appetite.

### Risk identification and assessment

Across all business areas, risk and control assessments are used to identify and assess material operational and conduct risks and key controls. To support identification of risk concentrations, all risks and controls are mapped to the risk directory. Risk assessments are refreshed at least annually to ensure they remain relevant and capture any emerging risks.

The process is designed to confirm that risks are effectively managed and prioritised in line with the stated risk appetite. Controls are tested at the appropriate frequency to verify that they remain fit-for-purpose and operate effectively.

During 2016, work continued on rolling out and embedding the enhanced end-to-end risk and control assessment methodology originally developed in 2015. This approach, which strengthens understanding of the risk profile of key products and services, is used to identify and quantify the most material operational risks. Subject matter experts and key stakeholders are engaged from across RBS to underpin management action in line with RBS's financial and non-financial appetite statement. Assessments were carried out on a number of critical products and services during 2016. The results of these assessments support RBS's on-going journey to build on, and enhance, its control environment.

### Risk mitigation

Risks are mitigated through the application of key preventative and detective controls. This is an integral step in the risk assessment methodology, which determines residual risk exposure. Control owners are accountable for the design, execution, performance and maintenance of key controls.

These key controls are regularly assessed for adequacy and tested for effectiveness. The control testing results are monitored and, where a material change in performance is identified, it results in a re-evaluation of the associated risk.

RBS purchases insurance to provide the business with financial protection against specific losses and to comply with statutory or contractual requirements.

### Risk monitoring

Monitoring and reporting are part of RBS's operational risk management processes, which aim to ensure that risks are identified, considered by senior executives, and managed effectively. The most material operational risks and their position relevant to risk appetite are regularly reviewed at the OREC, along with any emerging risks and the actions taken to mitigate them. These are also reported to the BRC and the ERF. Exposures specific to each business are communicated through regular risk and control reports discussed at business risk committees.

\*unaudited

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## Business review **Capital and risk management**

### Operational risk\* continued

#### Risk measurement

RBS uses the standardised approach to calculate its operational risk capital requirement. This is based upon multiplying three years' average historical gross income by coefficients set by the regulator based on type of income.

As part of the wider ICAAP an operational risk economic capital model is used as a key capital benchmark. The model uses loss data and scenario analysis inputs from the operational risk framework, plus external loss data and certain other factors to provide a risk-sensitive view of RBS's operational risk capital requirement.

Scenario analysis is used to assess how extreme but plausible operational risks will affect RBS. It provides a forward-looking basis for evaluating and managing operational risk exposures.

Refer to the Capital risk section for operational risk capital requirement figures.

#### Event and loss data management

The operational risk event and loss data management process ensures RBS captures and records operational risk loss events that meet defined criteria. Loss data is used for regulatory and industry reporting and is included in capital modelling when calculating economic capital for operational risk.

The most serious events are escalated in a simple, standardised process to all senior management, by way of a 'Group Notifiable Event Process'.

All losses and recoveries associated with an operational risk event are reported against their financial accounting date. A single event can result in multiple losses (or recoveries) that may take time to crystallise. Losses and recoveries with a financial accounting date in 2016 may relate to events that occurred, or were identified in, prior years.

\*unaudited

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**Business review** Capital and risk management

## Operational risk\* continued

## Percentage and value of events

At 31 December 2016, events aligned to the 'clients, products and business practices' event category accounted for 99% of RBS's operational risk losses (compared to 98% in 2015). These losses primarily resulted from new conduct-related provisions in respect of RBS's issuance and underwriting of residential mortgage-backed securities (RMBS), the majority settlement of the 2008 shareholder litigation, the automatic refund of complex fees paid by SME customers in RBS's Global Restructuring Group and further increased provisions relating to Payment Protection Insurance, together with other regulatory settlements.

A small number of operational risk events contributed a high percentage of the total losses. In 2016, around 1% of the events contributed 97% of the losses. This was in line with 2015.

	Value of events				Volume of events (1)	
	£m		Proportion		Proportion	
	2016	2015	2016	2015	2016	2015
Fraud	51	40	1%	1%	79%	78%
Clients, products and business practices	6,282	3,449	99%	98%	13%	14%
Execution, delivery and process management	15	23	—	1%	8%	7%
Employment practices and workplace safety	1	15	—	—	—	1%
	6,349	3,527	100%	100%	100%	100%

Note:

(1) The calculation in the above table is based on the volume and value of events where the associated loss is more than or equal to £10,000.

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## Business review **Capital and risk management**

### **Pension risk\***

#### **Definition**

Pension obligation risk is the risk to RBS caused by its contractual or other liabilities to or with respect to a pension scheme (whether established for its employees or those of a related company or otherwise). It also means the risk that RBS will make payments or other contributions to or with respect to a pension scheme because of a moral obligation or because RBS considers that it needs to do so for some other reason.

#### **Sources of risk**

RBS has exposure to pension risk through its defined benefit schemes worldwide. The five largest schemes, which represent around 97% of RBS's pension liabilities are: the Main Section of The Royal Bank of Scotland Group Pension Fund (the Main scheme), the AA Section of The Royal Bank of Scotland Group Pension Fund, the Ulster Bank Pension Scheme, the Ulster Bank Pension Scheme (Republic of Ireland), and the Royal Bank of Scotland International Pension Trust. The Main scheme is the principal source of pension risk. Further detail on the Group's pension obligations can be found in Note 4 on the consolidated accounts.

Pension scheme liabilities vary with changes in long-term interest rates and inflation as well as with pensionable salaries, the longevity of scheme members and legislation. Pension scheme assets vary with changes in interest rates, inflation expectations, credit spreads, exchange rates, and equity and property prices. RBS is exposed to the risk that the schemes' assets, together with future returns and additional future contributions, are insufficient to meet liabilities as they fall due. In such circumstances, RBS could be obliged (or might choose) to make additional contributions to the schemes, or be required to hold additional capital to mitigate this risk.

Prior to 6 April 1997 individuals who contracted out of the UK State Second Pension were entitled to a Guaranteed Minimum Pension (GMP). Men accrued GMP at different rates to women. The Government intends that GMP should be equalised but until the mechanism is defined, pension funds are uncertain of their obligations. In the meantime, no allowance is made for GMP equalisation in the IAS 19 defined benefit obligations and risk disclosures.

#### **Key developments in 2016**



As part of the 31 December 2015 triennial valuation, RBS made a single £4.2 billion payment to the RBS Group Pension Fund in March 2016, instead of a series of annual contributions up to 2023, removing an element of pension risk. RBS and the trustee also agreed that the next valuation of the RBS Group Pension Fund will take place as at 31 December 2018, giving certainty to pension funding commitments until at least 2020.

\*unaudited

## Business review **Capital and risk management**

### **Pension risk\*** continued

Throughout 2016, various pension risk stress-testing initiatives were undertaken, focused both on internally defined scenarios and on scenarios to meet integrated Bank of England and European Banking Authority stress-testing requirements. For more information on stress testing, refer to the following page.

### Governance

The Main scheme operates under a trust deed. The corporate trustee, RBS Pension Trustee Limited, is a wholly owned subsidiary of National Westminster Bank Plc. The trustee board comprises six directors selected by RBS and four directors nominated by members. The trustee is supported by RBS Investment Executive Ltd (RIEL), which specialises in pension investment strategy.

The Pension Committee (PC) chaired by the RBS Chief Risk Officer, acts as a sub-committee of the RBS Asset and Liability Committee (ALCo) and formulates RBS's view of pension risk. The PC considers mechanisms that could potentially be used for managing risk within the funds as well as financial strategy. It also reviews actuarial assumptions from a sponsor perspective as appropriate. The PC is a key component of RBS's approach to managing pension risk and it reviews and monitors risk management, asset strategy and financing issues on behalf of RBS. The PC also serves as a formal link between RBS, RIEL and the trustee.

For further information on Risk governance, refer to page 224.

### Risk appetite

Investment policy for the schemes is defined by the trustee with input from RIEL and other specialist advisers employed by the trustee. While the trustee is responsible for the management of the scheme assets, it consults with RBS on material changes to the Main scheme's risk appetite and investment policy.

RBS maintains an independent view of the risk inherent in pension funds, with an associated risk appetite, and has defined metrics against which risk is measured. In addition to the scrutiny provided by the PC, RBS undertakes regular pension risk monitoring and reporting to the Board and the BRC on the material pension schemes that RBS has an obligation to support.

## Risk mitigation

The trustee has taken measures to mitigate inflation and interest rate risks, both by investing in suitable financial assets and by entering into inflation and interest rate swaps. The Main scheme also uses derivatives to manage the allocation of the portfolio to different asset classes and to manage risk within asset classes. The assets of the Main scheme, which represented around 89% of RBS's pension plan assets at 31 December 2016, are invested in a diversified portfolio. This includes quoted and private equity, government and corporate fixed interest and index-linked bonds, property and other alternative assets.

\*unaudited

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## Business review **Capital and risk management**

### **Pension risk\*** continued

#### Risk monitoring and measurement

Pension risk reports are submitted quarterly in the RBS Risk and Conduct Report. The report includes a measurement of the overall deficit or surplus position, estimated capital requirements, and an assessment of the associated assets and liabilities.

RBS also undertakes stress tests and scenario analyses on its material defined benefit pension schemes each year as part of its risk measurement framework. These stress tests are also used to satisfy the requests of regulatory bodies such as the Bank of England. The stress testing framework includes pension risk capital calculations for the purposes of the ICAAP as well as additional stress tests for a number of internal management purposes.

Pension stress tests take the form of both stochastic and deterministic stresses over time horizons ranging from instantaneous to five years in duration. They are designed to examine the behaviour of the pension schemes' assets and liabilities under a range of financial and demographic shocks. The results of the stress tests and their consequential impact on RBS's balance sheet, income statement and capital position are incorporated into the overall RBS-wide stress test results.

\*unaudited

**Business review** Capital and risk management**Pension risk\*** continued

The table below shows the sensitivity of the Main scheme's assets and liabilities (measured according to IAS 19 'Employee Benefits'). It includes changes in interest rates and equity values at the year-end, taking account of the current asset allocation and hedging arrangements. Asset sensitivity to changes in nominal yields increased over the year as swap yields fell at longer durations.

	Change in value of assets	Change in value of liabilities	Change in net pension obligations
	£m	£m	£m
<b>2016</b>			
Fall in nominal swap yields of 0.25% at all durations with no change in credit spreads or real swap yields	1,048	502	546
Fall in real swap yields of 0.25% at all durations with no change in credit spreads or nominal swap yields	1,485	1,552	(67)
Fall in AA credit spreads of 0.25% at all durations with no change in nominal or real swap yields			
or other credit spreads	9	2,074	(2,065)
Fall in equity values of 10%	(905)	—	(905)
<b>2015</b>			
Fall in nominal swap yields of 0.25% at all durations with no change in credit spreads or real swap yields	874	363	511
Fall in real swap yields of 0.25% at all durations with no change in credit spreads or nominal swap yields	1,029	1,104	(75)
Fall in AA credit spreads of 0.25% at all durations with no change in nominal or real swap yields			
or other credit spreads	7	1,526	(1,519)
Fall in equity values of 10%	(667)	—	(667)

The chart below shows the pension liability cash flow profile, allowing for expected indexation of future payments. The majority of expected cash flows (80%) are anticipated within the next 40 years. The profile will vary depending on the assumptions made regarding inflation expectations and mortality.



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## Business review **Capital and risk management**

### **Credit risk: management basis**

#### **Definition**

Credit risk is the risk of financial loss due to the failure of a customer or counterparty to meet its obligation to settle outstanding amounts.

The following disclosures in this section are audited:

- Risk assessment and monitoring
- Portfolio overview - geography
- Wholesale credit risk management
- Risk mitigation
- Problem debt management - Forbearance
- Key credit portfolios - Commercial Real Estate LTV distribution
- Personal credit risk management
- Problem debt management - Forbearance
- Overview of personal portfolios - Forbearance, mortgage balances, and LTV distribution.

#### **Sources of credit risk\***

The principal sources of credit risk for RBS are as follows:

**Lending** - RBS offers a number of lending products that involve an obligation to provide credit facilities to customers. To mitigate the risk of loss, security may be obtained in the form of physical collateral (such as commercial real estate assets and residential property) or financial collateral (such as cash and bonds). Exposures arising from leasing activities are also included.

**Off-balance sheet products** - RBS provides trade finance and guarantees for customers, as well as committed but undrawn lending facilities, and is exposed to credit risk as a result.



**Derivatives and securities financing** - RBS enters into derivatives contracts and securities financing transactions. These result in counterparty credit risk, which is the risk of financial loss arising from the failure of a counterparty to meet obligations that vary in value by reference to a market rate or asset price. To mitigate the risk of loss, collateral and netting are used along with the additional legal rights provided under the terms of over-the-counter contracts.

**Debt securities** - RBS holds some debt securities for liquidity management purposes and is exposed to credit risk as a result.

**Other activities** - RBS is exposed to settlement risk through its activities in foreign exchange, trade finance and payments.

### **Key developments in 2016\***

**Credit quality** - The portfolio was reduced due to strategic disposals and the ongoing run-off of assets in Capital Resolution, although this was offset by the depreciation of the value of sterling relative to most major currencies. Asset quality remained stable against a backdrop of challenging economic conditions in the Shipping and Natural Resources sectors.

\*unaudited

## Business review **Capital and risk management**

### **Credit risk: management basis** continued

**UK personal lending** - The increase in the UK Personal portfolio was driven by significant mortgage lending activity. Underwriting standards are constantly monitored to ensure that they remain adequate in the current market environment and were not weakened to sustain the growth observed during the period. The UK unsecured lending portfolio remained stable during the year with no material changes to asset quality.

**Shipping** - RBS is winding down its shipping portfolio and has also disposed of assets during the year. RBS continues to witness difficult market conditions which are affecting vessel values and contributing to high levels of forbearance and impairments.

**Natural Resources** - The Oil & Gas sector continued to be affected by low oil prices which are predominantly due to over- supply. Exposures to the Oil & Gas sector were further reduced during 2016 and credit quality remained strong with the majority of the portfolio investment grade. The prolonged challenging market conditions did however result in a limited number of customers experiencing financial stress during the year, which resulted in impairments in the sector. For further information, refer to the Key credit portfolios section on page 308.

**Credit risk measurement** .RBS has changed its measure of credit risk exposure from Credit Risk Assets (CRA) to Current Exposure (CE) and Potential Exposure (PE). This change is discussed further on page 289.

**Risk of Credit Loss** - A new framework for managing problem debts in the wholesale portfolio was introduced during the year. The framework is discussed in detail on page 302.

**IFRS 9** - The new IFRS 9 accounting requirement for loan impairments will draw extensively on the bank's risk models and measures in the calculation of expected credit loss required by the standard. A cross-functional programme involving teams in Finance, Risk and Services is delivering the additional capabilities in terms of models, systems and operational processes.

### **Credit risk management function\***

## Governance

The activities of the RBS credit risk management function, which is led by the Group Chief Credit Officer (GCCO), include:

- Approving credit for customers;
- Ensuring that credit risk is within the risk appetite set by the Board;
- Managing concentration risk and credit risk control frameworks;
- Developing and ensuring compliance with credit risk policies; and
- Conducting RBS-wide assessments of provision adequacy.

\*unaudited

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**Business review** **Capital and risk management****Credit risk: management basis** *continued*

The key elements of the credit risk management function are set out below.

Element	Managed by	Description
<b>Leadership</b>	GCCO	The GCCO has overall responsibility for the credit risk function. The GCCO chairs the Credit Risk Committee and, with the CRO, co-chairs the RBS Provisions Committee.
<b>Governance</b>	Credit Risk Committees	The Wholesale Credit Risk Committee and the Retail Credit Risk Committee have authority for risk appetite (within appetite set by the board), strategy, frameworks and policy as well as oversight of RBS's credit profile.
	Provisions Committee (1,2)	The Provisions Committee has authority over provisions adequacy and to approve recommendations from business provisions committees in accordance with approval thresholds.
<b>Risk appetite</b>	<p>Concentration frameworks</p> <ul style="list-style-type: none"> <li>- Wholesale <ul style="list-style-type: none"> <li>◦ Single name</li> <li>◦ Sector</li> <li>◦ Country</li> <li>◦ Product and asset class</li> </ul> </li> <li>- Personal credit risk appetite framework</li> </ul> <p>Reputational and environmental, social and ethical frameworks</p>	<p>Wholesale frameworks are maintained to ensure that the risk of an outsized loss due to concentration to a particular borrower, sector, product type or country remains within appetite. The credit frameworks are aligned to the RBS risk appetite framework.</p> <p>RBS uses a product and asset class framework to control credit risk for its Personal businesses. The framework sets limits that measure and control the quality of both existing and new business for each relevant franchise or segment.</p>

	<a href="#">Credit policy</a>	
<b>Controls and risk assurance</b>	<a href="#">Risk Assurance</a>	<p>Credit policy standards are in place for both</p> <p>Wholesale and Personal portfolios and are expressed as a set of mandatory controls. Assurance activities, as defined by the RBS credit policy, are undertaken by the independent Risk Assurance function.</p>
<b>Credit stewardship</b>	<a href="#">Credit assessment standards</a> <a href="#">Credit risk mitigation and collateral</a> <a href="#">Credit documentation</a> <a href="#">Regular portfolio/customer review</a> <a href="#">Problem debt identification and management</a>	<p>Credit risk stewardship takes place throughout the customer relationship, from initial credit approval and on a continuous basis thereafter.</p> <p>The methodology applied for assessing and monitoring credit risk varies between customer types and segments.</p>
<b>Customers</b>	<a href="#">Segmentation</a>	<p>Customers are managed differently reflecting different customer types and risks.</p> <p>Wholesale customers - including corporates, banks and other financial institutions - are grouped by industry sectors and geography as well as by product/asset class and are managed on an individual basis.</p> <p>Personal customers - usually in UK PBB and Ulster Bank RoI as well as personal lending activities in Private Banking - are grouped into portfolios of similar risk and managed on a portfolio basis.</p>

## Notes:

- (1) Authority is delegated by the Executive Risk Forum.
- (2) For further information on the RBS provisioning and impairment practices refer to page 390.

\*unaudited



**Business review** Capital and risk management**Credit risk: management basis** continued**Risk appetite**

Risk appetite across all risk types is set using specific quantitative targets under stress, including earnings volatility and capital adequacy. The credit risk appetite frameworks have been designed to reflect factors that influence the ability to meet those targets. Tools such as stress testing and economic capital are used to measure credit risk volatility and develop links between the credit risk appetite frameworks and risk appetite targets. The frameworks are supported by a suite of policies and transaction acceptance standards that set out the risk parameters within which franchises must operate. For further information on the specific frameworks for Wholesale and Personal refer to page 299 and 318 respectively.

**Risk measurements and models\***

RBS has changed its measure of credit risk exposure from Credit Risk Assets (CRA) to Current Exposure (CE) and Potential Exposure (PE). In these credit risk disclosures the measure used, unless otherwise stated, is Current Exposure. 2015 comparatives have been restated in Current Exposure. The table below summarises the differences between CRA, Current Exposure and Potential Exposure:

	CRA	Current Exposure	Potential Exposure (1)
<b>Lending exposure</b> Comprises cash balances at central banks as well as loans and advances to banks and customers.	Drawn balances (gross of impairment provisions)	Drawn balances  Measured net of individual, collective and latent provisions unless otherwise stated.	Legally committed limits (2)
<b>Counterparty exposure</b>	Measured using the mark-to-market value of derivatives after the effect of enforceable netting agreements and regulator-approved models but before the effect of collateral. Calculations are gross of credit valuation adjustments (CVAs).	Measured using the mark-to-market value of derivatives after the effect of enforceable netting agreements and net of legally enforceable financial collateral. (3)  Current and Potential Exposures are measured net of CVA unless otherwise stated.	Measured using scaled credit limit utilisation, which takes into account mark-to-market movements, any collateral held and expected market movements over a specified horizon. (2,3)
<b>Contingent obligations</b>	Drawn balances	Drawn balances	Legally committed amount (2)

Primarily letters of credit and guarantees.			
Exclusions	<ul style="list-style-type: none"> <li>• Trading book bonds</li> <li>• Equity securities</li> <li>• Settlement risk</li> <li>• Intra-group credit exposures</li> <li>• Securities financing transactions (repos)</li> <li>• Banking book debt securities</li> </ul>	<ul style="list-style-type: none"> <li>• Trading book bonds</li> <li>• Equity securities</li> <li>• Settlement risk</li> <li>• Suretyships</li> <li>• Intra-group credit exposures</li> </ul>	
Other		<ul style="list-style-type: none"> <li>• Net of cash and gold collateral.</li> <li>• Current Exposure and Potential Exposure are reported against the guarantor of a transaction to reflect the transfer of risk.</li> </ul>	

## Notes:

- (1) Potential Exposure includes all drawn exposure and all legally committed undrawn exposure.
- (2) Cannot be less than Current Exposure.
- (3) Current Exposure and Potential Exposure for exchange-traded derivatives are defined as exposure at default (EAD).

\*unaudited



**Business review** **Capital and risk management****Credit risk: management basis** *continued*

Comparing the Current Exposure measure to the previous CRA measure, the following changes are noted:

- Exposures to the Sovereign sector are higher. This is primarily due to the inclusion of government bond exposure held in the banking book and managed in Treasury and Capital Resolution. The increased current exposure value, compared to CRA, is also a result of risk transfer related to guarantees (pledged by sovereign customers) for obligors active in other sectors.
- In the Banks & Other Financial Institutions sector, the netting of financial collateral reduced the Current Exposure value compared to CRA. Risk transfer also reduced current exposure compared to CRA.
- Outside these sectors, the impact of risk transfer is less material. However, the impact of netting impairment provisions means that for most other wholesale sectors Current Exposure is less than CRA.

**Risk models**

RBS uses the output of credit risk models in the credit approval process, as well as for ongoing credit risk assessment, monitoring and reporting, to inform credit risk appetite decisions. These models are divided into different categories:

Model	Calculation method	Wholesale	Personal
PD model	Individual counterparty/account	Each customer is assigned a probability of default (PD) rating and corresponding grade. PD is calculated using a combination of quantitative inputs, such as recent financial performance, and qualitative inputs such as management performance and sector outlook.	Each customer account is scored and models are used to assign a PD rating. Inputs vary across portfolios and include both internal account and customer level data, as well as data from credit bureaus. This score is used to support automated credit decision-making through the use of a statistically-derived scorecard.
LGD model	Individual counterparty/facility/product	Loss given default (LGD) models estimate the amount that would not be recovered in the event of a customer default. When estimating LGD, RBS's models assess both borrower and facility characteristics, as well as any credit risk mitigants. The cost of collections and a time-discount factor for the delay in cash recovery are also incorporated.	
EAD model	Individual counterparty/facility/product	Exposure at default (EAD) models provide estimates of credit facility utilisation at the time of a customer default, recognising	

		<p>that customers may make further drawings on unused credit facilities prior to default or that exposures may increase due to market movements. EAD estimates for committed and uncommitted facilities are based on historic data on limit utilisation. The estimates are also gross of provisions, as well as cash and gold collateral, and as a result can be higher or lower than Potential Exposure. In accordance with regulatory requirements, EAD for Lending Exposures must always be equal to, or higher, than the drawn balance sheet amount, though it can be reduced by a legally enforceable netting agreement.</p>
<p>EC model</p>	<p>Portfolio level</p>	<p>The credit economic capital (EC) model is a framework that allows for the calculation of portfolio credit loss distributions and associated metrics over a given risk horizon for a variety of business purposes. The model takes into account migration risk (the risk that credit assets will deteriorate in credit quality across multiple years), factor correlation (the assumption that groups of obligors share a common factor) and contagion risk (for example, the risk that the weakening of the sovereign's credit worthiness has a significant impact on the creditworthiness of a business operating in that country).</p>

\*unaudited

## Business review **Capital and risk management**

### **Credit risk: management basis** continued

#### Impact of credit model changes

RBS reviews and updates models on an ongoing basis in order to reflect the effects of more recent data, changes to products and portfolios, and new regulatory requirements. The PD models for banks, local authorities, housing associations, property, housebuilders and mortgages were recalibrated during the year. This resulted in some downwards ratings migrations across internal asset quality bands.

Model changes affect year-on-year comparisons of risk measures in certain disclosures. Where meaningful, in commentary RBS has differentiated between instances where movements in risk measures reflect the impact of model changes and those where such movements reflect changes in the size of underlying credit portfolios or their credit quality.

For more information on model governance and review refer to the Models used in Risk section on page 229.

#### Asset quality\*

Credit grades are assigned at legal entity level for wholesale customers.

All credit grades map to both an RBS-level asset quality scale, used for external financial reporting, and a master grading scale for wholesale exposures, used for internal management reporting across portfolios. Accordingly, measures of risk exposure may be aggregated and reported at differing levels of detail depending on stakeholder or business requirements. Performing loans are defined as AQ1-AQ9 (where the PD is less than 100%) and non-performing loans as AQ10 (where the PD is 100%).

The PD models used to assign a credit grade for the purposes of credit risk management assess the probability of a customer failing to honour its credit obligations over a one-year time period.

The AQ bands and corresponding probability of default ranges are set out below:

AQ band	Probability of default (mid-point)	Indicative S&P rating
AQ1	0% - 0.034%	AAA to AA
AQ2	0.034% - 0.048%	AA-
AQ3	0.048% - 0.095%	A+ to A-
AQ4	0.095% - 0.381%	BBB+ to BBB-
AQ5	0.381% - 1.076%	BB+ to BB
AQ6	1.076% - 2.153%	BB to B+
AQ7	2.153% - 6.089%	B+ to B
AQ8	6.089% - 17.222%	B- to CCC+
AQ9	17.222% - 100%	CCC to C
AQ10	100%	D

\*unaudited

## Business review **Capital and risk management**

### **Credit risk: management basis** continued

#### **Risk mitigation\***

Risk mitigation techniques, as set out in RBS's credit policies, are used in the management of credit portfolios across RBS, typically to mitigate credit concentrations in relation to an individual customer, a borrower group or a collection of related borrowers. Where possible, customer credit balances are netted against obligations. Mitigation tools applied can include: structuring a security interest in a physical or financial asset; use of credit derivatives, including credit default swaps, credit-linked debt instruments and securitisation structures; and use of guarantees and similar instruments (for example, credit insurance) from related and third parties. When seeking to mitigate risk, at a minimum RBS considers the following:

- The suitability of the proposed risk mitigation, particularly if restrictions apply;
- The means by which legal certainty is to be established, including required documentation, supportive legal opinions and the steps needed to establish legal rights;
- The acceptability of the methodologies to be used for initial and subsequent valuation of collateral, the frequency of valuations and the advance rates given;
- The actions which can be taken if the value of collateral or other mitigants is less than needed;
- The risk that the value of mitigants and counterparty credit quality may deteriorate simultaneously;
- The need to manage concentration risks arising from collateral types; and
- The need to ensure that any risk mitigation remains legally effective and enforceable.

The business and credit teams are supported by specialist in-house documentation teams. RBS uses industry-standard loan and security documentation wherever possible. However, when non-standard documentation is used, external lawyers are employed to review it on a case-by-case basis. Mitigants (including any associated insurance) are monitored throughout the life of the transaction to ensure that they perform as anticipated. Similarly, documentation is also monitored to ensure it remains enforceable.

For further information refer to the sub-sections on Wholesale credit risk management and Personal credit risk management.

#### **Counterparty credit risk**

RBS mitigates counterparty credit risk arising from both derivatives transactions and repurchase agreements through the use of market standard documentation, enabling netting, and through collateralisation.

Amounts owed by RBS to a counterparty are netted against amounts the counterparty owes the bank, in accordance with relevant regulatory and internal policies. However, generally, this is only done if a netting agreement is in place. A legal opinion, to the effect that the agreement is enforceable in the relevant jurisdictions, is also required.

Collateral may consist of either cash or securities. Additional collateral may be called should the net value of the obligations to RBS rise or should the value of the collateral itself fall. The majority of agreements are subject to daily collateral calls with collateral valued using RBS's internal valuation methodologies.

RBS restricts counterparty credit exposures by setting limits that take into account the potential adverse movement of an exposure after adjusting for the impact of netting and collateral (where applicable).

### **Risk assessment and monitoring**

Practices for credit stewardship - including credit assessment, approval and monitoring as well as the identification and management of problem debts - differ between the Wholesale and Personal portfolios. For further information refer to the relevant sub-sections on page 299 and 318. A key aspect of credit risk stewardship is ensuring that, when signs of impairment are identified, appropriate impairment provisions are recognised.

\*unaudited

## Business review **Capital and risk management**

### Credit risk: management basis *continued*

#### Impairment, provisioning and write-offs

In the overall assessment of credit risk, impairment, provisioning and write-offs are used as key indicators of credit quality.

#### Impairment

A financial asset is impaired if there is objective evidence that the amount, or timing, of future cash flows has been adversely affected. Refer to accounting policies on page 390 for details regarding the quantification of impairment losses.

Days-past-due measures are typically used to identify evidence of impairment. In both Wholesale and Personal portfolios, a period of 90 days past due is used. In sovereign portfolios, the period used is 180 days past due. Indicators of impairment include the borrower's financial condition; a forbearance event; a loan restructuring; the probability of bankruptcy; or evidence of diminished cash flows.

#### Provisioning

The amount of an impairment loss is measured as the difference between the asset carrying amount and the present value of the estimated future cash flows discounted at the financial asset's original effective interest rate. The current net realisable value of the collateral will be taken into account in determining the need for a provision. This includes cash flows from foreclosure (less costs of obtaining and selling the collateral), whether or not foreclosure is probable. Impairment provisions are not recognised where amounts due are expected to be settled in full on the realisation of collateral. RBS uses one of the following three methods to quantify the provision required: individual; collective; and latent, as set out below:

Provision method	Asset type	Quantification method	Key factors considered
Individual	Impaired, individually significant	Case-by-case assessment of future cash flows	<ul style="list-style-type: none"> <li>• Customer and guarantor performance.</li> <li>• Future value of collateral.</li> <li>• Future economic conditions based on</li> </ul>

			factors available at the time.
Collective	Impaired but not individually significant, grouped into homogenous portfolios, by Retail products and Wholesale businesses	Quantitative review of relevant portfolio	<ul style="list-style-type: none"> <li>• Level of arrears.</li> <li>• Value of security.</li> <li>• Historical and projected cash recovery trends.</li> <li>• Current economic conditions.</li> <li>• Operational processes.</li> <li>• Latest cash collection profile.</li> </ul>
Latent	Not impaired	$PD\% \times LGD\% \times EAD$ $\times$ Emergence Period	<ul style="list-style-type: none"> <li>• For Wholesale customers PD, LGD and EAD values are used.</li> <li>• For Personal, calculations are performed at portfolio level by product (e.g. mortgages, credit cards or unsecured loans).</li> <li>• Portfolio-level emergence periods are based on products or businesses with similar homogenous characteristics. Emergence periods range from 120 to 365 days.</li> </ul>

## Note:

(1) Refer to pages 336 to 341 for an analysis of impaired loans, related provisions and impairments. Refer to page 390 for details of accounting policies. For details on collateral, refer to the Counterparty credit risk section on page 292 as well as the Wholesale and Personal risk mitigation sections on pages 299 and 318.



## Business review **Capital and risk management**

### **Credit risk: management basis** *continued*

#### *Sensitivity of impairments to assumptions*

Key assumptions relating to impairment levels relate to economic conditions, the interest rate environment, the ease and timing of enforcing loan agreements in varying legal jurisdictions and the level of customer co-operation.

In addition, for secured lending, key assumptions relate to the valuation of the security and collateral held, as well as the timing and cost of asset disposals based on underlying market depth and liquidity. Assessments are made by relationship managers on a case-by-case basis for individually-assessed provisions and are validated by credit teams. The Restructuring Credit team will ultimately recommend or approve any provisions that may be required under their delegated authority. For individual impairments greater than £1 million, oversight is provided by the RBS Provisions Committee.

#### *Available-for-sale portfolios*

Available-for-sale portfolios are also regularly reviewed for evidence of impairment, including: default or delinquency in interest or principal payments; significant financial difficulty of the issuer or obligor; and increased likelihood that the issuer will enter bankruptcy or other financial reorganisation.

Determining whether evidence of impairment exists requires the exercise of management judgement. It should be noted that the following factors are not, of themselves, evidence of impairment, but may be evidence of impairment when considered with other factors:

- Disappearance of an active market because an entity's financial instruments are no longer publicly traded.
- A downgrade of an entity's credit rating.
- A decline in the fair value of a financial asset below its cost or amortised cost.

#### *Write-offs*

Impaired loans and receivables are written-off when there is no longer any realistic prospect of recovery of part, or the entire loan. For loans that are individually assessed for impairment, the timing of write-off is determined on a case-by-case basis. Such loans are reviewed regularly and write-offs may be prompted by bankruptcy, insolvency, forbearance and similar events. For details of the typical time frames, from initial impairment to write off, for collectively assessed portfolios refer to the accounting policies section on page 390.

Amounts recovered after a loan has been written-off are credited to the loan impairment charge for the period in which they are received.

## Business review Capital and risk management

Credit risk: management basis continued								
Portfolio overview - asset quality*								
The table below summarises Current and Potential Exposure, net of provisions and after risk transfer, by sector and asset quality.								
	Wholesale (1)							
		Banks and other FIs	Sovereigns (2)	Property	Natural resources	Transport	Other	Total
	Personal							
	£m	£m	£m	£m	£m	£m	£m	£m
2016								
AQ1-AQ4	111,899	42,903	118,049	19,087	8,708	5,452	15,874	321,972
AQ5-AQ8	47,992	4,392	135	21,728	3,357	9,077	38,178	124,859
AQ9	2,622	32	4	149	33	52	357	3,249
AQ10	3,693	355	—	1,387	302	1,004	772	7,513
Total	166,206	47,682	118,188	42,351	12,400	15,585	55,181	457,593
Potential Exposure	172,607	84,300	119,056	54,734	25,425	23,690	81,442	561,254
Risk of Credit Loss (3)	—	1	4	93	2	386	370	856
Flow into forbearance (4)	834	5	1	637	531	755	1,309	4,072
Forbearance stock (5)	5,284	63	1	787	785	836	1,805	9,561
Provisions	2,192	58	1	696	237	469	802	4,455
- Individual and collective	1,966	52	—	659	226	454	698	4,055
- Latent	226	6	1	37	11	15	104	400

2015**								
AQ1-AQ4	96,830	41,254	123,410	21,062	8,773	7,960	17,054	316,343
AQ5-AQ8	49,684	4,214	183	18,233	2,733	10,924	36,613	122,584
AQ9	2,840	35	—	279	127	55	297	3,633
AQ10	3,765	769	1	2,284	149	396	888	8,252
Total	153,119	46,272	123,594	41,858	11,782	19,335	54,852	450,812
Potential Exposure	159,837	82,434	125,048	53,955	24,565	26,795	81,823	554,457

Watch Red	—	20	73	529	348	145	858	1,973
Flow into forbearance (4)	1,829	85	—	1,035	643	205	1,207	5,004
Forbearance stock (5)	7,143	181	—	1,549	734	275	1,728	11,610
Provisions	3,003	73	1	2,282	133	300	1,347	7,139
- <i>Individual and collective</i>	2,613	60	—	2,232	124	276	1,250	6,555
- <i>Latent</i>	390	13	1	50	9	24	97	584

## Notes:

(1) Includes SME customers managed in UK PBB Business Banking who are assigned a sector under the Bank's sector concentration framework.

(2) Includes exposure to central governments, central banks and sub-sovereigns such as local authorities.

(3) Excludes Private Banking, Lombard and Invoice Finance exposures which are not material in context of the Risk of Credit Loss portfolio.

(4) Completed during the year.

(5) Forbearance stock: Wholesale forbearance stock represents loans that have been subject to a forbearance event in the two years up to the reported date. Personal forbearance stock is aligned to the European Banking Authority definition for forbearance reporting (refer to individual Personal section on page 319 for further details).

\*unaudited

\*\*restated - refer to page 289 for further details

## Business review **Capital and risk management**

### Credit risk: management basis *continued*

#### Key points

The following key portfolios are either designated high-oversight sectors under the sector framework or constitute a material proportion of Current Exposure and are discussed in more detail below.

Commercial Real Estate (CRE) (in Property) - refer to page 308;

Oil & Gas (in Natural Resources) - refer to page 312;

Mining & Metals (in Natural Resources) - refer to page 315;

Shipping - refer to page 316; and

Personal, including mortgages - refer to page 321.

- RBS's credit risk exposure has been affected by the significant appreciation of both the euro and US dollar against sterling. This was relevant to exposures in Ireland, Western Europe and the US and is discussed in further detail on page 297.
- The increase in credit risk exposure in the personal sector was predominantly driven by growth in UK mortgage lending. This portfolio is managed on a specific risk appetite framework and the growth observed the year was within risk appetite. For further information refer to page 321.
- The Wholesale portfolio decreased by 8% (£25.1 billion) on a constant currency basis (foreign exchange impact of £18.8 billion). This was predominately due to a reduction in the sovereign sector, driven by liquidity management activities, and in the transport sector in line with the exit strategy for the shipping sector.
- The quality of the Personal portfolio improved with AQ1-AQ4 making up 67% of personal lending against 63% in 2015. For the Wholesale portfolio AQ1-AQ4 made up 72% of the portfolio (2015 - 74%).
- The Risk of Credit Loss framework was fully implemented in April 2016. Exposure classified as Risk of Credit Loss decreased during 2016 due to customers who defaulted during the year and are shown in AQ10.
- For Wholesale, the flow into forbearance remained stable and continued to reflect the challenging conditions in certain sectors, notably Transport. 45% (2015 - 29%) of the total forbearance granted related to non-performing loans. Provision coverage of non-performing forborne loans was 27% (2015 - 43%). Refer to the Wholesale Forbearance section (page 304) for further details.

- The reduction in defaulted exposures during the year was primarily due to specific portfolio disposals, including in the Republic of Ireland of small and medium enterprise-related exposures and buy-to-let mortgages, during the fourth quarter of 2016. This was partly offset by higher defaulted assets in Capital Resolution's Shipping portfolio.
- Credit impairment charges increased during 2016. In particular large individual charges were incurred in the Shipping, Oil & Gas and Mining & Metals sectors. Challenging economic conditions resulted in reduced global demand, oversupply and consequently volatile commodity prices, which adversely affected the shipping market and vessel values. Credit impairment releases were lower in 2016 with less asset disposal activity.
- In Personal, including mortgages, the flow into defaults was broadly stable year-on-year. Cash repayments and recoveries on previously defaulted debt remained strong.

\*unaudited

\*\*restated - refer to page 289 for further details

**Business review** Capital and risk management**Credit risk: management basis** continued

## Portfolio overview - geography

The table below summarises both Current and Potential Exposure, net of provisions and after risk transfer by geographic region, as well as providing further detail for selected country risk exposure.

	Personal	Wholesale (1)						Current	Potential
		Banks and other FI	Sovereigns (2)	Property	Natural resources	Transport	Other	Exposure total	Exposure total
2016	£m	£m	£m	£m	£m	£m	£m	£m	
UK	148,882	19,393	69,390	38,001	8,357	9,324	45,515	338,862	391,370
RoI (3)	15,079	433	2,387	950	443	206	2,966	22,464	23,771
Other Western Europe	528	9,978	36,603	2,332	2,406	1,760	3,602	57,209	86,659
US	329	11,116	7,338	350	610	488	2,159	22,390	38,177
RoW (4)	1,388	6,762	2,470	718	584	3,807	939	16,668	21,277
Total	166,206	47,682	118,188	42,351	12,400	15,585	55,181	457,593	561,254
Of which:									
<b>Southern Europe</b>									
Spain	63	52	7	845	487	25	341	1,820	3,250
Italy	27	477	67	70	113	176	30	960	2,568
Portugal	6	90	8	13	148	2	1	268	439
Cyprus	9	—	—	—	—	—	—	9	10
Greece	13	—	—	5	—	—	12	30	30
<b>Southern Europe total</b>	118	619	82	933	748	203	384	3,087	6,297
<b>Eurozone other (5)</b>									
Germany	70	1,789	26,107	74	137	223	1,057	29,457	34,761
RoI (3)	15,079	433	2,387	950	443	206	2,966	22,464	23,771
Netherlands	32	2,399	4,740	235	230	118	563	8,317	12,217
France	69	1,835	3,170	288	563	611	578	7,114	15,299
Belgium	21	1,067	869	44	48	178	17	2,244	2,905

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Luxembourg	9	703	28	490	1	41	274	1,546	2,736
Other (6)	14	365	674	47	22	72	261	1,455	2,383
Eurozone other total	15,294	8,591	37,975	2,128	1,444	1,449	5,716	72,597	94,072
Eurozone total	15,412	9,210	38,057	3,061	2,192	1,652	6,100	75,684	100,369
Japan (7)	25	467	1,008	—	—	—	146	1,646	2,613
India (7)	14	169	499	1	25	1	77	786	810
2015**									
UK	136,024	21,187	60,068	37,328	7,386	9,524	43,262	314,779	365,407
Rol (3)	13,440	433	1,624	692	436	218	2,542	19,385	20,661
Other Western Europe	548	9,481	33,942	2,408	2,144	2,567	4,334	55,424	84,143
US	301	8,121	21,819	622	864	911	2,386	35,024	54,120
RoW (4)	2,806	7,050	6,141	808	952	6,115	2,328	26,200	30,126
Total	153,119	46,272	123,594	41,858	11,782	19,335	54,852	450,812	554,457
Southern Europe									
Spain	79	58	6	671	526	75	326	1,741	2,960
Italy	27	428	52	62	175	67	59	870	2,271
Portugal	6	87	10	26	139	63	1	332	492
Cyprus	12	—	—	—	—	38	—	50	52
Greece	15	1	—	8	—	1	10	35	39
Southern Europe total	139	574	68	767	840	244	396	3,028	5,814
Eurozone other (5)									
Germany	63	1,533	23,801	91	150	800	1,073	27,511	32,574
Rol (3)	13,440	433	1,624	692	436	218	2,542	19,385	20,661
Netherlands	30	1,966	4,176	451	94	138	1,126	7,981	12,247
France	76	2,309	2,402	357	447	827	679	7,097	15,982
Belgium	22	702	537	158	44	138	61	1,662	2,427
Luxembourg	6	625	21	346	32	41	106	1,177	1,917
Other (6)	14	382	609	55	84	34	123	1,301	2,022
Eurozone other total	13,651	7,950	33,170	2,150	1,287	2,196	5,710	66,114	87,830
Eurozone total	13,790	8,524	33,238	2,917	2,127	2,440	6,106	69,142	93,644



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Japan (7)	31	249	1,417	2	—	3	112	1,814	2,639	
India (7)	11	227	824	1	92	43	436	1,634	1,733	
**restated - refer to page 289 for further details. 2015 data is unaudited.										

## Business review **Capital and risk management**

### Credit risk: management basis *continued*

#### Notes:

- (1) Includes SME customers managed in UK PBB Business Banking who are assigned a sector under RBS's sector concentration framework.
- (2) Includes exposures to central governments, central banks and sub-sovereigns such as local authorities.
- (3) RoI: Republic of Ireland.
- (4) Comprises Asia Pacific, Central and Eastern Europe, the Middle East, Central Asia and Africa. RoW also includes supranationals such as the World Bank and exposure relating to ocean-going vessels which cannot be meaningfully assigned to specific countries from a country risk perspective.
- (5) Countries where current exposure is greater than £1 billion.
- (6) Finland, Austria, Malta, Slovakia, Estonia, Lithuania, Latvia and Slovenia.
- (7) Non-eurozone countries displayed in the table are those that are A+ or worse and with current exposure greater than £1 billion.

#### Key points\*

- Country Risk exposure was significantly affected by foreign exchange movements (£10.4 billion) during the year. On a constant currency basis, eurozone exposure decreased by £3.9 billion.
- Sovereign exposure to the US and RoW decreased. This is in line with RBS strategy to reduce activity in the US as well as reductions in RoW, which were partly due to reduced exposure in the shipping sector and other Capital Resolution disposals.
- The proportion of RBS's exposure to the UK is now 74% (70% - 2015).

\*unaudited



**Business review** **Capital and risk management****Credit risk: management basis** *continued***Wholesale credit risk management**

This section sets out further detail on RBS's approach to credit risk management for its Wholesale customers. Four formal frameworks are used to manage Wholesale credit concentration risks within RBS's risk appetite. These frameworks are regularly reassessed to ensure they remain appropriate for RBS's varied business franchises, economic and market conditions and to reflect refinements in risk measurement models as well as agreed risk appetite.

**Wholesale credit risk framework\***

A summary of the frameworks is set out below.

<b>Concentration framework</b>	<b>Single name concentration (SNC)</b>	<b>Sector</b>	<b>Product and asset class</b>	<b>Country</b>
<b>Risk addressed</b>	Concentration on a single borrower or borrower group.	Concentration in a single sector or across sectors susceptible to similar stress events.	Concentration on certain products or asset classes.	Concentration on a particular country.
<b>Basis for classification</b>	Size or LGD - based on net customer exposure for a given probability of default.	Size - based on exposure; and risk - based on Economic Capital and other qualitative factors.	Size - based on exposure to a product or asset class; and risk - based on heightened risk characteristics of a product.	Size - based on exposure to a particular country.
<b>Limit types</b>	Customer exposure and LGD limits relative to PD.	Bank-wide and franchise sector and sub-sector exposure limits.	Bank-wide and franchise product/asset class exposure limits and sub-limits.	Bank-wide country limits.
<b>Controls within the framework</b>	Elevated approval requirements, mandatory controls and procedures, monitoring and reporting, the requirement for regular reviews and for plans to address any exposures in excess of limit.			
<b>Exposure measure (net/gross)</b>	Both net and gross of "eligible" mitigants. To be eligible under the framework, mitigants must be legally	Gross exposure to a sector/sub-sector. Where PE is used it is net of eligible collateral and	Net/gross - dependent on type of risk and limit definition. Where PE is used it is net of	Net of provisions and risk transfer.

	enforceable, structurally effective and of appropriate maturity.	provisions.	eligible collateral and provisions.	
Recent developments	The aggregate SNC exposure remained outside RBS long term risk appetite. Whilst the number of SNC excesses increased by 17.1%, the value of the SNC excesses decreased by 9.1% during the year. The top ten SNC excesses comprised 87.7% of total SNC excesses.	Risk appetite has remained broadly stable across all sectors, allowing for growth in our core franchises in accordance with our strategy. CRE limits have remained broadly flat, allowing for a limited amount of targeted growth within the sector and there has been some notable growth in certain of our non-Bank FI sectors where a more targeted growth strategy has been in place.	The product and asset class framework was enhanced during the year to encompass all products and asset classes where there is a specific identified credit risk which needs to be managed at the product and asset class level rather than at customer or sector level.	Risk appetite limits were reduced for exit countries taking account of the revised risk appetite and international strategy.

\*unaudited

## Business review **Capital and risk management**

### **Credit risk: management basis** continued

#### Risk assessment\*

Before credit facilities are made available to customers a credit assessment is undertaken. The assessment process is the same for all customers. However, in RBS credit risk management is organised in terms of the complexity of the assessment rather than aligned to franchises. Capital Resolution is not managed separately but is shown in tables to aid understanding of the size of the exit portfolio. Credit is only granted to customers following joint approval by an approver from the business and the credit risk function.

These approvers act within a delegated approval authority under the wholesale Credit Authorities Framework (CAF) approved by the Executive Risk Forum.

The level of delegated authority held by approvers is dependent on their experience and expertise. Only a small number of senior executives hold the highest authority provided under the CAF. Both business and credit approvers are accountable for the quality of each decision taken but the credit risk approver holds ultimate sanctioning authority.

In 2016, new sector specific Transaction Acceptance Standards (TAS) were introduced to provide more detailed transactional lending and risk acceptance rules and guidelines. TAS are one of the tools used to control risk appetite at the customer/transaction level. The introduction of sector-specific TAS followed the introduction of general sector TAS in November 2015, providing full sector coverage. TAS are supplementary to the Credit Policy.

When assessing credit risk the following must be considered at a minimum:

- The amount, terms, tenor, structure, conditions, purpose and appropriateness of all credit facilities;
- Compliance with relevant credit policies and transaction acceptance standards;
- The customer's ability to meet obligations, based on an analysis of financial information;
- A review of payment and covenant compliance history;
- The customer's risk profile, including sector, sensitivity to economic and market developments and management capability;

- Legal capacity of the customer to engage in the transaction;
- Credit risk mitigation including requirements for valuation and revaluation. The customer's credit grade and the loss given default estimate for the facilities, including any expected changes;
- The requirement for the provision of financial information, covenants and/or monitoring formulae to monitor the customer's financial performance;
- Refinancing risk - the risk of loss arising from the failure of a customer to settle an obligation on expiry of a facility through the drawdown of another credit facility provided by RBS or by another lender;
- Consideration of other risks such as environmental, social and ethical, regulatory and reputational risks; and
- The portfolio impact of the transaction, including the impact on any credit risk concentration limits or agreed business franchise risk appetite.

Where the customer is part of a group, the credit assessment considers aggregated credit risk limits for the customer group as well as the nature of the relationship with the broader group (e.g. parental support) and its impact on credit risk.

Credit relationships are reviewed and credit grades (PD and LGD) re-approved annually. The review process addresses borrower performance, including reconfirmation or adjustment of risk parameter estimates; the adequacy of security; compliance with terms and conditions; and refinancing risk.

\*unaudited

## Business review **Capital and risk management**

### **Credit risk: management basis** continued

#### Risk mitigation

RBS mitigates credit risk relating to Wholesale customers through the use of netting, collateral and market standard documentation, depending on the nature of the counterparty and its assets. The most common types of mitigation are:

- Commercial real estate - Refer to CRE section on page 308.
- Other physical assets - Including stock, plant, equipment, machinery, vehicles, ships and aircraft. Such assets are suitable collateral only if RBS can identify, locate, and segregate them from other assets on which it does not have a claim. RBS values physical assets in a variety of ways, depending on the type of asset and may rely on balance sheet valuations in certain cases.
- Receivables - These are amounts owed to RBS's counterparties by their own customers. RBS values them after taking into account the quality of its counterparty's receivable management processes and excluding any that are past due.
- Financial collateral - Refer to Counterparty credit risk section on page 292.

All collateral is assessed case by case to ensure that it will retain its value independently of the provider. RBS monitors the value of the collateral and, if there is a shortfall, will seek additional collateral.



## Business review **Capital and risk management**

### **Credit risk: management basis** *continued*

Key sectors where RBS provides asset-backed lending are commercial real estate and shipping. Valuation methodologies are detailed below.

*Commercial real estate valuations* - RBS has a panel of chartered surveying firms that cover the spectrum of geography and property sectors in which RBS takes collateral. RBS has a programme that identifies suitable valuers for particular assets. They are contracted through a single service agreement to ensure consistency of quality and advice. Valuations are commissioned when an asset is taken as security; a material increase in a facility is requested; or an event of default is anticipated or has occurred. In the UK, RBS also applies an independent third-party market indexation to update external valuations once they are more than a year old.

*Shipping valuations* - Vessel valuations are obtained using several different independent sources. Valuations are usually undertaken on a desktop basis, assuming a willing buyer and willing seller. Most vessels are valued on a charter-free basis, but in certain circumstances the valuations take account of longer term committed charter income. Valuations are normally performed on a quarterly basis. From time to time, particularly for facilities showing increased signs of financial stress, a more formal valuation or specialist advice will be obtained.

### **Problem debt management**

#### *Early problem identification\**

Each segment has defined early warning indicators (EWIs) to identify customers experiencing financial difficulty, and to increase monitoring if needed. EWIs may be internal, such as a customer's bank account activity, or external, such as a publicly-listed customer's share price. If EWIs show a customer is experiencing potential or actual difficulty, or if relationship managers or credit officers identify other signs of financial difficulty they may decide to classify the customer within the Risk of Credit Loss Framework.

#### *Risk of Credit Loss Framework\**

The Risk of Credit Loss framework, which was fully implemented in April 2016, has replaced RBS's previous Watchlist process for managing problem debts. The new framework focuses on Wholesale customers whose credit profiles have deteriorated since origination. Expert judgement is applied by experienced credit risk officers to classify cases into categories that reflect progressively deteriorating credit risk to the bank. All customers that have been granted forbearance are managed under this framework. There are two classifications which apply to non-defaulted customers within the framework - Heightened

Monitoring and Risk of Credit Loss. The framework also applies to those customers that have met the bank's default criteria (AQ10 exposures).

\*unaudited

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## Business review **Capital and risk management**

### **Credit risk: management basis** continued

Heightened Monitoring customers are performing customers who have met certain characteristics, which have led to material credit deterioration. Collectively, characteristics reflect circumstances that may affect the customer's ability to meet repayment obligations. Characteristics include trading issues, covenant breaches, material PD downgrades and past due facilities. Sector specific characteristics also exist. Heightened Monitoring customers require pre-emptive actions (outside the customer's normal trading patterns) to return or maintain their facilities within the bank's current risk appetite prior to maturity.

Risk of Credit Loss customers are performing customers who have met the criteria for Heightened Monitoring and also pose a risk of credit loss to the bank in the next 12 months, should mitigating action not be taken or be successful.

Once classified as either Heightened Monitoring or Risk of Credit Loss a number of mandatory actions are taken in accordance with RBS-wide policies. This includes a review of the customer's credit grade, facility and security documentation and the valuation of security. Depending on the severity of the financial difficulty and the size of the exposure, the customer relationship strategy is reassessed by credit officers, by specialist credit risk or relationship management units in the relevant business or by Restructuring.

Agreed customer management strategies are regularly monitored by both the business and credit teams. The largest Risk of Credit Loss exposures in RBS and in each business are regularly reviewed by a Risk of Credit Loss Committee. The committee members are experienced credit, business and Restructuring specialists. The purpose of the committee is to review and challenge the strategies undertaken for those customers who pose the largest risk of credit loss to the bank.

Appropriate corrective action is taken when circumstances emerge that may affect the customer's ability to service its debt (see Heightened Monitoring characteristics). Corrective actions may include granting a customer various types of concessions. Any decision to approve a concession will be a function of specific country and sector appetite, the credit quality of the customer, the market environment and the loan structure and security. All customers granted forbearance are classified Heightened Monitoring as a minimum. For further information, refer to the Wholesale forbearance section.

Other potential outcomes of the relationship review are to: take the customer off the Risk of Credit Loss framework; offer additional lending and continue monitoring; transfer the relationship to Restructuring if appropriate; or exit the relationship altogether.

The Risk of Credit Loss framework does not apply to problem debt management for Business Banking customers in UK PBB. These customers are, where necessary, managed by specialised problem debt management teams, depending on the size of exposure or the Business Banking recoveries team where a loan has been impaired.

\*unaudited

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## Business review **Capital and risk management**

### **Credit risk: management basis** continued

#### Restructuring\*

For the Wholesale problem debt portfolio, customer relationships are managed by the Restructuring team (this excludes customers managed by PBB). The factor common to all customers with Restructuring involvement is that RBS's exposure is outside risk appetite. The purpose of Restructuring is to protect the bank's capital. Where practicable, Restructuring do this by working with corporate and commercial customers to support their turnaround and recovery strategies and enable them to return to mainstream banking. Restructuring will always aim to recover capital in a fair and efficient manner.

Specialists in Restructuring work with customers experiencing financial difficulties, and showing signs of financial stress, with the aim of restoring their business to financial health whenever practicable. The objective is to find a mutually acceptable solution, including restructuring of existing facilities, repayment or refinancing.

An assessment of the viability of the business, as well as the ability of management to deal with the causes of financial difficulty, is carried out by specialists in Restructuring, focusing on both financial and operational issues. Following the assessment, options which may include forbearance and/or restructuring of facilities are developed. Credit risk decisions, including reviewing and approving any restructuring solutions in relation to these customers, are made by a dedicated Restructuring Credit team, which is part of the credit risk management function.

Where a solvent outcome is not possible, insolvency may be considered as a last resort. However, helping the customer return to financial health and restoring a normal banking relationship is always the preferred outcome.

#### Forbearance

Forbearance takes place when a concession is made on the contractual terms of a loan in response to a customer's financial difficulties. Concessions granted where there is no evidence of financial difficulty, or where any changes to terms and conditions are within current risk appetite, or reflect improving credit market conditions for the customer, are not considered forbearance.

The aim of forbearance is to restore the customer to financial health while minimising risk to RBS. To ensure that forbearance is appropriate for the needs and financial profile of the customer, RBS applies

minimum standards when assessing, recording, monitoring and reporting forbearance.

\*unaudited

## Business review **Capital and risk management**

### **Credit risk: management basis** continued

#### *Types of wholesale forbearance*

The type of forbearance offered is tailored to the customer's individual circumstances. For wholesale customers forbearance may involve the following types of concessions:

- **Covenant waiver**

A recalibration of covenants or a covenant amendment may be used to cure a potential or actual covenant breach. In return for this relief, RBS may seek to obtain a return commensurate with the risk that it is required to take. The increased return for the increased risk can be structured flexibly to take into account the customer's circumstances. For example it may be structured as either increased margin on a cash or payment-in-kind basis, deferred-return instruments or both. While RBS considers these types of concessions qualitatively different from other forms of forbearance, they constitute a significant proportion of UK Wholesale forborne loans and are therefore included in these disclosures.

- **Amendment to margin**

Contractual margin may be amended to assist the customer's day-to-day liquidity to help sustain its business as a going concern. This would normally be a short-term solution. RBS would seek a return commensurate to the risk that it is required to take.

- **Payment concessions and loan rescheduling (including extensions in contractual maturity)**

May be granted to improve the customer's liquidity or in the expectation that the customer's liquidity will recover when market conditions improve. In addition, they may be granted if the customer will benefit from access to alternative sources of liquidity, such as an issue of equity capital. These options have been used in CRE transactions, particularly during periods where a shortage of market liquidity has ruled out immediate refinancing and made short-term collateral sales unattractive.

- **Debt forgiveness/debt for equity swap**

May be granted where the customer's business condition or economic environment is such that it cannot meet obligations and where other forms of forbearance are unlikely to succeed. Debt forgiveness can be used for stressed corporate transactions and is typically structured on the basis of projected cash flows from operational activities, rather than underlying tangible asset values. Provided that the underlying business model, strategy and debt level are viable, maintaining the business as a going concern is the preferred option, rather than realising the value of the underlying assets.

Loans may be forborne more than once, generally where a temporary concession has been granted and circumstances warrant another temporary or permanent revision of the loan's terms. All customers are assigned a PD and related facilities an LGD. These are re-assessed prior to finalising any forbearance arrangement in light of the loan's amended terms and any revised grading is incorporated in the calculation

of the impairment loss provisions for RBS's wholesale exposures.



## Business review **Capital and risk management**

### **Credit risk: management basis** continued

The ultimate outcome of a forbearance strategy is unknown at the time of execution. It is highly dependent on the cooperation of the borrower and the continued existence of a viable business. Where forbearance is no longer viable, RBS will consider other options such as the enforcement of security, insolvency proceedings or both. The following are generally considered to be options of last resort:

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

Provisions for forbore wholesale loans are assessed in accordance with normal provisioning policies (refer to Impairment loss provision methodology). The customer's financial position and prospects as well as the likely effect of the forbearance, including any concessions granted, are considered in order to establish whether an impairment provision is required.

Wholesale loans granted forbearance are individually assessed in most cases and are not therefore segregated into a separate risk pool.

Forbearance may result in the value of the outstanding debt exceeding the present value of the estimated future cash flows. This may result in the recognition of an impairment loss or a write-off.

For performing loans, credit metrics are an integral part of the latent provision methodology and therefore the impact of covenant concessions will be reflected in the latent provision. For non-performing loans, covenant concessions will be considered in determining the overall provision for these loans.

In the case of non-performing forbore loans, the loan impairment provision assessment almost invariably takes place prior to forbearance being granted. The amount of the loan impairment provision may change once the terms of the forbearance are known, resulting in an additional provision charge or a release of the provision in the period the forbearance is granted.

The transfer of wholesale loans subject to forbearance from impaired to performing status follows assessment by relationship managers and the Restructuring credit team. When no further losses are anticipated and the customer is expected to meet the loan's revised terms, any provision is written off and the balance of the loan returned to performing status. This course of action is not dependent on a specified time period and follows the credit risk manager's assessment.

**Business review** Capital and risk management**Credit risk: management basis** continued

## Flow into forbearance

The table below shows the value of loans (excluding loans where RBS has initiated recovery procedures) where forbearance was completed during the year, by sector and types. This includes only the forbore facility Current Exposure net of provisions and after risk transfer. No exit criteria are currently applied.

Wholesale forbearance during the year by sector	2016				2015**			
	Performing	Non-performing	Total	Provision	Performing	Non-performing	Total	Provision
				coverage (1)				coverage (1)
£m	£m	£m	%	£m	£m	£m	%	
Property	330	307	637	25	474	561	1,035	45
Natural resources	365	166	531	36	610	33	643	36
Transport	141	614	755	25	147	58	205	29
Retail and leisure	424	87	511	22	269	99	368	32
Services	201	225	426	33	451	105	556	44
Other	324	54	378	8	297	71	368	46
Total	1,785	1,453	3,238	27	2,248	927	3,175	43

Note:

(1) Provision coverage reflects impairment provision as a percentage of non-performing loans gross of provisions.

*Forbearance arrangements*

The table below shows the main types of Wholesale renegotiations. This includes only the forbore facility Current Exposure net of provisions and after risk transfer.

Wholesale renegotiations during the year by type (1)	2016	2015**
	£m	£m
Payment concessions	1,751	2,091
Non-payment concessions	1,487	1,084
Total	3,238	3,175

Note:

(1) Previously reported forbearance types are classified as non-payment (covenant concessions, release of security) and payment (payment concessions and loan rescheduling, forgiveness of all or part of the outstanding debt, variation in margin, standstill agreements).

**\*\*Restated - refer to page 289 for further details. 2015 data is unaudited.**

## Key points

- The levels of completed forbearance in 2016 remained stable. Year-on-year comparisons of the level of forbearance within the various sectors may be impacted by individual material cases during a given year.
- Loans totalling £1.4 billion were granted approval for forbearance but had not yet reached legal completion at 31 December 2016 (2015 - £1.4 billion). These exposures are referred to as "in process" and are not included in the tables above. 61% (£0.9 billion) of these "in process" exposures related to non-performing customers and 39% (£0.5 billion) related to performing loans. The principal types of arrangements offered were payment concessions and loan rescheduling.
- Forbearance in the Transport sector has increased in 2016 driven by the Shipping sector (£0.7 billion). A number of Shipping facilities which were forborne in 2016 were included in a portfolio sale during Q4. (Refer to page 316 for further information).
- The decrease in exposure in the Natural Resources sector is reflective of forbearance being granted to defaulted customers with provisions in the Oil & Gas sector given the sector's challenges (refer to page 312 for further information). As the exposure measure is net of provisions, this reduced forborne exposure is not reported in the table above. On a gross basis, the level of forbearance granted to customers in the Natural Resources sector was consistent with 2015.
- Forbearance for performing Retail & Leisure customers increased driven by a limited number of covenant waivers for individually material cases, while the volume of customers receiving forbearance decreased.
- £1.6 billion of the facilities granted forbearance in 2016 were managed by Restructuring Credit. This equated to 48% of loans managed by Restructuring Credit (excluding loans to customers where recovery procedures have commenced).
- The value of loans forborne during 2015 and 2016 and still outstanding at 31 December 2016 was £4.3 billion (2015 - £4.5 billion), of which £1.0 billion related to arrangements completed during 2015 (2015 - £1.3 billion completed in 2014).
- By value, 77% (£1.7 billion) of the performing loans granted forbearance in 2015 (£2.2 billion) remained performing at 31 December 2016.
- Provisions for non-performing loans disclosed above are for the most part individually assessed. As a result, material provisions and associated fluctuations in coverage levels can impact direct comparison across periods. Provision coverage decreased in 2016, which is reflective of the proportion of the 2015 forborne portfolio relating to Exit portfolios where the strategy resulted in high levels of provisions. Provision coverage for non-performing "in process" loans was 29%. Additional provisions charged in 2016 and relating to loans forborne during 2015 totalled £160 million. Provision coverage of these loans at 31 December 2016 was 50%.

- The data presented above include loans forborne during 2015 and 2014. Until April 2014 a reporting threshold was in place which ranged from nil to £3 million after which no thresholds were in use. A number of immaterial portfolios have forbearance assessed under a portfolio approach.

**Business review** Capital and risk management**Credit risk: management basis** continued**Key credit portfolios**

## Commercial Real Estate

The CRE sector relates to lending activity for the development of, and investment in, commercial and residential properties.

A dedicated portfolio controls team is responsible for reviewing portfolio strategy, credit risk appetite and policies, as well as oversight of valuations and environmental frameworks. The sector is reviewed regularly at senior executive committees. Reviews include portfolio credit quality, capital consumption and control frameworks.

The majority of CRE lending applications are reviewed by specialist CRE transactional credit teams, including a dedicated development team. Lending guidelines and policy are informed by lessons learned from the 2008 financial crisis.

New business is monitored and controlled against agreed underwriting standards. Sub-sector and asset class limits are used to restrict exposure to emerging risks when appropriate. This activity is reviewed and monitored on a regular basis.

CRE lending exposure by geography and property type on a Current Exposure basis net of provisions and after risk transfer*								
By geography (1)	Investment			Development			Overall	
	Commercial	Residential	Total	Commercial	Residential	Total	total	
	£m	£m	£m	£m	£m	£m	£m	
2016								
UK	16,773	3,762	20,535	367	3,127	3,494	24,029	
RoI	459	70	529	49	133	182	711	
Other Western Europe	739	34	773	13	39	52	825	
US	154	1	155	—	4	4	159	
RoW	25	2	27	2	1	3	30	
Total	18,150	3,869	22,019	431	3,304	3,735	25,754	

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Of which: Capital Resolution	953	46	999		1	74	75	1,074
Williams & Glyn	2,050	668	2,718		32	633	665	3,383
2015**								
UK	15,825	4,173	19,998		613	3,251	3,864	23,862
RoI	342	95	437		24	80	104	541
Other Western Europe	597	8	605		15	1	16	621
US	241	1	242		—	—	—	242
RoW	211	12	223		5	13	18	241
Total	17,216	4,289	21,505		657	3,345	4,002	25,507
Of which: Capital Resolution	1,318	47	1,365		50	104	154	1,519
Williams & Glyn	2,080	644	2,724		82	483	565	3,289

Note:

(1) Geography is based on country of collateral risk.

\*unaudited

\*\*restated - refer to page 289 for further details



## Business review Capital and risk management

<b>Credit risk: management basis continued</b>						
CRE lending exposure by sub-sector based on current exposure net of provisions and after risk transfer*						
			Other			
			Western			
By sub-sector	UK	RoI	Europe	US	RoW	Total
	£m	£m	£m	£m	£m	£m
2016						
Residential	6,889	204	73	4	3	7,173
Office	3,322	155	518	41	15	4,051
Retail	4,970	50	56	—	2	5,078
Industrial	2,696	33	65	1	—	2,795
Mixed/other	6,152	269	113	113	10	6,657
Total	24,029	711	825	159	30	25,754
2015						
Residential	7,424	175	9	1	25	7,634
Office	2,938	76	398	85	62	3,559
Retail	4,497	93	85	19	22	4,716
Industrial	2,600	36	39	—	7	2,682
Mixed/other	6,403	161	90	137	125	6,916
Total	23,862	541	621	242	241	25,507

A breakdown of the Commercial Banking UK investment portfolio for 2016 by UK region is set out below.

UK region (1)	Proportion
Greater London	29%
Portfolio (2)	22%
Midlands	13%
South East	12%
North	11%
Scotland	7%
Rest of the UK (3)	6%

Notes:

- (1) Based on management estimates using the postcode of the security. Percentages are based on current exposure gross of provisions.
- (2) Includes lending secured against property portfolios comprising numerous properties across multiple UK locations.
- (3) Includes Northern Ireland.

### Key points

- A slowdown in the UK commercial property investment market, which began in the third quarter of 2015, continued after the EU referendum result in June 2016. As a result, capital values were down by approximately 3% on average in the second half of 2016. Despite a minor recovery in the final months of 2016, forecasts suggest that values will remain under pressure during 2017. However, the sector continues to attract equity flows given its attractive yields.
- With the outlook for UK commercial property more uncertain, underwriting standards have been tightened across all commercial property investment portfolios to mitigate potential declines in property values.
- Lending to the CRE sector in the UK increased during the year as a result of CPB and PBB having appetite to support activity in the sector.
- The increase in exposure in RoI and Western Europe was primarily due to foreign exchange movements.

\*unaudited

**Business review** Capital and risk management**Credit risk: management basis** continued

## CRE exposure by LTV band

The table below provides a breakdown of the CRE portfolio by LTV band.

	2016			2015**		
	AQ1-AQ9	AQ10	Total	AQ1-AQ9	AQ10	Total
	£m	£m	£m	£m	£m	£m
<= 50%	10,695	53	10,748	9,896	72	9,968
> 50% and <= 70%	6,508	120	6,628	5,964	116	6,080
> 70% and <= 80%	474	67	541	685	125	810
> 80% and <= 90%	299	57	356	353	376	729
> 90% and <= 100%	130	41	171	143	150	293
> 100% and <= 110%	74	24	98	149	75	224
> 110% and <= 130%	136	357	493	221	122	343
> 130% and <= 150%	82	28	110	44	65	109
> 150%	108	61	169	253	199	452
Total with LTVs	18,506	808	19,314	17,708	1,300	19,008
Total portfolio average LTV (1)	48%	113%	51%	52%	167%	63%
Minimal security	1	—	1	2	4	6
Other	2,357	349	2,706	2,253	238	2,491
Development (2)	3,553	180	3,733	3,641	361	4,002
	24,417	1,337	25,754	23,604	1,903	25,507

Notes:

(1) Weighted average by Current Exposure gross of provisions

(2) Relates to the development of commercial and residential properties. LTV is not a meaningful measure for this type of lending activity.

**Key points**

- The reduction in overall portfolio average is primarily the result of repayments, asset sales and write-offs of legacy non-performing assets from Ulster Bank Rol, CPB and NatWest Markets. Remaining exposures with LTVs greater than 100% are legacy transactions.

- The exposure in Other relates mainly to lending to large corporate entities. It is not asset-backed but lent against corporate balance sheets.
- Interest payable on outstanding loans was covered 3.7x in Commercial Banking and 1.1x in Capital Resolution (2015 - 3.4x and 1.6x respectively).

**Business review** Capital and risk management

<b>Credit risk: management basis</b>							
<b>continued</b>							
A breakdown of CRE portfolio lending, gross of provision and after risk transfer, risk elements in lending (REIL) and provisions is provided below.							
	Total		Commercial Banking		Capital Resolution		
CRE loans, REIL and provisions	2016	2015*	2016	2015*	2016	2015*	
	£m	£m	£m	£m	£m	£m	
Lending (gross of provisions)	26,265	27,561	18,296	18,178	1,193	2,842	
Of which REIL	1,407	3,560	731	1,050	497	1,951	
Provisions	511	2,054	263	305	119	1,323	
REIL as a % of gross loans to customers	5.4%	12.9%	4.0%	5.8%	41.7%	68.6%	
Provisions as a % of REIL	36%	58%	36%	29%	24%	68%	

**Asset quality\***

A breakdown of asset quality of the CRE portfolio measured on a Current Exposure basis, net of provisions and after risk transfer, is set out below.\*\*

(1) There is little variation between CE and PE figures for the CRE portfolio as facilities tend to be fully drawn.

### Key point

- The growth in AQ6 band is the result of the introduction of a more conservative calibration of certain commercial real estate asset quality models, rather than deterioration of underlying asset quality.

\*unaudited

\*\*restated - refer to page 289 for further details



**Business review** Capital and risk management**Credit risk: management basis** continued**Natural Resources\***

Exposure to the Natural Resources sector, measured on both a Current Exposure (CE) and Potential Exposure (PE) basis, net of provisions and after risk transfer, is summarised below.

	2016				2015**			
		Of which:		Of which:		Of which:		Of which:
		Capital		Capital		Capital		Capital
	CE	Resolution	PE	Resolution	CE	Resolution	PE	Resolution
	£m	£m	£m	£m	£m	£m	£m	£m
Oil and gas	2,911	159	5,286	191	3,544	1,539	6,798	2,117
Mining and metals	623	32	1,887	126	729	237	1,823	391
Electricity	3,430	797	9,076	1,087	2,851	1,128	7,683	1,773
Water and waste	5,436	3,386	9,176	6,041	4,657	1,648	8,261	3,039
	12,400	4,374	25,425	7,445	11,781	4,552	24,565	7,320
Commodity traders	631	1	992	1	900	444	1,320	452
<i>Of which: Natural resources</i>	568	—	744	—	521	212	752	212

**Key points**

- Oil & Gas - CE and PE decreased during the year by 27% and 32% (£1.1 billion and £2.5 billion) respectively on a constant currency basis, with foreign exchange impact of £0.5 billion (CE) and £1.0 billion (PE). This portfolio remains subject to active risk management (see below).
- Mining & Metals - CE and PE decreased during the year by 23% and 10% (£0.2 billion and £0.2 billion) on a constant currency basis, with foreign exchange impact of £0.1 billion (CE) and £0.3 billion (PE). There was some deterioration in asset quality due to challenging market conditions and this portfolio remains subject to active risk management (see below).
- Electricity - CE and PE increased during the year by 9% and 5% (£0.3 billion and £0.4 billion) on a constant currency basis, with foreign exchange impact of £0.3 billion (CE) and £1.0 billion (PE). This was mainly due to refined classification of exposure in the natural resources sector which lead to a transfer of regulated utility exposure from Oil and Gas to Electricity and an increase in Project Finance exposure as part of the RBS growth strategy.



- Water & Waste - CE and PE increased during the year by 16% and 10% (£0.7 billion and £0.8 billion) on a constant currency basis, with foreign exchange impact of £0.1 billion (CE) and £0.1 billion (PE). These increases are predominately due to mark-to-market movements in long-dated inflation linked swaps driven by changes in long-term inflation outlook.

## Oil & Gas\*

Exposure to the Oil & Gas sector, split by sub-sector and geography, measured on a Potential Exposure basis, net of provisions and after risk transfer, is summarised below.

			Other			
			Western			
	UK	RoI	Europe	US	RoW (1)	Total
2016	£m	£m	£m	£m	£m	£m
Producers (including international oil companies)	664	—	1,087	2	236	1,989
Oilfield service providers	701	9	630	68	5	1,413
Other wholesale and trading activities	489	43	542	46	280	1,400
Refineries	27	—	—	285	3	315
Pipelines	33	4	121	1	10	169
	1,914	56	2,380	402	534	5,286
Of which:						
National oil companies	—	—	16	—	76	92
International oil companies	450	—	821	155	14	1,440
Exploration and production	302	—	154	2	141	599
2015**						
Producers (including international oil companies)	1,177	51	1,028	275	256	2,787
Oilfield service providers	700	10	678	279	51	1,718
Other wholesale and trading activities	450	76	475	45	432	1,478
Refineries	21	2	—	327	18	368
Pipelines	98	—	310	31	8	447
	2,446	139	2,491	957	765	6,798
Of which:						
National oil companies	—	—	21	—	70	91
International oil companies	654	—	868	273	10	1,805
Exploration and production	338	—	38	130	118	624

Note:

- (1) Comprises Asia Pacific, Central and Eastern Europe, the Middle East, Central Asia and Africa.

\*unaudited

\*\*restated - refer to page 289 for further details

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**Business review** [Capital and risk management](#)

**Credit risk: management basis** [continued](#)

[Asset quality](#)

breakdown of asset quality for the oil and gas portfolio, measured on both a Current Exposure and Potential Exposure basis, net of provisions and after risk transfer, is summarised below.\*\*

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\*unaudited

\*restated – refer to page 289 for further details

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## Business review **Capital and risk management**

### Credit risk: management basis *continued*

#### Key points

- Oil prices dipped below \$30 per barrel at the start of the year but ended the year above \$50 per barrel following positive announcements from OPEC and Non-OPEC producers around implementing production cuts of 1.8 million barrels a day. However, there is considerable market uncertainty around future oil prices and the outlook for the sector remains challenging.
- The portfolio reduced by £1.5 billion during the year or 22% (32% or £2.5 billion on a constant currency basis). Regulated gas distribution companies are no longer reported under the Oil and Gas sector and this reclassification reduced sector exposure by £724 million. The other reductions are attributable to the continued run-off of the US and APAC portfolios and active risk management in all regions.
- The risk management strategy during the year remained to focus the portfolio towards investment grade customers with robust credit profiles and strong liquidity to manage through the extended downturn. At 31 December 2016, 71% (2015 - 76%) of the portfolio exposure was investment grade (AQ1-AQ4 or equivalent to BBB- and above).
- The sub-sector in which a customer operates is a primary consideration for assessing credit risk. Customers involved in exploration and production (E&P) are most immediately exposed to low oil prices and these companies have introduced capital spending reductions and tight cost controls to conserve cash. In turn, this has impacted oilfield service providers, with E&P companies buying fewer products and services from the oilfield service providers, and demanding lower prices for those they do purchase.
- The other principal components of exposure to producers are International Oil Companies (IOCs) and National Oil Companies (NOCs). IOCs and NOCs are less vulnerable to the oil price decline due to scale, diversification and, in the case of NOCs, implicit support from governments. At 31 December 2016, 29% of the portfolio exposure was to IOCs and NOCS combined (2015 - 28%).
- Committed lending exposure included legal commitments to syndicated bank facilities and bilateral facilities with tenors up to five years. These committed facilities are for general corporate purposes - including funding operating needs and capital expenditures - and are available as long as counterparties comply with the terms of the credit agreement. Contingent obligations relate to guarantees, letters of credit and suretyships provided to customers. RBS had no high-yield bond or loan underwriting positions at 31 December 2016 (2015 - Nil).
- The number of forbearance events was consistent with 2015. In 2016 there was an increase in payment concessions granted compared to 2015 which predominantly involved the relaxation of financial covenants to give customers more financial flexibility. Most forbearance involved customers in the E&P and oilfield services sub-sectors where earnings have been more immediately and materially affected by the downturn.
- The number and value of cases on the Risk of Credit Loss framework in the Oil & Gas sector decreased during the year. The framework exposure is predominantly classified as Heightened Monitoring and the sector continues to be monitored closely. At 31 December 2016, exposures classified as Risk of

Credit Loss totalled £2 million.

- The increase in AQ10 reflected ongoing challenging market conditions which resulted in a small number of customers experiencing financial stress during the year. AQ10 assets at 31 December 2016 totalled £181 million (2015 - £44 million).

\*unaudited

\*\*restated - refer to page 289 for further details

**Business review** Capital and risk management**Credit risk: management basis** continued**Mining & Metals\***

Exposure to the Mining & Metals sector, measured on a Potential Exposure basis, net of provisions and after risk transfer, is summarised below.

	UK	RoI	Other Western Europe	US	RoW (1)	Total
	£m	£m	£m	£m	£m	£m
2016						
Mining	118	36	129	—	566	849
Metals - production	120	1	340	—	2	463
- wholesale	184	3	382	6	—	575
	422	40	851	6	568	1,887
2015**						
Mining	31	1	7	105	447	591
Metals - production	308	1	361	13	40	723
- wholesale	164	2	309	34	—	509
	503	4	677	152	487	1,823

Note:

(1) Comprises Asia Pacific, Central and Eastern Europe, the Middle East, Central Asia and Africa .

**Asset quality**

A breakdown of asset quality for the Mining & Metals portfolio, measured on both a Current Exposure and Potential Exposure basis, net of provisions and after risk transfer, is summarised below.\*\*

**Key point**

- The deterioration in asset quality reflected the challenging operating environment in 2016.

\*unaudited

\*\*restated - refer to page 289 for further details

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**Business review** Capital and risk management

<b>Credit risk: management basis</b>									
<b>continued</b>									
<b>Shipping*</b>									
Exposure to the Shipping sector, measured on both a Current Exposure and Potential Exposure basis net of provisions and after risk transfer, is summarised below.									
2016					2015**				
	Current	Of which: Capital	Potential	Of which: Capital		Current	Of which: Capital	Potential	Of which: Capital
	Exposure	Resolution	Exposure	Resolution		Exposure	Resolution	Exposure	Resolution
	£m	£m	£m	£m		£m	£m	£m	£m
Shipping	4,553	3,854	5,173	4,005		6,776	6,162	7,301	6,309

**Asset quality**

A breakdown of asset quality for the Shipping sector, measured on both a Current Exposure and Potential Exposure basis, net of provisions and after risk transfer, is summarised below.\*\*



\*unaudited

\*\*restated - refer to page 289 for further details

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## Business review **Capital and risk management**

### Credit risk: management basis *continued*

#### Key points

- Shipping exposure was £4.6 billion on a Current Exposure basis (down 43% or £3.4 billion on a constant currency basis compared with 2015, with foreign exchange impact of £1.2 billion) and £5.2 billion on a Potential Exposure basis (down 40% or £3.4 billion on a constant currency basis compared with 2015, with foreign exchange impact of £1.3 billion).
- Most of the Shipping portfolio is managed in Capital Resolution and is related to exposure secured by ocean-going vessels. The remaining exposure outside Capital Resolution related principally to is within the Shipbuilding and Inland Water Transport sub-sectors. The reduction in exposure was mainly driven by asset sales and debt repayments in Capital Resolution, in line with RBS's strategy.
- Within Capital Resolution, Concentrations were as follows: Containers 34% (2015 - 21%), Dry Bulk 26% (2015 - 37%), Tankers at 18% (2015 - 23%). Other vessel types included liquid petroleum gas, natural gas and roll-on/roll-off vessels at 22% of exposure (2015 - 19%).
- Conditions remained depressed in the Dry Bulk market, notwithstanding a gradual improvement during the second half of the year. The Container market also saw a marked downturn in 2016 with a significant reduction in spot rates and vessel values and this is set to continue into 2017. Tanker rates also weakened in 2016 with a general deterioration in vessel values.
- The Capital Resolution portfolio LTV at 31 December 2016 was 102% (2015 - 85%), or 92% net of the provisions outlined below. The year-on-year increase in LTV is reflective of the market and vessel value movements outlined above. The LTV calculation includes vessel security only and does not incorporate any non-vessel security such as cash or guarantees.
- At 31 December 2016, exposures classified as Risk of Credit Loss totalled £363 million reflecting the prolonged market downturn in this sector.
- Provisions, excluding latent provisions, increased from £169 million to £386 million during 2016. Again, this was due to weak market conditions, and increasing LTV, which led to an increase in the portfolio's levels of default.
- At 31 December 2016, AQ10 exposure, net of provisions was £867 million (2015 - £210 million).
- There was an increase in the number of forbearance events, mainly involving the relaxation of minimum security covenants due to deteriorating asset prices. Total forbearance for this sector was £723 million.

\*unaudited

## Business review **Capital and risk management**

### Credit risk: management basis **continued**

#### Personal credit risk management

This section sets out further detail on RBS's approach to credit risk management for its personal customers.

#### Risk appetite\*

RBS uses a credit risk appetite framework to control credit risk for its personal businesses. The framework sets limits that measure and control, for each relevant franchise or reportable segment, the quality of both existing and new business. The actual performance of each portfolio is tracked relative to these limits and action taken where necessary. These limits apply to a range of credit risk-related measures including expected loss of the portfolio, the expected loss in a given stress scenario, projected credit default rates and the LTV of personal mortgage portfolios.

#### Personal credit risk assessment\*

Personal lending entails making a large number of small-value loans. To ensure that these lending decisions are made consistently, RBS analyses credit information, including the historical debt servicing behaviour of customers with respect to both RBS and their other lenders. RBS then sets its lending rules accordingly, developing different rules for different products. The process is then largely automated, with customers receiving a credit score that reflects a comparison of their credit profile with the rule set. However, for relatively high-value, complex personal loans, including some residential mortgage lending, specialist credit managers make the final lending decisions.

#### Personal risk mitigation\*

RBS takes collateral in the form of residential property to mitigate the credit risk arising from mortgages and home equity lending. RBS values residential property during the loan underwriting process by either appraising properties individually or valuing them collectively using statistically valid models. RBS updates residential property values quarterly using the relevant residential property index, namely:

Region	Index used
UK	Halifax quarterly regional house price index
Northern Ireland	UK House Price Index (published by the Land Registry)
RoI	Central Statistics Office residential property price index

### Problem debt management\*

Personal customers in financial difficulty are managed through either collections or recoveries functions.

### Collections\*

Collections functions in each of RBS's personal businesses provide support to customers who cannot meet their obligations to RBS. Such customers may miss a payment on their loan, borrow more than their agreed limit, or ask for help. Dedicated support teams are also in place to identify and help customers who have not yet missed a payment but may be facing financial difficulty. The collections function uses a range of tools to initiate contact with such customers, establish the cause of their financial difficulty and support them where possible.

\*unaudited

## Business review **Capital and risk management**

### **Credit risk: management basis** continued

In the process, they may consider granting the customer forbearance.

Additionally, in the UK and Ireland support is provided to customers with unsecured loans who establish a repayment plan with RBS through a debt advice agency or a self-help tool. Such “breathing space” suspends collections activity for a 30-day period to allow time for the repayment plan to be put in place. Arrears continue to accrue for customer loans granted breathing space.

If collections strategies are unsuccessful the relationship is transferred to the recoveries team.

### Forbearance

Forbearance takes place when a concession is made on the contractual terms of a loan in response to a customer's financial difficulties.

Customers who contact RBS directly because of financial difficulties, or who are already in payment arrears, may be granted forbearance. In the course of assisting customers, more than one forbearance treatment may be granted.

The type of forbearance granted will differ based upon an assessment of the customer's circumstances. Forbearance is granted principally to customers with mortgages and less frequently to customers with unsecured loans. This includes instances where forbearance may be taken for customers with highly flexible mortgages.

Forbearance options include, but are not limited to:

- **Payment concessions** - A temporary reduction in, or elimination of, the periodic (usually monthly) loan repayment is agreed with the customer. At the end of the concessionary period, forborne principal and accrued interest outstanding is scheduled for repayment over an agreed period. Ulster Bank RoI also offers payment concessions in the form of discounted interest rates that involve the forgiveness of some interest.
- **Capitalisation of arrears** - The customer repays the arrears over the remaining term of the mortgage and returns to an up-to-date position.



- **Term extensions** - The loan's maturity date is extended.
- **Interest only conversions** - The loan converts from principal and interest repayment to interest only repayment. This is only available in Ulster Bank RoI and Ulster Bank North on a temporary basis. These forbearance concessions are no longer offered to customers in UK PBB, RBSI and Private Banking.

Types of forbearance offered in the unsecured portfolios vary by reportable segment.

\*unaudited

## Business review **Capital and risk management**

### **Credit risk: management basis** *continued*

*Monitoring of forbearance* - Forborne loans are separated into a distinct population and reported on a regular basis until they exit the forborne population.

A loan is considered to have exited forbearance when it meets the criteria set out by the European Banking Authority (EBA) requirements for Financial Reporting. These include being classified as performing for two years since the last forbearance event, making regular repayments and the debtor being less than 30 days past due.

The act of granting of forbearance in itself will only change the delinquency status of the loan in exceptional circumstances, which can include capitalisation of principal and interest in arrears, where the loan may be returned to the performing book if it remains up to date for the duration of the probation period and is deemed likely to continue to do so.

Additionally for some forbearance types a loan may be transferred to the performing book (following a probationary period) if a customer makes payments that reduce loan arrears below 90 days (Ulster Bank RoI, UK PBB collections function).

### *Impairments for forbearance*

The methodology used for provisioning in respect of forborne loans will differ depending on whether the loans are performing or non-performing and which business is managing them due to local market conditions.

For the latent calculation, an extended emergence period is applied to account for the impact of forbearance within the portfolio. Additionally for portfolios with material forbearance, forborne loans form a separate risk pool and use different PD model:

- UK PBB (excl. NI) and W&G: forborne mortgages form a separate risk pool for 24 months after the agreement of forbearance and the calculation uses the higher of the observed default rates or PD. On unsecured loans, separate risk pools are used for the duration of the forbearance treatment.
- Ulster Bank: forborne and previously forborne mortgages form a separate risk pool taking into account the term of the forbearance treatment and applicable probationary periods. The PD model used is calibrated separately for forborne loans, using information on the historic performance of loans subject to

similar arrangements.

For non-performing loans, there is no difference in treatment with the exception of Ulster Bank, where forborne loans which result in an economic loss to the group form a separate risk pool where specific LGDs are allocated using observed cohort performance.

### Recoveries\*

Once a loan has been identified as impaired it is managed by recoveries teams in the relevant businesses. The teams seek to minimise RBS's loss by maximising cash recovery while treating customers fairly.

Where an acceptable repayment arrangement cannot be agreed with the customer litigation may be considered. In the UK and Northern Ireland, no repossession procedures are initiated until at least six months following the emergence of arrears (in the Republic of Ireland, regulations prohibit taking legal action for an extended period). Additionally, certain forbearance options are made available to customers managed by the recoveries function.

\*unaudited

## Business review Capital and risk management

Credit risk: management basis continued						
Overview of personal portfolio split by product type and segment on a Current Exposure basis net of provisions*						
	UK PBB	Ulster Bank Rol	Private Banking	RBSI	W&G	Total
2016	£m	£m	£m	£m	£m	£m
Mortgages	117,040	14,396	7,168	2,637	10,856	152,097
Of which:						
Interest only variable rate	11,694	349	3,625	692	1,317	17,677
Interest only fixed rate	11,132	7	2,290	81	1,186	14,696
Mixed (capital and interest only)	5,316	75	—	23	687	6,101
Buy-to-let	16,678	1,777	770	881	1,427	21,533
Provisions	151	919	2	27	23	1,122
REIL	736	3,144	23	84	101	4,088
Other lending (1)	8,962	291	1,730	64	958	12,005
Provisions	834	48	18	1	113	1,014
REIL	860	50	61	5	117	1,093
Total lending	126,002	14,687	8,898	2,701	11,814	164,102
Mortgage LTV ratios (2)						
- Total portfolio	56%	76%	56%	57%	54%	58%
- New business	69%	74%	55%	66%	69%	68%
- Buy-to-let	56%	82%	54%	49%	55%	56%
- Performing	56%	72%	56%	56%	53%	57%
- Non-performing	60%	94%	68%	105%	56%	77%

2015**							
Mortgages		104,599	12,713	6,552	2,525	10,430	136,819
Of which:							

Interest only variable rate	13,252	407	3,025	730	1,388	18,802
Interest only fixed rate	9,112	6	2,431	49	1,076	12,674
Mixed (capital and interest only)	5,380	76	7	29	745	6,237
Buy-to-let	14,098	1,762	476	835	1,150	18,321
Provisions	180	1,062	4	18	26	1,290
REIL	878	2,550	19	63	123	3,633
Other lending (1)	8,795	233	3,458	62	958	13,506
Provisions	1,028	48	22	1	129	1,228
REIL	1,028	49	53	5	140	1,275
Total lending	113,394	12,946	10,010	2,587	11,388	150,325
Mortgage LTV ratios (2)						
- Total portfolio	56%	83%	54%	57%	54%	59%
- New business	69%	77%	57%	62%	68%	68%
- Buy-to-let	57%	95%	58%	51%	57%	60%
- Performing	56%	80%	54%	57%	54%	58%
- Non-performing	63%	106%	92%	96%	60%	83%

Notes:

- (1) Excludes loans guaranteed by a company and commercial real estate lending to personal customers.
- (2) Weighted by current exposure gross of provisions.

\*unaudited

\*\*restated - refer to page 289 for further details

## Business review Capital and risk management

Credit risk: management basis continued						
Overview of new mortgage lending on a Current Exposure basis net of provisions*						
	UK PBB	Ulster Bank Rol	Private Banking	RBSI	W&G	Total
	£m	£m	£m	£m	£m	£m
2016						
Gross new mortgage lending (1)	29,027	893	3,291	470	2,156	35,837
Of which:						
Owner occupied	25,086	876	2,819	300	1,833	30,914
Average LTV by weighted value	71%	74%	55%	69%	70%	70%
Buy-to-let	3,941	17	472	170	323	4,923
Average LTV by weighted value	62%	59%	54%	62%	62%	61%
(1) Excludes additional lending to existing customers.						
2015						
Gross new mortgage lending	22,713	553	2,383	258	1,728	27,635
Of which:						
Owner occupied	18,884	541	2,161	179	1,412	23,177
Average LTV by weighted value	71%	77%	54%	64%	69%	69%
Buy-to-let	3,829	12	222	79	316	4,458
Average LTV by weighted value	64%	65%	64%	57%	64%	64%

Forbearance stock and flow on a Current Exposure basis net of provisions						
2016						
Forbearance stock (1)	1,290	3,709	65	43	177	5,284
Forbearance stock: arrears						
Current	790	2,077	65	29	107	3,068
1-3 months in arrears	286	473	—	2	41	802
>3 months in arrears	214	1,159	—	12	29	1,414
Provisions against forbearance stock	51	790	—	1	8	850
Forbearance type:						
Long-term arrangements (2)	701	1,249	63	37	111	2,161

Short-term arrangements (3)	860	2,460	2	6	110	3,438
Forbearance flow	406	316	49	10	53	834
2015*						
Forbearance stock (1)	1,444	3,643	64	43	202	5,396
Forbearance stock: arrears						
Current	863	2,165	64	31	124	3,247
1-3 months in arrears	329	470	—	6	46	851
>3 months in arrears	252	1,008	—	6	32	1,298
Provisions against forbearance stock	59	884	—	1	8	952
Forbearance type:						
Long-term arrangements (2)	800	1,173	39	35	129	2,176
Short-term arrangements (3)	953	2,470	25	8	120	3,576
Forbearance flow	435	197	47	17	57	753

## Notes:

- (1) Q4 2016 forbearance calculation has moved to the FINREP EBA basis.
- (2) Capitalisation term extensions, economic concessions.
- (3) Payment concessions, amortising payments of outstanding balances, payment holidays and temporary interest arrangements.

\*unaudited

## Business review Capital and risk management

Credit risk: management basis continued												
Mortgage LTV distribution by segment on a Current Exposure basis net of provisions												
		50%	70%	80%	90%	100%	110%	130%		Total with		
LTV ratio value (1)	<=50%	<=70%	<=80%	<=90%	<=100%	<=110%	<=130%	<=150%	>150%	LTVs	Other	Total
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
<b>2016</b>												
<b>UK PBB</b>												
AQ1-AQ9	43,332	41,442	15,778	10,862	2,885	175	150	76	55	114,755	705	115,460
AQ10	548	637	182	113	51	15	7	3	5	1,561	19	1,580
	43,880	42,079	15,960	10,975	2,936	190	157	79	60	116,316	724	117,040
Of which: buy-to-let	5,645	8,196	2,290	360	105	27	20	14	6	16,663	15	16,678
<b>Ulster Bank Rol</b>												
AQ1-AQ9	3,079	2,897	1,649	1,411	1,144	1,056	1,205	119	22	12,582	—	12,582
AQ10	252	296	169	179	177	199	340	154	48	1,814	—	1,814
	3,331	3,193	1,818	1,590	1,321	1,255	1,545	273	70	14,396	—	14,396
<b>Private Banking</b>												
AQ1-AQ9	2,594	3,188	820	163	29	7	2	8	13	6,824	233	7,057
AQ10	25	49	12	8	1	5	2	—	—	102	9	111
	2,619	3,237	832	171	30	12	4	8	13	6,926	242	7,168
<b>RBSI</b>												
AQ1-AQ9	1,099	812	378	236	26	29	6	6	15	2,607	—	2,607
AQ10	(2)	11	3	4	4	3	2	—	5	30	—	30
	1,097	823	381	240	30	32	8	6	20	2,637	—	2,637
<b>W&amp;G</b>												
AQ1-AQ9	4,565	3,754	1,280	867	178	6	—	—	—	10,650	10	10,660
AQ10	81	89	17	7	2	—	—	—	—	196	—	196
	4,646	3,843	1,297	874	180	6	—	—	—	10,846	10	10,856



2015**												
UK PBB												
AQ1-AQ9	38,430	38,645	14,372	7,985	2,646	255	174	90	18	102,615	251	102,866
AQ10	483	713	250	152	77	26	12	7	3	1,723	10	1,733
	38,913	39,358	14,622	8,137	2,723	281	186	97	21	104,338	261	104,599
Of which: buy-to-let	4,374	6,879	2,202	431	131	34	30	14	1	14,096	2	14,098
Ulster Bank Rol												
AQ1-AQ9	2,276	2,075	1,222	1,155	1,004	964	1,633	410	49	10,788	—	10,788
AQ10	226	258	153	163	179	178	385	264	119	1,925	—	1,925
	2,502	2,333	1,375	1,318	1,183	1,142	2,018	674	168	12,713	—	12,713
Private Banking												
AQ1-AQ9	2,431	2,846	707	147	30	15	1	12	20	6,209	323	6,532
AQ10	3	1	3	1	9	1	1	—	1	20	—	20
	2,434	2,847	710	148	39	16	2	12	21	6,229	323	6,552
RBSI												
AQ1-AQ9	985	873	339	190	40	27	19	2	14	2,489	—	2,489
AQ10	5	11	2	3	5	1	3	1	5	36	—	36
	990	884	341	193	45	28	22	3	19	2,525	—	2,525
W&G												
AQ1-AQ9	4,113	3,738	1,216	648	174	11	1	—	—	9,901	297	10,198
AQ10	71	100	27	18	8	1	—	—	—	225	7	232
	4,184	3,838	1,243	666	182	12	1	—	—	10,126	304	10,430

Note:

(1) LTV is calculated on a Current Exposure basis, gross of provisions.

\*\*restated - refer to page 289 for further details. 2015 data is unaudited.



## Business review **Capital and risk management**

### Credit risk: management basis **continued**

#### Key points

##### UK PBB\*

- The total portfolio increased by 11.9% from 31 December 2015. This was in line with the segment's growth strategy and within risk appetite. The portfolio is closely monitored and risk appetite is regularly reviewed to ensure it is appropriate for market conditions. Underwriting standards were not relaxed during the year.
- Other Personal lending remained stable during the year in the context of an upward trend in unsecured household debt in the wider UK market. Asset quality remained stable with no deterioration in the arrears rate from the prior year.
- Gross new mortgage lending amounted to £29.0 billion (excluding additional lending to existing customers) in 2016 with an average LTV by weighted value of 69% (2015 - 69%). Lending to owner-occupiers during this period was £25.1 billion (2015 - £18.9 billion) and had an average LTV by weighted value of 71% (2015 - 71%). Buy-to-let lending was £3.9 billion (2015 - £3.8 billion) with an average LTV by weighted value of 62% (2015 - 64%).
- Approximately 12% by value of owner-occupied mortgages were on interest-only terms with a bullet repayment and 5% were on a combination of interest-only and capital and interest. The remainder were capital and interest. 65% by value of the buy-to-let mortgages were on interest-only terms and 3% on a combination of interest only and capital and interest.
- Fixed interest rate products of varying time durations accounted for approximately 73% by value of the mortgage portfolio with 2% a combination of fixed and variable rates and the remainder variable rate. The proportion of the portfolio on fixed rate products rose due to the very high proportion of customers taking out fixed rate mortgages in 2016.
- Based on the Halifax House Price Index at September 2016, the portfolio average indexed LTV by volume was 50% (2015 - 49%) and 56% by weighted value of debt outstanding (2015 - 56%). The £2.2 billion of mortgages granted by Ulster Bank North were indexed against the UK house price index published by the Land Registry.
- The arrears rate (three or more repayments past due) fell from 0.8% (by volume) in December 2015 to 0.7% at 31 December 2016. The number of properties repossessed in 2016 was also lower at 519 compared with 727 in 2015.
- The flow of new forbearance was £406 million in 2016 compared with £435 million in 2015. The value of mortgages subject to forbearance decreased by 10.4% compared with 2015 to £1.3 billion (equivalent to 1.1% of the total mortgage book). This was mainly driven by benign market conditions.
- A release of provision on historically-impaired mortgages was the key driver in an overall provision release of £20.5 million for the year (2015 charge of £2.8 million). The value of underlying defaults was

slightly lower year-on-year.

\*unaudited

## Business review Capital and risk management

## Credit risk: management basis continued

The table below summarises UK mortgage exposure by region and LTV.

		50%	70%	80%	90%	100%	110%	130%		Total with (1)	WA (1)		
LTV ratio value	<=50%	<=70%	<=80%	<=90%	<=100%	<=110%	<=130%	<=150%	>150%	LTVs	LTV	Other	To
2016	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	%	£m	£
South East	12,793	11,521	3,371	1,734	320	4	8	1	—	29,752	53%	153	29,90
Greater London	12,624	7,108	1,715	675	228	1	2	1	—	22,354	48%	158	22,51
Scotland	2,931	3,521	1,684	1,316	553	42	4	—	—	10,051	61%	51	10,10
North West	2,713	3,728	1,836	1,682	342	13	4	2	—	10,320	62%	70	10,39
South West	3,535	4,116	1,499	853	97	5	3	5	—	10,113	56%	62	10,17
West Midlands	2,033	2,960	1,334	1,001	289	3	2	2	—	7,624	61%	47	7,67
Rest of the UK (2)	7,251	9,125	4,521	3,714	1,107	122	134	68	60	26,102	62%	183	26,28
<b>Total</b>	<b>43,880</b>	<b>42,079</b>	<b>15,960</b>	<b>10,975</b>	<b>2,936</b>	<b>190</b>	<b>157</b>	<b>79</b>	<b>60</b>	<b>116,316</b>	<b>56%</b>	<b>724</b>	<b>117,04</b>
<b>2015</b>													
South East	10,402	10,668	3,279	1,410	318	8	7	6	—	26,098	54%	45	26,14
Greater London	11,402	6,426	1,252	418	90	1	2	1	—	19,592	47%	68	19,66
Scotland	3,198	3,775	1,497	840	323	34	2	—	—	9,669	58%	25	9,69
North West	2,475	3,548	1,662	1,162	476	47	5	—	—	9,375	61%	31	9,40
South West	2,850	3,549	1,581	851	217	8	6	5	—	9,067	58%	23	9,09
West Midlands	1,728	2,601	1,301	737	324	17	2	3	—	6,713	61%	23	6,73
Rest of the UK (2)	6,858	8,791	4,050	2,719	975	166	162	82	21	23,824	62%	46	23,87
<b>Total</b>	<b>38,913</b>	<b>39,358</b>	<b>14,622</b>	<b>8,137</b>	<b>2,723</b>	<b>281</b>	<b>186</b>	<b>97</b>	<b>21</b>	<b>104,338</b>	<b>56%</b>	<b>261</b>	<b>104,59</b>

Notes:

- (1) Weighted average.
- (2) Includes Northern Ireland.

\*unaudited

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## Business review Capital and risk management

<b>Credit risk: management basis continued</b>								
The table below shows interest only mortgage portfolios (excluding mixed repayment mortgages) by type and by contractual year of maturity.								
	2017 (1)	2018-19	2020-24	2025-29	2030-34	2035-44	After 2044	Total
	£m	£m	£m	£m	£m	£m	£m	£m
2016								
Bullet principal repayment (2)	452	956	3,528	5,320	6,015	6,096	453	22,820
Conversion to amortising (2,3)	6	—	—	—	—	—	—	6
Total	458	956	3,528	5,320	6,015	6,096	453	22,826
	2016 (4)	2017-18	2019-23	2024-28	2029-33	2034-43	After 2043	Total
	£m	£m	£m	£m	£m	£m	£m	£m
2015**								
Bullet principal repayment (2)	461	1,028	3,413	5,006	6,362	5,743	348	22,361
Conversion to amortising (2,3)	3	—	—	—	—	—	—	3
Total	464	1,028	3,413	5,006	6,362	5,743	348	22,364

Notes:

- (1) 2017 includes pre-2017 maturity exposure.
- (2) Includes £0.1 billion (2015 - £0.1 billion) of repayment mortgages that have been granted interest-only concessions (forbearance).
- (3) Maturity date relates to the expiry of the interest only period.
- (4) 2016 includes pre-2016 maturity exposure.

\*unaudited

**Business review** Capital and risk management**Credit risk: management basis** continued**Key points**

## Ulster Bank Rol \*

- Excluding the impact of exchange rate movements of £2,174 million, the portfolio decreased by 2.9% (£433 million) from 31 December 2015 as a result of amortisation and portfolio sales (£588 million). The volume of new business has increased reflecting continuing market demand.
- Tracker-rate products accounted for approximately 64% of the portfolio, while variable rate totalled 21% and fixed rate 15%.
- The decrease in portfolio average indexed LTV reflected positive house price index trends over the last 12 months and the impacts of Central Bank of Ireland requirements for new lending.
- At 31 December 2016, 26% of total mortgage assets (£3.7 billion) were subject to a forbearance arrangement, an increase of 2% (£66 million) from 31 December 2015. Excluding the impact of exchange rate movements of £606 million, the value of mortgage assets subject to a forbearance arrangement decreased by £540 million (13%).
- The number of customers approaching Ulster Bank Rol for the first time in respect of forbearance assistance declined during 2016. The majority (69%) of forbearance arrangements were less than 90 days in arrears.
- A key driver of both reduced forbearance rates and longer average forbearance durations was the introduction of Ulster Bank Rol's sustainability policy in the fourth quarter of 2015. Under that policy customers are only eligible for forbearance as part of a sustainable solution. The use of forbearance is therefore more limited than previously, applying only to those customers who can be returned to a sustainable status through forbearance.
- The AQ10 population reduced to £1.8 billion. This was mainly the result of the disposal of a distressed portfolio. There was a very high provision coverage in relation to this portfolio and, as a result, the disposal also led to a reduction in provision coverage.

The table below shows interest only mortgage portfolios (excluding mixed repayment mortgages) by type and by contractual year of maturity.								
	2017 (1)	2018-19	2020-24	2025-29	2030-34	2035-44		Total



							After 2044	
2016	£m	£m	£m	£m	£m	£m	£m	£m
Bullet principal repayment (2)	9	11	31	47	59	34	6	197
Conversion to amortising (2,3)	110	29	4	3	7	5	2	160
Total	119	40	35	50	66	39	8	357
	2016 (4)	2017-18	2019-23	2024-28	2029-33	2034-43	After 2043	Total
2015**	£m	£m	£m	£m	£m	£m	£m	£m
Bullet principal repayment (2)	6	13	25	41	63	25	5	178
Conversion to amortising (2,3)	118	104	5	3	3	1	1	235
Total	124	117	30	44	66	26	6	413

## Notes:

- (1) 2017 includes pre-2017 maturity exposure.
- (2) Includes £0.2 billion (2015 - £0.3 billion) of repayment mortgages that have been granted interest only concessions (forbearance).
- (3) Maturity date relates to the expiry of the interest only period.
- (4) 2016 includes pre-2016 maturity exposure.

\*unaudited

\*\*restated - refer to page 289 for further details

**Business review** Capital and risk management**Credit risk: management basis** continued**Key points**

## Private Banking\*

- The majority of the Private Banking personal lending portfolio related to mortgage lending. The net portfolio increase was £616 million (9.4%) from 31 December 2015, in line with the segment's growth strategy and risk appetite.
- Gross new mortgage lending amounted to £3.3 billion in 2016. Lending to owner-occupiers during the period was £2.8 billion (2015 - £2.2 billion) and had an average LTV by weighted value of 55% (2015 - 54%). Buy-to-let lending was £472 million (2015 - £222 million) with an average LTV by weighted value of 54% (2015 - 64%).
- Fixed interest rate products accounted for approximately 41% of the mortgage portfolio, with two-year term products accounting for 58% of all fixed deals.
- Approximately 82% of all mortgages were on interest-only terms; 82% of owner-occupied mortgages were interest-only with 90% of buy-to-let mortgages on interest-only terms.
- Provisions remained minimal during the period.

The table below shows interest only mortgage portfolios (excluding mixed repayment mortgages) by type and by contractual year of maturity.

	2017 (1)	2018-19	2020-24	2025-29	2030-34	2035-44	After 2044	Total
	£m	£m	£m	£m	£m	£m	£m	£m
2016								
Bullet principal repayment	1,399	1,081	1,452	1,111	453	415	3	5,914
	2016 (2)	2017-18	2019-23	2024-28	2029-33	2034-43	After 2043	Total
	£m	£m	£m	£m	£m	£m	£m	£m
2015**								
Bullet principal repayment	846	1,585	1,658	859	296	210	2	5,456

Notes:

(1) 2017 includes pre-2017 maturity exposure.

(2) 2016 includes pre-2016 maturity exposure.

\*unaudited

\*\*restated – refer to page 289 for further details

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**Business review** Capital and risk management**Credit risk: management basis** continued**Key points**

## RBS International\*

- The total portfolio increased by 4% from £2.6 billion to £2.7 billion from 31 December 2015 in line with the franchise's growth strategy and risk appetite.
- Gross new mortgage lending amounted to £470 million in 2016. Lending to owner-occupiers during this period was £300 million (2015 - £175 million) and had an average LTV by weighted value of 69% (2015 - 64%). Buy-to-let lending was £170 million (2015 - £79 million) with an average LTV by weighted value of 62% (2015 - 57%).
- The number of customers granted forbearance in 2016 decreased by 28%. A total of £37 million of forbore loans were subject to a long-term arrangement (term extensions and covenant breaches) at 31st December 2016 (2015 - £35 million). Short term forbearance comprises payment suspensions and reduced payments.
- The arrears rate increased from 0.75% in December 2015 to 0.78% at the end of December 2016.
- There was a provision impairment charge of £8.5 million for personal mortgages in 2016 (release of £1 million in 2015).

The table below shows interest only mortgage portfolios (excluding mixed repayment mortgages) by type and by contractual year of maturity.

	2017 (1)	2018-19	2020-24	2025-29	2030-34	2035-44	After 2044	Total
2016	£m	£m	£m	£m	£m	£m	£m	£m
Bullet principal repayment	117	98	107	170	128	59	94	773
	2016 (2)	2017-18	2019-23	2024-28	2029-33	2034-43	After 2043	Total
2015**	£m	£m	£m	£m	£m	£m	£m	£m
Bullet principal repayment	77	177	157	183	145	39	1	779

Notes:

- (1) 2017 includes pre-2017 maturity exposure.
- (2) 2016 includes pre-2016 maturity exposure.

\*unaudited

\*\*restated - refer to page 289 for further details

**Business review** Capital and risk management**Credit risk: management basis** continued**Key points**

## Williams &amp; Glyn\*

- The total portfolio increased by 3.74% from 31 December 2015, driven by gross new mortgage lending amounting to £2.2 billion in 2016 but remained within risk appetite. Lending to owner-occupiers during this period was £1.8 billion (2015 - £1.4 billion) and had an average LTV by weighted value of 70% (2015 - 70%). Buy-to-let lending was £323 million (2015 - £316 million) with an average LTV by weighted value of 62% (2015 - 64%).
- Fixed interest rate products of varying time durations accounted for approximately 65% of the mortgage portfolio with 6% a combination of fixed and variable rates and the remainder variable rate.
- The flow of new forbearance remained low during the year, with exposure totalling £53 million (2015 - £57 million) granted forbearance in 2016. The value of mortgages subject to forbearance remain low, showing a decrease of 12% in 2016 to £0.18 billion (equivalent to 1.6% of the total mortgage portfolio) as a result of improved market conditions.
- There was a reduction of impairment provision balances for personal mortgages in 2016 to £23 million compared with £26 million in 2015. The provision release resulted from revised modelling assumptions reflecting current market conditions.

The table below shows interest only mortgage portfolios (excluding mixed repayment mortgages) by type and by contractual year of maturity.

	2017 (1)	2018-19	2020-24	2025-29	2030-34	2035-44	After 2044	Total
	£m	£m	£m	£m	£m	£m	£m	£m
2016								
Bullet principal repayment	66	136	451	702	626	486	37	2,504
	2016 (2)	2017-18	2019-23	2024-28	2029-33	2034-43	After 2043	Total
	£m	£m	£m	£m	£m	£m	£m	£m
2015**								
Bullet principal repayment	58	124	419	621	670	538	34	2,464

Notes:

- (1) 2017 includes pre-2017 maturity exposure.
- (2) 2016 includes pre-2016 maturity exposure.

\*unaudited

\*\*restated - refer to page 289 for further details

## Business review Capital and risk management

## Credit risk: management basis continued

Balance sheet to current exposure bridge*							
The table below provides a bridge between the balance sheet and the related components of Current Exposure (CE).							
	Balance sheet	Within the scope of market risk (1)	Disposal groups (2)	Netting and collateral (3)	Methodology differences and reclassifications (4)	Not within the scope of CE (5)	CE
	£bn	£bn	£bn	£bn	£bn	£bn	£bn
2016							
Cash and balances at central banks	74.3	—	—	—	(0.6)	(4.2)	69.5
Reverse repurchase agreements and stock borrowing (6)	41.8	—	—	(39.4)	—	—	2.4
Loans and advances	340.3	(0.2)	—	(24.4)	(8.4)	(1.7)	305.6
Debt securities	72.5	(24.4)	—	—	0.4	—	48.5
Equity shares	0.7	(0.2)	—	—	(0.5)	—	—
Settlement balances	5.5	—	—	—	—	(5.5)	—
Derivatives	247.2	—	—	(226.8)	(1.4)	—	19.0
Other assets (7)	16.8	—	—	—	—	(15.5)	1.3
<b>Total assets</b>	<b>799.1</b>	<b>(24.8)</b>	<b>—</b>	<b>(290.6)</b>	<b>(10.5)</b>	<b>(26.9)</b>	<b>446.3</b>
Contingent obligations							11.3
							457.6
<b>2015</b>							
Cash and balances at central banks	79.4	—	0.5	—	(0.2)	(3.9)	75.8
Reverse repurchase agreements and stock borrowing (6)	39.8	—	—	(37.3)	—	—	2.5
Loans and advances	324.7	(0.3)	2.4	(28.9)	(8.3)	(1.5)	288.1
Debt securities	82.1	(35.7)	0.5	—	0.6	(0.3)	47.2
Equity shares	1.4	(0.7)	—	—	(0.7)	—	—
Settlement balances	4.1	—	—	—	—	(4.1)	—



Derivatives	262.5	—	—	(244.0)	2.2	—	20.7
Other assets (7)	21.4	—	(3.4)	—	(0.1)	(16.5)	1.4
Total assets	815.4	(36.7)	—	(310.2)	(6.5)	(26.3)	435.7
Contingent obligations							15.1
							450.8

## Notes:

(1) The exposures in regulatory trading book businesses are subject to market risk and are hence excluded from current exposure.

(2) Amounts reclassified to balance sheet lines.

(3) Primarily includes:

- Reverse repos: reflects netting of collateral and cash legs.

- Loans and advances: cash collateral pledged with counterparties in relation to net derivative liability positions.

- Derivatives: impact of master netting arrangements.

(4) Primarily includes cash management pooling arrangements not allowed under IFRS for loans and advances.

- Settlement balances: exposure not included in current exposure measure

(5) Primarily includes cash in ATMs and branches; Other assets (see note below); and Settlement balances (not within the scope of current exposure).

(6) Balance sheet position shows reverse repurchase and stock borrowing position; current exposure position shows net reverse repurchase / stock borrowing and repurchase / stock lending position.

(7) Balance sheet position includes intangible assets, property, plant and equipment, deferred tax, prepayments and accrued income and assets of disposal groups.

\*unaudited

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## Business review **Capital and risk management**

### Credit risk: balance sheet analysis

Current and Potential Exposures presented in Credit risk: management basis are used by Risk Management for risk management and monitoring. However, they exclude certain exposures, primarily trading securities and take account of legal netting agreements that provide a right of legal set-off but do not meet the offset criteria in IFRS. The tables that follow are therefore provided to supplement the disclosures in the Credit risk: management basis section, to reconcile to the balance sheet. The tables in this section include balances relating to disposal groups, reflecting the total credit risk and losses faced by RBS. All the disclosures in this section are audited.

### Financial assets

#### Exposure summary and credit mitigation

The following table analyses financial asset exposures, both gross and net of offset arrangements, as well as credit mitigation and enhancement.

	Gross exposure	IFRS offset (1)	Carrying value (2)	Balance sheet offset (3)	Collateral (4)				Credit enhancement (8)	Exposure post credit mitigation and enhancement (9)
					Cash (5)	Securities (6)	Real estate and other Residential (7)	Commercial (7)		
2016	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn	
Cash and balances										
at central banks	74.3	—	74.3	—	—	—	—	—	—	74.3
Reverse repos	73.5	(31.7)	41.8	(1.1)	—	(40.7)	—	—	—	—
Lending	340.9	(0.6)	340.3	(29.8)	(0.8)	(3.5)	(154.3)	(52.8)	(2.1)	97.0
Debt securities	72.5	—	72.5	—	—	—	—	—	—	72.5
Equity shares	0.7	—	0.7	—	—	—	—	—	—	0.7
Derivatives	298.1	(51.1)	247.0	(197.3)	(28.7)	(8.4)	—	—	(12.6)	—
Settlement balances	7.0	(1.5)	5.5	—	—	—	—	—	—	5.5
Total	867.0	(84.9)	782.1	(228.2)	(29.5)	(52.6)	(154.3)	(52.8)	(14.7)	250.0
Short positions	(22.1)	—	(22.1)	—	—	—	—	—	—	(22.1)
	844.9	(84.9)	760.0	(228.2)	(29.5)	(52.6)	(154.3)	(52.8)	(14.7)	227.9

Net of short positions										
2015										
Cash and balances										
at central banks	79.9	—	79.9	—	—	—	—	—	—	79.9
Reverse repos	74.3	(34.4)	39.9	(2.5)	—	(37.3)	—	—	—	0.0
Lending	330.0	(3.0)	327.0	(35.6)	(0.7)	(3.3)	(140.8)	(52.7)	(3.4)	90.0
Debt securities	82.5	—	82.5	—	—	—	—	—	—	82.5
Equity shares	1.4	—	1.4	—	—	—	—	—	—	1.4
Derivatives	386.3	(123.7)	262.6	(214.8)	(27.6)	(7.5)	—	—	(12.7)	—
Settlement balances	5.3	(1.2)	4.1	—	—	—	—	—	—	4.1
Total	959.7	(162.3)	797.4	(252.9)	(28.3)	(48.1)	(140.8)	(52.7)	(16.1)	258.0
Short positions	(20.8)	—	(20.8)	—	—	—	—	—	—	(20.8)
Net of short positions	938.9	(162.3)	776.6	(252.9)	(28.3)	(48.1)	(140.8)	(52.7)	(16.1)	237.2

## Notes:

(1) Relates to offset arrangements that comply with IFRS criteria and transactions cleared through and novated to central clearing houses, primarily London Clearing House and US Government Securities Clearing Corporation. During 2016, changes in the legal contracts with LCH led to many derivatives cleared through that counterparty being settled to market each day rather than being collateralised as previously. This led to the derecognition of the associated assets and liabilities.

(2) The carrying value on the balance sheet represents the exposure to credit risk by class of financial instrument.

(3) The amount by which credit risk exposure is reduced through arrangements, such as master netting agreements and cash management pooling, which give RBS a legal right to set off the financial asset against a financial liability due to the same counterparty.

(4) RBS holds collateral in respect of individual loans and advances to banks and customers. This collateral includes mortgages over property (both personal and commercial); charges over business assets such as plant, inventories and trade debtors; and guarantees of lending from parties other than the borrower. RBS obtains collateral in the form of securities in reverse repurchase agreements. Cash and securities are received as collateral in respect of derivative transactions.

- (5) Includes cash collateral pledged by counterparties based on daily mark-to-market movements of net derivative positions with the counterparty.
- (6) Represent the fair value of securities received from counterparties, mainly relating to reverse repo transactions as part of netting arrangements.
- (7) Property valuations are capped at the loan value and reflect the application of haircuts in line with regulatory rules to indexed valuations. Commercial collateral includes ships and plant and equipment collateral.
- (8) Comprises credit derivatives (bought protection) and guarantees against exposures.

### Key points

- The majority of the £227.9 billion net exposure comprises cash and balances at central banks, unsecured commercial and personal bank lending and sovereign debt securities.
- Net exposure fell by £9.8 billion or 4% reflecting disposals and run-down within Ulster Bank RoI and Capital Resolution and lower held-for-trading bonds partially offset by higher unsecured lending.
- Lending increase of £6.5 billion primarily reflected growth in PBB and CPB.

Business review **Capital and risk management****Credit risk: balance sheet analysis** continued

## Sector concentration

The following table analyses financial assets by industry sector.

		Reverse	Securities			Derivatives	Other financial assets	Balance sheet value	Offset	Exposure post offset
		repos	Lending	Debt	Equity					
		£m	£m	£m	£m	£m	£m	£m	£m	
2016										
Central and local government		219	6,091	58,472	—	2,508	63	67,353	(5,188)	62,165
Financial institutions	- banks	12,860	17,291	3,437	11	145,565	74,250	253,414	(149,941)	103,473
	- other (1)	28,407	33,083	9,738	619	87,965	5,290	165,102	(91,395)	73,707
Personal - mortgages			153,319	—	—	—	8	153,327	—	153,327
- unsecured			14,492	—	—	39		14,531		14,531
Property			34,756	148	54	1,140	13	36,111	(1,111)	35,000
Construction			4,247	—	—	105	35	4,387	(779)	3,608
Manufacturing		43	9,609	198	12	2,007	18	11,887	(1,083)	10,804
Finance leases and instalment credit			12,269	—	—	3		12,272	(3)	12,269
Retail, wholesale and repairs			12,823	7	—	662	2	13,494	(1,610)	11,884
Transport and storage			6,428	28	—	1,178		7,634	(971)	6,663
Health, education and leisure			11,526	17	—	685	11	12,239	(648)	11,591
Hotels and restaurants			6,079	6	—	50		6,135	(181)	5,954
Utilities		193	3,938	159	—	3,783	15	8,088	(1,603)	6,485
Other		65	18,818	394	88	1,291	71	20,727	(2,324)	18,403
Total gross of provisions		41,787	344,769	72,604	784	246,981	79,776	786,701	(256,837)	529,864
Provisions			(4,455)	(82)	(81)			(4,618)	n/a	(4,618)
Total		41,787	340,314	72,522	703	246,981	79,776	782,083	(256,837)	525,246
2015										
Central and local government		10	6,707	67,720	—	3,307	126	77,870	(6,346)	71,524

Financial institutions	- banks	12,352	19,004	2,378	52	169,517	79,939	283,242	(177,804)	105,438
	- other (1)	27,314	31,981	11,724	956	78,522	3,777	154,274	(84,992)	69,282
Personal - mortgages		-137,601						-137,601		-137,601
	- unsecured	-16,654				45		-16,699		-16,699
Property		-35,744	124	99		1,343		-37,310	(1,084)	36,226
Construction		-4,421		3		266		-4,690	(932)	3,758
Manufacturing		184	9,861	128	160	1,947	94	12,374	(1,593)	10,781
Finance leases and instalment credit		-11,443	1			10		-11,454	(2)	11,452
Retail, wholesale and repairs		-12,096	156	31		570	10	12,863	(1,329)	11,534
Transport and storage		-8,909	87	2		1,494		-10,492	(873)	9,619
Health, education and leisure		-10,960	17	6		641	7	11,631	(690)	10,941
Hotels and restaurants		-5,372	11			81	5	5,469	(232)	5,237
Utilities		-3,463	53	19		3,284		-6,819	(1,689)	5,130
Other		50	19,899	311	144	1,517	97	22,018	(2,957)	19,061
Total gross of provisions		39,910	334,115	82,710	1,472	262,544	84,055	804,806	(280,523)	524,283
Provisions		(7,139)	(194)	(87)				(7,420)	n/a	(7,420)
Total		39,910	326,976	82,516	1,385	262,544	84,055	797,386	(280,523)	516,863

Note:

(1) Includes loans made by consolidated conduits to asset owning companies.

For geographic concentrations refer to:

- Lending: Loans and related credit metrics and Credit risk management basis: Portfolio overview - asset quality
- Debt securities: Issuer and IFRS measurement and Credit risk - Country risk and Credit risk management basis: Portfolio overview - geography
- Derivatives: Summary and uncollateralised exposures
- Equity shares.





**Business review** Capital and risk management**Credit risk: balance sheet analysis** continued

## Asset quality

The asset quality analysis presented below is based on internal asset quality ratings which have ranges for the probability of default. 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 RBS map to both an asset quality scale, used for external financial reporting, and a master grading scale for wholesale exposures used for internal management reporting across portfolios. Debt securities are analysed by external ratings and are therefore excluded from the following table and are set out on pages 342 to 344.

The table that follows details the relationship between internal asset quality (AQ) bands and external ratings published by Standard & Poor's (S&P), for illustrative purposes only. This relationship is established by observing S&P's default study statistics, notably the one year default rates for each S&P rating grade. A degree of judgement is required to relate the probability of default ranges associated with the master grading scale to these default rates given that, for example, the S&P published default rates do not increase uniformly by grade and the historical default rate is nil for the highest rating categories.

Internal asset quality band	Probability of default range	Indicative S&P rating
AQ1	0% - 0.034%	AAA to AA
AQ2	0.034% - 0.048%	AA-
AQ3	0.048% - 0.095%	A+ to A
AQ4	0.095% - 0.381%	BBB+ to BBB-
AQ5	0.381% - 1.076%	BB+ to BB
AQ6	1.076% - 2.153%	BB- to B+
AQ7	2.153% - 6.089%	B+ to B
AQ8	6.089% - 17.222%	B- to CCC+
AQ9	17.222% - 100%	CCC to C
AQ10	100%	D

The mapping to the S&P ratings is used by RBS as one of several benchmarks for its wholesale portfolios, depending on customer type and the purpose of the benchmark. The mapping is based on all issuer types rated by S&P. It should therefore be considered illustrative and does not, for instance, indicate that exposures reported against S&P ratings either have been or would be assigned those ratings if assessed by S&P. In addition, the relationship is not relevant for retail portfolios, smaller corporate exposures or

specialist corporate segments given that S&P does not typically assign ratings to such entities.

## Business review Capital and risk management

## Credit risk: balance sheet analysis continued

													Impairment	
	AQ1	AQ2	AQ3	AQ4	AQ5	AQ6	AQ7	AQ8	AQ9	AQ10	Past due	Impaired	provision	Total
2016	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn
Cash and balances at central banks	74.2		-0.1											-74.3
Banks														
- Reverse repos	4.7			6.4	0.6	0.4	0.4		-0.4					-12.9
- Derivative cash collateral	0.9		-1.2	4.4	0.2									6.7
- Bank loans	6.1		-2.7	1.2	0.3	0.1			-0.1					-10.5
- Total	11.7		-3.9	12.0	1.1	0.5	0.4		-0.5					-30.1
Customers														
- Reverse repos	23.2	0.2	0.5	4.4	0.6									-28.9
- Derivative cash collateral	8.1	0.4	1.0	7.3	0.2									-17.0
- Customer loans	25.3	12.3	35.7	107.3	53.7	30.9	20.1	4.5	4.2	1.0	6.6	8.9	(4.5)	306.0
- Total	56.6	12.9	37.2	119.0	54.5	30.9	20.1	4.5	4.2	1.0	6.6	8.9	(4.5)	351.9
Settlement balances and other financial assets	3.8	0.2	0.2	0.9	0.1		-0.2			-0.1				5.5
Derivatives	38.2	1.4	25.9	168.7	9.4	1.1	2.3							-247.0
Undrawn commitments	22.9	7.7	15.2	42.8	26.7	11.4	10.7	0.5	0.1	0.6				-138.6
Contingent liabilities	0.7	0.4	1.0	7.1	1.5	0.7	0.4	0.1		-0.1				-12.0
Total	208.1	22.6	83.5	350.5	93.3	44.6	34.1	5.1	4.8	1.8	6.6	8.9	(4.5)	859.4
Total %	24.2%	2.6%	9.7%	40.8%	10.9%	5.2%	4.0%	0.6%	0.6%	0.2%	0.7%	1.0%	(0.5%)	100%

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	AQ1	AQ2	AQ3	AQ4	AQ5	AQ6	AQ7	AQ8	AQ9	AQ10	Past due	Impaired	provision	Total
2015	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn
Cash and balances at central banks	77.5	—	2.3	0.1	—	—	—	—	—	—	—	—	—	—79.9
Banks														
- Reverse repos	1.6	0.6	3.5	4.8	1.3	0.4	0.2	—	—	—	—	—	—	—12.4
- Derivative cash collateral	3.6	4.6	1.4	1.2	0.2	—	—	—	—	—	—	—	—	—11.0
- Bank loans	2.5	0.6	3.4	0.7	0.3	0.1	0.1	—0.2	—	—0.1	—	—	—	— 8.0
- Total	7.7	5.8	8.3	6.7	1.8	0.5	0.3	—0.2	—	—0.1	—	—	—	—31.4
Customers														
- Reverse repos	20.7	0.4	1.5	3.2	1.7	0.1	—	—	—	—	—	—	—	—27.6
- Derivative cash collateral	9.2	1.1	3.6	3.0	0.2	0.1	—	—	—	—	—	—	—	—17.2
- Customer loans	23.3	12.1	28.8	106.6	52.0	29.3	20.3	4.2	2.6	1.1	6.7	10.9	(7.1)	290.8
- Total	53.2	13.6	33.9	112.8	53.9	29.5	20.3	4.2	2.6	1.1	6.7	10.9	(7.1)	335.6
Settlement balances and other financial assets	2.3	0.1	0.1	0.6	—	—	—	—	—	—	—1.0	—	—	— 4.1
Derivatives	41.5	65.7	89.1	57.8	6.2	1.1	0.8	—0.2	—	0.1	—	—	—	—262.5
Undrawn commitments	24.1	6.9	20.1	41.9	27.6	8.8	7.0	0.6	0.2	0.5	—	—	—	—437.7
Contingent liabilities	0.9	1.3	1.8	8.3	1.9	0.6	0.9	0.1	0.1	0.1	—	—	—	—16.0
Total	207.2	93.4	155.6	228.2	91.4	40.5	29.3	4.9	3.3	1.8	7.8	10.9	(7.1)	867.2
Total %	23.8%	10.8%	17.9%	26.3%	10.5%	4.7%	3.4%	0.6%	0.4%	0.2%	0.9%	1.3%	(0.8%)	100%

## Business review **Capital and risk management**

### Credit risk: balance sheet analysis *continued*

#### Loans, REIL and impairment provisions

Risk elements in lending (REIL) comprises impaired loans and accruing loans past due 90 days or more as to principal or interest. Impaired loans are all loans (including loans subject to forbearance) for which an impairment provision has been established; for collectively assessed loans, impairment loss provisions are not allocated to individual loans and the entire portfolio is included in impaired loans. Accruing loans past due 90 days or more comprise loans past due 90 days where no impairment loss is expected.

#### Loans and related credit metrics

The tables below analyse gross loans and advances (excluding reverse repos) and related credit metrics by reportable segment.

2016	Gross loans to		REIL £m	Provisions £m	Credit metrics				
	Banks £m	Customers £m			REIL as a % of gross loans to customers	Provisions as a % of REIL	Provisions as a % of gross loans to customers	Impairment losses/ (releases)	Amounts written-off
					%	%	%	£m	£m
	£m	£m			£m	£m	%	%	%
UK PBB	504	133,399	1,992	1,292	1.5	65	1.0	83	453
Ulster Bank RoI	2,418	20,130	3,513	1,200	17.5	34	6.0	(113)	2,057
Commercial Banking	582	101,824	1,946	845	1.9	43	0.8	206	577
Private Banking	111	12,188	105	31	0.9	30	0.3	(3)	3
RBS International	18	7,902	109	38	1.4	35	0.5	10	6
NatWest Markets	3,313	17,419	—	1	—	nm	—	—	—
Capital Resolution	4,558	13,569	2,264	802	16.7	35	5.9	312	509
W&G	—	20,791	380	245	1.8	64	1.2	42	68
Central items & other	5,787	256	1	1	0.4	100	0.4	—	22
<b>Total</b>	<b>17,291</b>	<b>327,478</b>	<b>10,310</b>	<b>4,455</b>	<b>3.1</b>	<b>43</b>	<b>1.4</b>	<b>537</b>	<b>3,695</b>

2015									
UK PBB	965	121,552	2,682	1,847	2.2	69	1.5	(6)	695
Ulster Bank Rol	1,971	18,584	3,503	1,911	18.8	55	10.3	(142)	168
Commercial Banking	665	92,002	1,911	749	2.1	39	0.8	69	263
Private Banking	54	11,230	115	37	1.0	32	0.3	13	7
RBS International	6	7,401	92	31	1.2	34	0.4	—	32
NatWest Markets	5,696	16,076	—	1	—	—	—	(7)	—
Capital Resolution	7,097	25,898	3,372	2,266	13.0	67	8.7	(794)	7,689
W&G	—	20,291	461	275	2.3	60	1.4	15	110
Central items & other	2,550	2,077	21	22	1.0	105	1.1	(1)	—
Total	19,004	315,111	12,157	7,139	3.9	59	2.3	(853)	8,964

### Key points

- Customer loans increased by £12.4 billion (4%) mainly reflecting lending in UK PBB and Commercial Banking offset by disposals and wind downs in Capital Resolution.
- UK PBB: mortgage growth of £13.8 billion was the principal driver of the £11.4 billion gross lending increase in 2016.
- Commercial Banking: lending growth of £9.7 billion was across a variety of sectors supporting businesses in the UK and Western Europe.
- Ulster Bank Rol: customer lending increased by £1.5 billion reflecting new lending, invoice finance and foreign exchange movements, partially offset by portfolio sales and repayments.
- Private Banking: lending growth of £1.0 billion primarily mortgage lending.
- Capital Resolution: lending fell by £14.9 billion including wind downs and disposals of Markets (£5.2 billion), GTS (£2.4 billion) and Shipping (£1.8 billion).
- REIL and loan impairment provisions declined by £1.8 billion and £2.7 billion to £10.3 billion and £4.5 billion respectively. These reductions were predominantly driven by the portfolio sale of non-performing SME lending and buy-to-let mortgages in Ulster Bank Rol in Q4 2016 and related write-offs. These decreases were offset by the adverse impact of exchange rate movements of £1.0 billion in REIL and £0.5 billion in loan impairment provisions respectively.
- Net impairment charge of £537 million largely related to the Shipping portfolio within Capital Resolution.
- Amounts written off were significantly lower at £3.7 billion compared with £9.0 billion in 2015, primarily in commercial real estate (£1.5 billion in 2016 compared with £6.2 billion in 2015).



**Business review** Capital and risk management**Credit risk: management basis** continued

## Impairment charge and provisions

The tables below analyse the categories of loan impairment losses/(releases) and provisions by reportable segment.

	Impairment losses/(releases)				Impairment provision			
	Individual	Collective	Latent	Total	Individual	Collective	Latent	Total
	£m	£m	£m	£m	£m	£m	£m	£m
2016								
UK PBB	—	83	—	83	—	1,116	176	1,292
Ulster Bank Rol	(8)	99	(204)	(113)	69	1,053	78	1,200
Commercial Banking	196	3	7	206	479	278	88	845
Private Banking	2	—	(5)	(3)	27	—	4	31
RBS International	9	—	1	10	32	—	6	38
NatWest Markets	—	—	—	—	—	—	1	1
Capital Resolution	331	(2)	(17)	312	761	23	18	802
W&G	5	35	2	42	26	190	29	245
Central items & other	—	—	—	—	1	—	—	1
Total	535	218	(216)	537	1,395	2,660	400	4,455

2015								
UK PBB	—	73	(79)	(6)	1	1,665	181	1,847
Ulster Bank Rol	8	(126)	(24)	(142)	46	1,620	245	1,911
Commercial Banking	58	33	(22)	69	373	299	77	749
Private Banking	8	—	5	13	28	—	9	37
RBS International	1	—	(1)	—	27	—	4	31
NatWest Markets	—	—	(7)	(7)	—	—	1	1
Capital Resolution	(505)	(22)	(267)	(794)	2,173	52	41	2,266
W&G	20	8	(13)	15	24	225	26	275
Central items & other	—	(1)	—	(1)	22	—	—	22
Total	(410)	(35)	(408)	(853)	2,694	3,861	584	7,139



## Business review **Capital and risk management**

### Credit risk: balance sheet analysis *continued*

#### Sector and geographical concentration

The tables below analyse gross loans and advances to banks and customers (excluding reverse repos) and related credit metrics by sector and geography based on the location of lending office. Ulster Bank RoI contributes a significant proportion of the European loan exposure. Refer to Business review on page 188.

	Gross loans £m	REIL £m	Provisions £m	Credit metrics			Impairment losses/ (releases) £m	Amounts written-off £m
				REIL	Provisions	Provisions		
				as a % of gross loans	as a % of REIL	as a % of gross loans		
2016	£m	£m	£m	%	%	%	£m	£m
Central and local government	6,091	1	1	—	100	—	1	2
Finance	33,083	61	51	0.2	84	0.2	(2)	17
Personal - mortgages (1)	153,319	4,091	1,019	2.7	25	0.7	222	290
- unsecured	14,492	1,113	900	7.7	81	6.2	138	396
Property	34,756	1,370	489	3.9	36	1.4	(162)	1,485
Construction	4,247	264	137	6.2	52	3.2	8	153
<i>of which: commercial real estate</i>	<i>26,265</i>	<i>1,407</i>	<i>511</i>	<i>5.4</i>	<i>36</i>	<i>1.9</i>	<i>(184)</i>	<i>1,483</i>
Manufacturing	9,609	173	90	1.8	52	0.9	13	90
Finance leases and instalment credit	12,269	139	79	1.1	57	0.6	8	12
Retail, wholesale and repairs	12,823	283	182	2.2	64	1.4	39	169
Transport and storage	6,428	1,388	422	21.6	30	6.6	419	301
Health, education and leisure	11,526	381	129	3.3	34	1.1	8	75
Hotels and restaurants	6,079	211	107	3.5	51	1.8	13	116
Utilities	3,938	95	50	2.4	53	1.3	(20)	2
Other	18,818	740	399	3.9	54	2.1	68	587
Latent	—	—	400	—	—	—	(216)	—
Total	327,478	10,310	4,455	3.1	43	1.4	537	3,695
Of which:								
UK								

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Personal - mortgages	137,427	943	143	0.7	15	0.1	(4)	3
- unsecured	14,198	1,060	853	7.5	80	6.0	132	362
Property and construction	37,942	1,543	537	4.1	35	1.4	(98)	676
<i>of which: commercial real estate</i>	<i>25,311</i>	<i>1,323</i>	<i>426</i>	<i>5.2</i>	<i>32</i>	<i>1.7</i>	<i>(102)</i>	<i>600</i>
Other	115,833	3,133	1,299	2.7	41	1.1	666	629
Latent	-	-	318	-	-	-	(12)	-
Total	305,400	6,679	3,150	2.2	47	1.0	684	1,670
Europe								
Personal - mortgages	15,548	3,144	872	20.2	28	5.6	226	287
- unsecured	265	52	46	19.6	88	17.4	5	11
Property and construction	1,055	85	84	8.1	99	8.0	(56)	933
<i>of which: commercial real estate</i>	<i>947</i>	<i>78</i>	<i>78</i>	<i>8.2</i>	<i>100</i>	<i>8.2</i>	<i>(83)</i>	<i>878</i>
Other	3,920	279	165	7.1	59	4.2	(156)	665
Latent	-	-	83	-	-	-	(204)	-
Total	20,788	3,560	1,250	17.1	35	6.0	(185)	1,896
Total banks	17,291	-	-	-	-	-	-	-

Note:

(1) Mortgages are reported in sectors other than personal mortgages by certain businesses based on the nature of the relationship with the customer.

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## Business review Capital and risk management

## Credit risk: balance sheet analysis continued

	Credit metrics							
	Gross	REIL	Provisions	REIL	Provisions	Provisions	Impairment	Amounts
				as a % of gross loans	as a % of REIL	as a % of gross loans	losses/ (release)	
loans	REIL	Provisions	as a % of gross loans	of REIL	gross loans	(release)	written-off	
2015	£m	£m	£m	%	%	%	£m	£m
Central and local government	6,707	1	1	—	100	—	—	—
Finance	31,981	87	61	0.3	70	0.2	(10)	165
Personal - mortgages (1)	137,601	3,637	1,006	2.6	28	0.7	(82)	171
- unsecured	16,654	1,331	1,151	8.0	86	6.9	122	513
Property	35,744	3,505	2,012	9.8	57	5.6	(557)	5,999
Construction	4,421	357	269	8.1	75	6.1	(14)	313
<i>of which: commercial real estate</i>	<i>27,630</i>	<i>3,560</i>	<i>2,054</i>	<i>12.9</i>	<i>58</i>	<i>7.4</i>	<i>(811)</i>	<i>6,151</i>
Manufacturing	9,861	263	154	2.7	59	1.6	—	154
Finance leases and instalment credit	11,443	107	79	0.9	74	0.7	(8)	37
Retail, wholesale and repairs	12,096	434	299	3.6	69	2.5	7	325
Transport and storage	8,909	563	258	6.3	46	2.9	115	370
Health, education and leisure	10,960	394	190	3.6	48	1.7	14	171
Hotels and restaurants	5,372	336	201	6.3	60	3.7	1	346
Utilities	3,463	131	63	3.8	48	1.8	8	27
Other	19,899	1,010	810	5.1	80	4.1	(37)	340
Latent	—	—	584	—	—	—	(408)	—
Total customers	315,111	12,156	7,138	3.9	59	2.3	(849)	8,931
Of which:								
UK								
Personal - mortgages	123,653	1,083	158	0.9	15	0.1	17	36
- unsecured	14,348	1,262	1,085	8.8	86	7.6	126	501
Property and construction	38,006	2,814	1,282	7.4	46	3.4	27	2,773
	25,676	2,568	1,107	10.0	43	4.3	(121)	2,575

<i>of which: commercial real estate</i>								
Other	110,193	2,198	1,182	2.0	54	1.1	125	800
Latent	—	—	330	—	—	—	(303)	—
Total	286,200	7,357	4,037	2.6	55	1.4	(8)	4,110
Europe								
Personal - mortgages	13,908	2,550	844	18.3	33	6.1	(101)	135
- unsecured	775	49	45	6.3	92	5.8	(5)	12
Property and construction	1,993	1,008	966	50.6	96	48.5	(593)	3,539
<i>of which: commercial real estate</i>	1,628	974	935	59.8	96	57.4	(688)	3,576
Other	7,148	1,011	864	14.1	85	12.1	(8)	1,014
Latent	—	—	255	—	—	—	(103)	—
Total	23,824	4,618	2,974	19.4	64	12.5	(810)	4,700
Total banks	19,004	1	1	—	100	—	(4)	33

Note:

(1) Mortgages are reported in sectors other than personal mortgages by certain businesses based on the nature of the relationship with the customer.

## Business review Capital and risk management

Credit risk: balance sheet analysis continued										
Risk elements in lending										
The tables below analyse REIL by segment.										
	2016									2015
	Ulster						Central			
	UK	Bank	Commercial	Private	RBS	Capital		items		
	PBB	Rol	Banking	Banking	International	Resolution	W&G	& other	Total	Total
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
At 1 January	2,682	3,503	1,911	115	92	3,372	461	21	12,157	28,219
Inter segment transfers	(187)	1,404	496	—	—	(1,685)	(28)	—	—	—
Currency translation and other adjustments	—	557	—	—	9	445	—	2	1,013	(860)
Additions	877	1,326	1,149	25	51	1,685	193	—	5,306	4,250
Transfers between REIL and potential problem loans	(155)	—	9	(6)	6	—	(20)	—	(166)	(222)
Transfer to performing book	(290)	(454)	(158)	—	(14)	(5)	(39)	—	(960)	(1,120)
Repayments and disposals	(482)	(766)	(884)	(26)	(29)	(1,039)	(119)	—	(3,345)	(8,966)
Amounts written-off	(453)	(2,057)	(577)	(3)	(6)	(509)	(68)	(22)	(3,695)	(9,144)
At 31 December	1,992	3,513	1,946	105	109	2,264	380	1	10,310	12,157

The table below analyses REIL between UK and overseas, based on the location of the lending office.

	2016		2015	
	Impaired loans	Accruing past due	Impaired loans	Accruing past due
	£m	£m	£m	£m
- UK	5,557	1,122	6,095	1,262
- overseas	3,308	323	4,775	25
Total	8,865	1,445	10,870	1,287

## Notes:

(1) REIL are stated without giving effect to any security held that could reduce the eventual loss should it occur or to any provisions marked.

(2) For details on impairment methodology refer to Credit risk on page 293 and Accounting policy 15 Impairment of financial assets on page 390.

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## Business review Capital and risk management

Credit risk: balance sheet analysis continued										
Provisions										
The tables below analyse provisions by segment.										
2016										
	UK	Ulster	Commercial	Private	RBS	NatWest	Capital	Central		
	PBB	Bank	Banking	Banking	International	Markets	Resolution	W&G	& other	Total
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
At 1 January	1,847	1,911	749	37	31	1	2,266	275	22	7,139
Inter segment transfers	(173)	1,257	443	—	—	—	(1,527)	—	—	—
Currency translation and other adjustments	—	215	8	—	3	—	253	—	1	480
Repayments and disposals	—	—	—	—	—	—	—	—	—	—
Amounts written-off	(453)	(2,057)	(577)	(3)	(6)	—	(511)	(68)	(22)	(3,697)
Recoveries of amounts previously written-off	28	24	28	1	—	—	27	1	—	109
Charges/(releases) to income statement										
from continuing operations	83	(113)	206	(3)	10	—	312	42	—	537
Charges/(releases) to income statement										
from discontinued operations	—	—	—	—	—	—	—	—	—	—
Unwind of discount	(40)	(37)	(12)	(1)	—	—	(18)	(5)	—	(113)
At 31 December	1,292	1,200	845	31	38	1	802	245	1	4,455

<i>Past due analysis</i>		
The table below shows loans and advances to customers that were past due at the balance sheet date but are not considered impaired.		
	2016	2015
	£m	£m
Past due 1-29 days	3,852	4,150
Past due 30-59 days	753	769
Past due 60-89 days	512	530
Past due 90 days or more	1,445	1,287
Total	6,562	6,736
<i>Past due analysis by sector</i>		
Personal	3,577	3,437
Property and construction	1,020	1,341
Financial institution	94	187
Other corporate	1,871	1,771
Total	6,562	6,736



Business review **Capital and risk management****Credit risk: balance sheet analysis** continued**Securities and available-for-sale reserves**

## Debt securities

The table below analyses debt securities by issuer and IFRS measurement classifications. The other financial institutions category includes US government sponsored agencies and securitisation entities, the latter principally relating to asset-backed securities (ABS). Ratings are based on the lowest of Standard & Poor's, Moody's and Fitch.

	Central and local government			Banks	Other financial institutions	Corporate	Total	Of which ABS
	UK	US	Other					
	£m	£m	£m					
2016				£m	£m	£m	£m	£m
Held-for-trading (HFT)	2,615	4,133	14,087	821	2,299	549	24,504	886
Designated as at fair value (DFV)	—	—	25	—	2	—	27	—
Available-for-sale (AFS)	10,581	6,953	15,678	1,852	4,072	118	39,254	2,263
Loans and receivables (LAR)	—	—	—	—	3,774	194	3,968	3,814
Held-to-maturity (HTM)	4,769	—	—	—	—	—	4,769	—
Total	17,965	11,086	29,790	2,673	10,147	861	72,522	6,963
<b>Ratings</b>								
AAA	—	—	11,478	1,610	6,024	36	19,148	3,993
AA to AA+	17,965	11,086	5,533	481	720	34	35,819	244
A to AA-	—	—	9,727	238	2,128	150	12,243	1,627
BBB- to A-	—	—	2,737	155	698	378	3,968	645
Non-investment grade	—	—	315	69	458	31	873	381
Unrated	—	—	—	120	119	232	471	73
Total	17,965	11,086	29,790	2,673	10,147	861	72,522	6,963
<b>Available-for-sale</b>								
AFS reserves (gross of tax)	79	(66)	190	5	144	(6)	346	46
Gross unrealised gains	768	56	504	8	93	2	1,431	75
Gross unrealised losses	(16)	(123)	(13)	(1)	(43)	(2)	(198)	(32)
Of which:								

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less than 12 months	(16)	(123)	(13)	(1)	(11)	(2)	(166)		(1)
more than 12 months	—	—	—	—	(32)	—	(32)		(31)

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## Business review Capital and risk management

Credit risk: balance sheet analysis continued	Central and local government			Banks	Other financial institutions	Corporate	Total	Of which ABS
	UK	US	Other					
	£m	£m	£m	£m	£m	£m	£m	£m
2015								
Held-for-trading (HFT)	4,107	4,627	22,222	576	3,689	636	35,857	707
Designated as at fair value (DFV)	—	—	111	—	—	—	111	—
Available-for-sale (AFS)	9,124	10,359	12,259	1,801	5,599	108	39,250	2,501
Loans and receivables (LAR)	—	—	—	1	2,242	144	2,387	2,222
Held-to-maturity (HTM)	4,911	—	—	—	—	—	4,911	—
Total	18,142	14,986	34,592	2,378	11,530	888	82,516	5,430
Of which US agencies	—	—	—	—	806	—	806	—
Short positions (HFT)	(4,697)	(3,347)	(11,796)	(391)	(411)	(165)	(20,807)	—
<i>Ratings</i>								
AAA	—	—	11,696	1,696	5,234	3	18,629	3,366
AA to AA+	18,142	14,986	6,879	119	1,611	66	41,803	261
A to AA-	—	—	8,880	420	1,991	147	11,438	445
BBB- to A-	—	—	6,785	79	1,460	301	8,625	363
Non-investment grade	—	—	352	32	526	200	1,110	446
Unrated	—	—	—	32	708	171	911	549
Total	18,142	14,986	34,592	2,378	11,530	888	82,516	5,430
<i>Available-for-sale</i>								
AFS reserves (gross of tax)	12	(78)	90	4	114	4	146	60
Gross unrealised gains	383	104	270	6	110	7	880	90
Gross unrealised losses	(7)	(62)	(9)	(1)	(58)	(3)	(140)	(42)
Of which:								
less than 12 months	(7)	(58)	(9)	(1)	(30)	(3)	(108)	(14)
more than 12 months	—	(4)	—	—	(28)	—	(32)	(28)

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## Business review Capital and risk management

Credit risk: balance sheet analysis continued								
Asset-backed securities								
The table below summarises the ratings of asset-backed securities on the balance sheet.								
2016	RMBS (1)							
	Government sponsored or similar (2)	Prime	Non-conforming	Sub-prime	CMBS (1)	CDOs & CLOs	Other ABS	Total
	£m		£m					
	AAA	—	654	—	—	—	23	3,316
AA to AA+	—	52	155	—	—	3	34	244
A to AA-	—	460	2	—	22	33	1,110	1,627
BBB- to A-	—	84	—	—	470	21	70	645
Non-investment grade (3)	—	182	1	8	15	121	54	381
Unrated (4)	—	5	—	—	—	19	49	73
Total	—	1,437	158	8	507	220	4,633	6,963
2015								
AAA	—	266	749	2	—	78	2,271	3,366
AA to AA+	—	2	150	—	1	12	96	261
A to AA-	109	4	24	5	13	9	281	445
BBB- to A-	—	13	144	20	21	121	44	363
Non-investment grade (3)	—	23	25	143	24	169	62	446
Unrated (4)	—	10	—	1	470	24	44	549
Total	109	318	1,092	171	529	413	2,798	5,430

## Notes:

(1) Residential mortgage-backed securities (RMBS) and commercial mortgaged-backed securities (CMBS) are securities that represent an interest in a portfolio of residential and commercial mortgages respectively. Repayments made on the underlying mortgages are used to make payments to holders of the mortgage-backed securities (MBS). The risk of the MBS will vary primarily depending on the quality and geographic region in which the underlying mortgage assets are located and the credit enhancement of the securitisation structure. Several tranches of notes are issued, each secured against the same portfolio of mortgages, but providing differing levels of seniority to match the risk appetite of investors. The most junior

(or equity) notes will suffer early capital and interest losses experienced by the referenced mortgage collateral, with each more senior note benefiting from the protection provided by the subordinated notes below. Additional credit enhancements may be provided to the holder of senior MBS notes.

The main categories of mortgages that serve as collateral to RMBS held by RBS are set out below and described in the Glossary on page 619. The US market has more established definitions of differing underlying mortgage quality and these are used as the basis for RBS's RMBS categorisation.

(2) Includes US agency and Dutch government guaranteed securities.

(3) Comprises HFT £282 million (2015 - £303 million), AFS £99 million (2015 - £106 million) and LAR nil (2015 - £37 million).

(4) Comprises HFT £25 million (2015 - £46 million), AFS nil (2015 - £28 million) and LAR £48 million (2015 - £475 million).

Business review **Capital and risk management****Credit risk: balance sheet analysis** continued

## Equity shares

The table below analyses holdings of equity shares for eurozone countries and other countries with balances of more than £50 million by country, issuer and measurement classification. The HFT positions are used mainly for economic hedging of debt issuances and equity derivatives. The AFS balances are individually small holdings in unlisted companies, mainly acquired through debt for equity transactions in Restructuring.

Countries	HFT				AFS/DFV (1)					
	Banks	Other financial institutions	Corporate	Total	Banks	Other financial institutions	Corporate	AFS/DFV	Total	AFS reserves
		(2)		HFT		(2)				
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
2016										
Luxembourg	—	91	—	91	—	—	—	—	91	—
Belgium	—	—	—	—	—	80	—	80	80	6
Netherlands	—	—	—	—	—	—	61	61	61	2
Other	—	8	11	19	—	5	3	8	27	—
Total eurozone	—	99	11	110	—	85	64	149	259	8
UK	10	32	11	53	—	284	9	293	346	(37)
US	—	1	—	1	—	53	2	55	56	12
Other	—	—	2	2	—	38	2	40	42	36
Total	10	132	24	166	—	460	77	537	703	19
2015										
Total	47	283	330	660	5	640	80	725	1,385	302

Notes:

(1) Designated as at fair value through profit or loss balances are £171 million (2015 - £147 million), of which £142 million are other financial institutions (2015 - £111 million) and

£29 million are corporate (2015 - £36 million).

(2) Includes government sponsored entities.

(3) HFT short positions of £3 million (2015 - £2 million) did not relate to non-periphery eurozone countries.

**Business review** **Capital and risk management****Credit risk: balance sheet analysis** *continued***Derivatives****Summary and net uncollateralised exposures**

The table below analyses derivatives by type of contract. The master netting agreements and collateral shown below do not result in a net presentation on the balance sheet under IFRS.

	2016							2015		
	Notional					Assets	Liabilities	Notional	Assets	Liabilities
	GBP	USD	Euro	Other	Total					
	£bn	£bn	£bn	£bn	£bn	£m	£m	£m	£m	
Interest rate	3,106	7,179	6,385	1,303	17,973	170,524	158,485	19,783	206,138	194,854
Exchange rate	418	1,969	856	1,208	4,451	75,442	77,148	3,702	54,938	58,243
Credit	—	22	20	—	42	682	557	67	909	840
Equity and commodity	4	7	12	2	25	333	285	18	559	796
Balance sheet	3,528	9,177	7,273	2,513	22,491	246,981	236,475	23,570	262,544	254,733
Counterparty mark-to-market netting						(197,288)	(197,288)		(214,800)	(214,800)
Cash collateral						(28,742)	(20,417)		(27,629)	(25,729)
Securities collateral						(8,435)	(11,048)		(7,535)	(8,213)
Net exposure						12,516	7,722		12,580	5,991
Banks (1)						830	1,061		1,011	1,311
Other financial institutions (2)						2,646	1,428		2,864	1,468
Corporate (3)						8,196	5,065		7,816	3,108
Government (4)						844	168		889	104
Net exposure						12,516	7,722		12,580	5,991
UK						7,329	2,300		6,270	1,199
Europe						3,300	2,485		4,069	2,408
US						757	1,738		639	714
RoW						1,130	1,199		1,602	1,670
Net exposure						12,516	7,722		12,580	5,991

Asset quality of uncollateralised derivative assets	2016	2015
	£m	£m



AQ1	1,415		2,335	
AQ2	582		829	
AQ3	2,870		3,421	
AQ4	4,908		3,923	
AQ5	1,028		1,260	
AQ6	449		275	
AQ7	1,222		226	
AQ8	25		39	
AQ9	4		177	
AQ10	13		95	
Net exposure	12,516		12,580	

## Notes:

- (1) Transactions with certain counterparties with whom RBS has netting arrangements but collateral is not posted on a daily basis; certain transactions with specific terms that may not fall within netting and collateral arrangements; derivative positions in certain jurisdictions for example China where the collateral agreements are not deemed to be legally enforceable.
- (2) Transactions with securitisation vehicles and funds where collateral posting is contingent on RBS's external rating.
- (3) Predominantly large corporate with whom RBS may have netting arrangements in place, but operational capability does not support collateral posting.
- (4) Sovereigns and supranational entities with one way collateral agreements in their favour.
- (5) The notional amount of interest rate derivatives include £9,724 billion (2015 - £11,555 billion) in respect of contracts cleared through central clearing counterparties. The associated derivatives assets and liabilities including variation margin reflect IFRS offset of £51 billion (2015 - £124 billion) and £51 billion (2015 - £118 billion) respectively.

## Key point

- At Group level, derivative assets and liabilities reduced reflecting lower trading volumes of £34 billion, TriOptima tear-ups of £9 billion, partially offset by the impact of foreign exchange movements. Increases in trading activity in NatWest Markets of £15 billion was more than offset by disposals and run-off in Capital Resolution.

**Business review** **Capital and risk management****Credit risk: balance sheet analysis** *continued*

## Valuation reserves

When valuing financial instruments in the trading book, adjustments are made to mid-market valuations to cover bid-offer spread, liquidity and credit risk. The following table shows credit valuation adjustments (CVA) and other valuation reserves. CVA represents an estimate of the adjustment to fair value that a market participant would make to incorporate the risk inherent in derivative exposures. For details of CVA methodology, refer to Note 9 on the consolidated accounts: Financial instruments - valuation.

	2016	2015
	£m	£m
Funding valuation adjustments (FVA)	936	752
Credit valuation adjustments (CVA)	618	774
Bid-offer reserves	334	304
Product and deal specific	643	660
Valuation reserves	2,531	2,490

The table below analyses CVA relating to counterparties by rating and sector.

	2016	2015
	£m	£m
<b>Ratings</b>		
AAA	4	37
AA to AA+	22	66
A to AA-	52	49
BBB- to A-	388	293
Non-investment grade and unrated	152	329
	618	774
<b>Counterparty</b>		
Banks	22	18
Other financial institutions	70	126
Corporate	337	470
Government	189	160
	618	774

**Key points**

- FVA reserves increased by £184 million during 2016, primarily driven by interest rates tightening with the movements in the first half of the year partially reversing in the second half of 2016.

- The decrease in CVA reserves of £156 million, was driven by credit spreads tightening together with trade close-outs and novations.
- The increase in bid-offer reserves of £30 million mainly reflected sterling weakening against all major currencies.

## Business review Capital and risk management

## Credit risk: balance sheet analysis continued

Derivatives: settlement basis and central counterparties								
The table below analyses the derivative notional and fair value by trading and settlement method.								
	Notional				Asset		Liability	
	Traded over the counter				Traded on	Traded	Traded on	Traded
	Traded on	Settled by	Not settled		Traded on	Traded	Traded on	Traded
	recognised	central	by central		recognised	over the	recognised	over the
	exchanges	counterparties	counterparties	Total	exchanges	counter	exchanges	counter
2016	£bn	£bn	£bn	£bn	£m	£m	£m	£m
Interest rate	2,849	9,724	5,400	17,973		-170,524		-158,485
Exchange rate	8	—	4,443	4,451		-75,442		-77,148
Credit	—	—	42	42		682		557
Equity and commodity	5	—	20	25		333	4	281
Total	2,862	9,724	9,905	22,491		-246,981	4	236,471
<b>2015</b>								
Interest rate	2,761	11,585	5,437	19,783		-206,138	2	194,852
Exchange rate	23	—	3,679	3,702		-54,938		-58,243
Credit	—	—	67	67		909		840
Equity and commodity	1	—	17	18	1	558	44	752
Total	2,785	11,585	9,200	23,570	1	262,543	46	254,687

## Business review **Capital and risk management**

### Market risk

#### Definition

Market risk is the risk of losses arising from fluctuations in interest rates, credit spreads, foreign currency rates, equity prices, commodity prices and other factors, such as market-implied volatilities, that may lead to a reduction in earnings, economic value or both.

RBS is exposed to traded market risk through its trading activities and to non-traded market risk as a result of its banking activities. It manages its traded and non-traded market risk exposures separately, largely in line with the regulatory definitions of the trading and non-trading books.

The following disclosures in this section are audited:

- Traded market risk - Internal VaR
- Non-traded market risk:
  - Internal banking book VaR; and
  - Foreign exchange risk

#### Key developments in 2016\*

##### Traded market risk:

- The year was characterised by higher market volatility. This was particularly notable during Q1 2016 - due to market concerns over the stability of the financial sector - and around key events, such as the UK referendum on EU membership in June and the US presidential election in November.
- NatWest Markets significantly reduced its traded market risk exposure in the run-up to these key events, reflecting market uncertainty. Value-at-Risk (VaR) fell as low as £11 million on 22 June, the day before the EU referendum, from £16 million at the start of that month. The focus of the risk reduction was in the Rates business.
- Market flows increased markedly following these events, supporting NatWest Markets' customer activity. Given the significant risk reduction achieved in recent years, notably in Capital Resolution, by year-end 2016 the Group's VaR profile was more reflective of NatWest Markets' areas of activity in line with its strategic focus.

- Total market risk RWAs fell 18% or £3.8 billion to £17.4 billion, driven by reductions under both the standardised approach and the internal model approach.
- The majority of the VaR back-testing exceptions by legal entity during the year were driven by the increased market volatility.

#### Non-traded market risk:

- The non-traded market risk appetite statement and metrics were revised in early 2016. The risk appetite metrics were enhanced to capture a combination of earnings-based and economic value-based metrics, as prescribed by regulatory guidelines. The appetite framework was also aligned to RBS's capital framework and directly supports the strategic risk objectives of maintaining capital adequacy and delivering stable earnings growth.
- Hedging activity aims to reduce RBS's sensitivity to potential adverse impacts of exchange rate and interest rate movements, in particular on its Common Equity Tier 1 ratio. Ahead of the EU referendum, the residual sensitivity of this ratio was low and no adverse impact from RBS's economic risk exposure resulted from the outcome of the vote. However, the sensitivity of interest income to a further downward shock in interest rates increased after the referendum as interest rates fell sharply, with the UK base rate cut from 0.5% to 0.25%. This reflected the limited ability of banks, including RBS, to pass on further rate cuts to customers that already receive low nominal returns on deposits. For more commentary on earnings sensitivity, refer to page 364.

\*unaudited

## Business review **Capital and risk management**

### Market risk **continued**

#### Sources of risk\*

##### Traded market risk

The majority of traded market risk exposure arises in NatWest Markets and Capital Resolution.

The primary objective of RBS's trading activities is to provide a range of financing, risk management and investment services to its customers - including major corporations and financial institutions around the world. From a market risk perspective, the trading activities are focused on the following markets: currencies; rates; securitised products; and traded credit.

RBS undertakes transactions in financial instruments including debt securities, loans, deposits and equities, as well as securities financing and derivatives.

Some of these transactions involve trading or clearing financial instruments on an exchange, including interest rate swaps, futures and options. Holders of these instruments provide margin on a daily basis with cash or other security at the exchange.

Other products are not transacted on an exchange. Of these over-the-counter transactions, those with standard terms may be cleared through central counterparties, while those that are more complex are settled directly with the counterparty and may give rise to counterparty credit risk. For more information on the management of counterparty credit risk, refer to the Credit risk section on page 292.

##### Non-traded market risk

The majority of RBS's non-traded market risk exposure arises from retail and commercial banking activities in all franchises from assets and liabilities that are not classified as held for trading.

Non-traded market risk is largely managed in line with the following key categories: interest rate risk; credit spread risk; foreign exchange risk; equity risk; and accounting volatility risk.

\*unaudited

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## Business review **Capital and risk management**

### Market risk continued

#### Interest rate risk

Non-traded interest rate risk (NTIRR) arises from the provision to customers of a range of banking products that have differing interest rate characteristics. When aggregated, these products form portfolios of assets and liabilities with varying degrees of sensitivity to changes in market interest rates. Mismatches in these characteristics can give rise to volatility in net interest income as interest rates vary.

NTIRR comprises three primary risk factors: gap risk, basis risk and option risk. For more information, refer to page 364.

#### Credit spread risk

Credit spread risk arises from the potential adverse economic impact of a move in the spread between bond yields and swap rates, where the bond portfolios are accounted at fair value in the non-trading book.

#### Foreign exchange risk

Non-traded foreign exchange risk exposures arise from two main sources:

- *Structural foreign exchange risk* - arising from the capital deployed in foreign subsidiaries, branches and joint arrangements and related currency funding where it differs from sterling.
- *Non-trading book foreign exchange risk* - arising from customer transactions and profits and losses that are in a currency other than the functional currency of the transacting operation.

#### Equity risk

Non-traded equity risk is the potential variation in income and reserves arising from changes in the values of non-trading book equity positions. Equity exposures may arise through strategic acquisitions, venture capital investments and certain restructuring arrangements.

#### Accounting volatility risk

Accounting volatility risk arises when a non-trading book exposure is accounted for at amortised cost but economically hedged by a derivative that is accounted for at fair value. Although this is not an economic risk, the difference in accounting between the exposure and the hedge creates volatility in the income statement.

### Pension risk

Pension-related activities also give rise to market risk. Refer to page 282 for more information on risk related to pensions.

\*unaudited

## **Business review** **Capital and risk management**

### **Market risk** **continued**

#### **Risk governance\***

RBS manages the key categories of traded and non-traded market risk separately. Each category is discussed in dedicated sections below.

Responsibility for identifying, measuring, monitoring and controlling the market risk arising from trading or non-trading activities lies with the relevant trading or non-trading business, with second-line-of-defence oversight provided by the Market Risk function, headed by the Director of Market Risk.

Market risk positions are reported monthly to the Executive Risk Forum (ERF) and quarterly to the Board Risk Committee. In addition, traded market risk positions are reported monthly to the Treasury and Market Risk Committee and non-traded market risk positions are reported to the ALCo (monthly in the case of interest rate, credit spread and accounting volatility risks and quarterly in the case of foreign exchange and equity risks).

The ERF approves market risk frameworks. Market risk policy statements set out the governance and risk management framework through effective identification, measurement, reporting, mitigation, monitoring and control.

RBS's policy is to manage risk exposures within an appetite that is set by the ERF and, in the case of non-traded market risk, endorsed by the ALCo. This appetite is expressed in the form of exposure limits.

#### **Risk appetite\***

RBS's qualitative market risk appetite is set out in policy statements.

Its quantitative market risk appetite is expressed in terms of limits for the trading and non-trading activities that are consistent with business plans.

The Market Risk Committee cascades the limits further down the organisation as required. For each trading business, a document known as a dealing authority compiles details of all applicable limits and trading restrictions.

The limit framework at RBS level comprises VaR, stressed value-at-risk (SVaR) and sensitivity and stress limits (for more details on VaR and SVaR, refer to pages 354 to 359). The limit framework at trading unit level also comprises additional metrics that are specific to the market risk exposures within its scope. These additional metrics aim to control various risk dimensions such as product type, exposure size, aged inventory, currency and tenor.

The limits are reviewed to reflect changes in risk appetite, business plans, portfolio composition and the market and economic environments.

To ensure approved limits are not breached and that RBS remains within its risk appetite, triggers at RBS and lower levels have been set such that if exposures exceed a specified level, action plans are developed by the front office, Market Risk and Finance.

For further information on risk appetite, refer to page 222.

\*unaudited

## **Business review** Capital and risk management

### **Market risk** continued

#### Risk controls and assurance

For information on risk controls and assurance, refer to page 228.

### **Traded market risk**

#### **Risk identification and assessment**

Identification and assessment of traded market risk is achieved through gathering, analysing, monitoring and reporting market risk information by business line or at a consolidated level. Industry expertise, continued system developments and techniques such as stress testing are also used to enhance the effectiveness of the identification and assessment of all material market risks.

This is complemented by the New Product Risk Assessment process, which requires market risk teams to assess and quantify the market risk associated with all proposed new products.

#### **Risk monitoring\***

Traded market risk exposures are monitored against limits and analysed daily by market risk reporting and control functions. A daily report that summarises market risk exposures against the limits set by the ERF is sent to the Chief Risk Officer and market risk managers across the function.

A risk review of trading businesses is undertaken weekly with senior risk and front office staff. This includes a review of profit and loss drivers, notable position concentrations and other positions of concern.

Businesses' profit and loss performance is monitored automatically via loss triggers which, if breached, require a remedial action plan to be agreed with the Market Risk function. The loss triggers are set using both a fall-from-peak approach and an absolute loss level.

The Market Risk function also prepares daily risk reports that detail exposures against a more granular set of limits and triggers.

Limit reporting is supplemented with regulatory capital and stress testing information as well as ad hoc reporting.

In addition, as noted under Risk governance above, regular updates on traded market risk positions are provided to the ERF, the Board Risk Committee, Treasury and the Market Risk Committee.

The reporting and updates facilitate frequent reviews and discussions of traded market risk exposures and related issues between the market risk functions, senior management and the front office.

\*unaudited

**Business review** **Capital and risk management**

**Market risk** *continued*

**Risk measurement**

RBS uses a comprehensive set of methodologies and techniques to measure traded market risk.

The main risk measurement methods are VaR, SVaR and the incremental risk charge. Risks that are not adequately captured by VaR or SVaR are captured by the Risks not in VaR (RNIV) framework to ensure that RBS is adequately capitalised for market risk. In addition, stress testing is used to identify any vulnerabilities and potential losses in excess of VaR and SVaR.

The key inputs into these measurement methods are market data and risk factor sensitivities. Sensitivities refer to the changes in deal or portfolio value that result from small changes in market parameters that are subject to the market risk limit framework. Revaluation ladders are used in place of sensitivities to capture the impact on the income statement of large moves in risk factors or the joint impact of two risk factors.

These methods have been designed to capture correlation effects and allow RBS to form an aggregated view of its traded market risk across risk types, markets and business lines while also taking into account the characteristics of each risk type.

#### Value-at-risk\*

VaR is a statistical estimate of the potential change in the market value of a portfolio (and, thus, the impact on the income statement) over a specified time horizon at a given confidence level.



For internal risk management purposes, VaR assumes a time horizon of one trading day and a confidence level of 99%. The VaR model is based on a historical simulation, utilising market data from the previous 500 days on an equally weighted basis.

The internal traded VaR model captures all trading book positions including those products approved by the regulator. For an explanation of the distinction between internal VaR and regulatory VaR, refer to page 361.

\*unaudited

## Business review **Capital and risk management**

### Market risk **continued**

The internal VaR model captures the potential impact of the following risk factors:

- General interest rate risk - which arises from the impact of changes in interest rates and volatilities on cash instruments and derivatives. This includes interest rate tenor basis risk and cross-currency basis risk.
- Specific interest rate risk - which arises from the impact of changes in the credit spreads of sovereign bonds, corporate bonds, securitised products and credit derivatives.
- Currency risk - which arises from the impact of changes in currency rates and volatilities.
- Equity risk - which arises from the impact of changes in equity prices, volatilities and dividend yields.
- Commodity risk - which arises from the impact of changes in commodity prices and volatilities.

When simulating potential movements in risk factors, a combination of absolute and relative returns is used, depending on the risk factor.

The following types of risk - which are components of the above-mentioned factors - are also considered:

- Basis risk - which is the risk that imperfect correlation between two instruments in a hedging strategy creates the potential for excess gains or losses, thus adding risk to the position;
- Prepayment risk - which is the risk associated with early unscheduled return of principal on a fixed rate security; and
- Inflation risk - which is the risk of a decrease in the value of instruments as a result of changes in inflation rates and associated volatilities.

### VaR limitations\*

Historical VaR and RBS's implementation of this risk measurement methodology have a number of known limitations, as summarised below, and VaR should be interpreted in light of these. RBS's approach is to supplement VaR with other risk metrics that address these limitations to ensure appropriate coverage of all material market risks.

Historical simulation VaR may not provide the best estimate of future market movements. It can only provide a forecast of portfolio losses based on events that occurred in the past. The RBS model uses the previous 500 days of data; this period represents a balance between model responsiveness to recent shocks and risk factor data coverage.

Market data time series are updated on a daily basis, with a ten-working-day time lag.

The use of a 99% confidence level VaR statistic does not provide information about losses beyond this level, usually referred to as 'tail' risks. These risks are more appropriately assessed using measures such as SVaR and stress testing.

Finally, where market data time series are not appropriate (due to poor quality or a lack of liquidity in the market), RBS uses proxy time series or excludes the risk factor from its VaR model and capitalises the risk through its RNIV framework.

#### 1-Day 99% traded internal VaR 2016

\*unaudited

**Business review** Capital and risk management**Market risk** continued

The table below analyses 1-day 99% internal VaR for RBS's trading portfolios, segregated by type of market risk exposure.

	2016				2015			
	Average	Period end	Maximum	Minimum	Average	Period end	Maximum	Minimum
Traded VaR (1-day 99%)	£m	£m	£m	£m	£m	£m	£m	£m
General interest rate	12.5	16.9	22.3	7.8	14.5	12.8	29.8	9.5
Specific interest rate	9.5	9.7	13.7	5.8	10.1	7.1	16.4	6.5
Currency	4.6	5.4	14.3	1.0	4.9	5.0	8.9	1.9
Equity	0.5	1.9	2.1	0.2	1.6	0.8	6.1	0.4
Commodity	0.7	0.3	2.4	0.2	0.4	0.5	2.2	0.2
Diversification (1)		(10.4)				(9.1)		
Total	17.0	23.8	29.3	9.9	18.9	17.1	30.1	12.1

Note:

(1) RBS benefits from diversification as it reduces risk by allocating positions across various financial instrument types, currencies and markets. The extent of the diversification benefit depends on the correlation between the assets and risk factors in the portfolio at a particular time. The diversification factor is the sum of the VaR on individual risk types less the total portfolio VaR.

**Key points**

- On an average basis, total traded VaR decreased in 2016 by 10%. The reduction was mainly driven by lower risk positions during Q1 2016, with reduced market activity reflecting concerns over the stability of the financial sector. Stronger client flows later in the year, mainly in NatWest Markets' strategic Rates and Currencies businesses, resulted in a risk increase in the second half of 2016.
- On a period end basis, total traded VaR increased in 2016 by 39%. The increase was mainly driven by the Rates business.
- VaR fluctuated throughout 2016, reflecting developments in US and the eurozone and other macroeconomic factors. These included, but were not limited to, the US presidential elections, the EU referendum in the UK and central bank actions. However, total traded VaR was managed within risk appetite.



## Business review **Capital and risk management**

### Market risk *continued*

#### *VaR validation\**

In addition to being a key risk management measure used by Market Risk in its second-line-of-defence oversight of the risk arising from trading activities, VaR is also used as one of the components of RBS's market risk regulatory capital requirements (refer to page 361 for more information).

Therefore, VaR is subject not only to model management review and validation but also to regulation compliance, which includes (but is not restricted to) regulator-prescribed back-testing.

The performance and adequacy of the VaR model are tested on a regular basis through the following processes:

- Back-testing - Internal and regulatory back-testing is conducted on a daily basis.
- Ongoing model validation - VaR model performance is assessed both regularly and on an ad-hoc basis if market conditions or book constitution change significantly.
- RNIV framework - The RNIV framework ensures that all material risks outside the internal VaR models are captured by, if necessary, developing an RNIV calculation to manage the risk (refer to page 359).
- Model Risk Management review - As part of the model lifecycle, all risk models (including the VaR model) are independently reviewed to ensure that the model is still fit for purpose given current market conditions and book constitution (refer to page 228).

#### *VaR back-testing\**

The main approach employed to assess the ongoing performance of the VaR model is back-testing, which counts the number of days when a loss exceeds the corresponding daily VaR estimate, measured at a 99% confidence level.

Two types of profit and loss (P&L) are used in back-testing comparisons: Actual P&L and Hypothetical (Hypo) P&L.

The Actual P&L for a particular business day is the firm's actual P&L for that day in respect of the trading activities within the scope of the firm's regulatory VaR model, including any intraday activities, adjusted by stripping out fees and commissions, brokerage, and additions to and releases from reserves that are not directly related to market risk.

The Hypo P&L reflects the firm's Actual P&L excluding any intra-day activities.

A portfolio is said to produce a back-testing exception when the Actual or Hypo P&L exceeds the VaR level on a given day. Such an event may be caused by a large market movement or may highlight issues such as missing risk factors or inappropriate time series. Any such issues identified are analysed and addressed through taking appropriate remediation or development action. RBS monitors both Actual and Hypo back-testing exceptions.

The table below shows internal back-testing exceptions for a period of 250 days for 1-day 99% traded internal VaR vs. Actual and Hypo P&L for major NatWest Markets businesses.

Description	Back-testing exceptions	
	Actual	Hypo
Rates	2	4
Credit	3	4
Currencies	—	9
Securitised products	3	2

\*unaudited

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## Business review **Capital and risk management**

### Market risk **continued**

#### Key points

- Statistically RBS would expect to see back-testing exceptions 1% of the time over the 250-day period.
- The top-level businesses presented in the table above are subject to quarterly review by the PRA. For these businesses, exceptions were noted during the period and analysis conducted as explained below.
- The exceptions in the Rates business were driven by rates and volatility changes adversely affecting the desk.
- The exceptions in the Credit business were mainly driven by mark-downs and changes in credit default swap spreads.
- The exceptions in the Currencies business were mainly driven by the increased volatility connected with the large market movements in the run-up to and following the EU referendum. In addition, a small number of exceptions were driven in part by movements in the independent price verification reserve.
- The exceptions in the Securitised Products business were mainly due to mark-downs and tightening in credit default swap spreads.

\*unaudited



## Business review **Capital and risk management**

### Market risk continued

#### *Stressed VaR (SVaR)\**

As with VaR, the SVaR technique produces estimates of the potential change in the market value of a portfolio, over a specified time horizon, at a given confidence level. SVaR is a VaR-based measure using historical data from a one-year period of stressed market conditions.

The risk system simulates 99% VaR on the current portfolio for each 250-day period from 2005 to the current VaR date, moving forward one day at a time. The SVaR is the worst VaR outcome of the simulated results.

This is in contrast with VaR, which is based on a rolling 500-day historical data set. For the purposes of both internal risk management and regulatory SVaR calculation, a time horizon of ten trading days is assumed with a confidence level of 99%.

The internal traded SVaR model captures all trading book positions, including not only those products, locations and legal entities approved by the regulator.

#### *10-day 99% trading internal SVaR\**

	2016	2015
	£m	£m
Total RBS	161	145

### Key point

- Total traded SVaR was broadly unchanged in 2016 compared to 2015, although it fluctuated during the year.

#### *Risks not in VaR (RNIVs)\**

The RNIV framework is used to identify and quantify market risks that are inadequately captured by the internal VaR and SVaR models.

The need for an RNIV calculation is typically identified in one of the following three circumstances: (i) as part of the New Product Risk Assessment process, when a risk manager determines that the associated risk is not adequately captured by the VaR model or system; (ii) when risks are mapped to time series that are deemed to be inadequate (for example, due to data quality problems or proxy series usage); or (iii) as a result of a recommendation made during the ongoing model validation or by Model Risk Management during its annual review of the VaR model.

RNIVs that are related specifically to instruments that have level 3 valuation hierarchy assumptions (refer to page 425) are mainly included in the following categories: proxied sensitivities or risk factors, higher-order sensitivity terms, and static pricing parameters.

RBS adopts two approaches for the quantification of RNIVs:

- A VaR/SVaR approach. Under this approach, two values are calculated: (i) the VaR RNIV; and (ii) the SVaR RNIV.
- A stress-scenario approach. Under this approach, an assessment of ten-day extreme, but plausible, market moves is used in combination with position sensitivities to give a stress-type loss number - the stress-based RNIV value.

\*unaudited

## Business review **Capital and risk management**

### Market risk *continued*

In each of these approaches, potential diversification benefits between RNIVs are ignored.

The RNIV calculations provide the additional capital required to capture the market risks not captured in the internal VaR model and are regularly reported to senior management and the regulator and discussed with them. The methodology used in the material RNIV calculations is internally reviewed by Model Risk Management. Where appropriate, risk managers set sensitivity limits to monitor specific risk factors. RNIV calculations form an integral part of RBS's ongoing model and data improvement efforts to capture all market risks in scope for model approval in VaR and SVaR.

### *Stress testing\**

RBS undertakes daily market risk stress testing to identify vulnerabilities and potential losses in excess of or not captured in VaR. The calculated stresses measure the impact of changes in risk factors on the fair values of the trading and available-for-sale portfolios.

RBS conducts historical, macroeconomic and vulnerability-based stress testing.

Historical stress testing is a measure that is used for internal management. Using the historical simulation framework employed for VaR, the current portfolio is stressed using historical data since 1 January 2005. The methodology simulates the impact of the 99.9 percentile loss that would be incurred by historical risk factor movements over the period, assuming variable holding periods specific to the risk factors and the businesses.

Historical stress tests form part of the market risk limit framework and their results are reported daily to senior management

Macroeconomic stress tests are carried out periodically as part of the firm-wide, cross-risk capital planning process. The scenario narratives are translated into risk factor shocks using historical events and insights by economists, risk managers and the front office. Market risk stress results are combined with those for other risks into the capital plan that is presented to the Board. The cross-risk capital planning process is conducted once a year, in September/October, with a planning horizon of five years. The scenario narratives cover both regulatory scenarios and macroeconomic scenarios identified by the firm.

Vulnerability-based stress testing begins with the analysis of a portfolio and expresses the key vulnerabilities of the portfolio in terms of plausible, so-called vulnerability scenarios under which the portfolio would suffer material losses. These scenarios can be historical, macroeconomic or forward-looking/hypothetical. Vulnerability-based stress testing is used for internal management information and is not subject to limits. However, the results for relevant scenarios are reported to senior management.

\*unaudited

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## Business review **Capital and risk management**

### Market risk **continued**

#### *Economic capital\**

The market risk economic capital framework uses models to calculate the market and default risk in the trading book which are aligned with other models that are used for limit setting and market risk management. The results are annualised to be consistent with the other economic capital models to permit consolidation of all risk types as part of the RBS-wide economic capital programme.

### Market risk **regulatory capital\***

#### *Regulatory treatment*

The market risks subject to capital requirements under Pillar 1 are primarily interest rate, credit spread and equity risks in the trading book and foreign exchange and commodity risks in both the trading and non-trading books. Interest rate and equity risks are split between general and specific risks. General risks represent market risks due to a move in a market as a whole, such as a main index or yield curve, while specific risks represent market risks arising from events particular to an underlying issuer.

The aggregation approach taken for general and specific risks is as follows:

- General risks are aggregated at the simulation level, adding P&L forecasts generated by the VaR model before statistics such as VaR and SVaR are extracted.
- Specific equity risks are aggregated with general risks using the simulation-level approach.
- Specific interest rate risks have both a systematic component and an idiosyncratic component. The systematic component captures the risk in market movements of credit spreads (across sectors, geographic locations and ratings) while the idiosyncratic component captures the credit spread variability of the underlying entity. The systematic components of specific interest rate risks are aggregated at the simulation level, while the idiosyncratic components are calculated as a standalone charge.

RBS uses two broad methodologies to calculate its market risk capital charge: (i) the standardised or non-modelled approach, whereby regulator-prescribed rules are applied, and (ii) the internal model approach, where, subject to regulatory approval, a model such as VaR is used to calculate the capital charge.

VaR and SVaR capture general and specific risks using a single model but not risks arising from the impact of defaults and rating changes associated with traded credit products and their derivatives. For these risks, two product-dependent approaches are used:

- The incremental risk charge model captures risks arising from rating migration and default events for the more liquid traded credit instruments and their derivatives.
- Securitisation and re-securitisation risks in the trading book are treated with the non-trading book non-modelled capitalisation approach.

### *Regulatory VaR*

The PRA renewed RBS's Internal Model Approach (IMA) permission with effect from 30 November 2016, incorporating changes to the legal entity coverage of the permission (removal of RBSSI) and minor revisions to its product and trading location coverage.

\*unaudited

## Business review **Capital and risk management**

### Market risk *continued*

The changes were requested by RBS, reflecting the continued simplification of its operations. RBS has IMA permission for the following material legal entities: RBS plc and NatWest Plc.

While internal VaR provides a measure of the economic risk, regulatory VaR is one of the measures of regulatory capital requirements by legal entity.

The calculation of regulatory VaR differs from that of the internal VaR as it takes into account only regulator-approved products, locations and legal entities. In addition, it is based on a directly modelled ten-day holding period, rather than a scaled one-day holding period, for market risk capital calculations.

The PRA approval covers general market risk in interest rate, foreign exchange, equity and commodity products and specific market risk in interest rate and equity products.

### *Regulatory SVaR\**

RBS's SVaR model has also been approved by the PRA for use in the capital requirement calculation. The distinction between regulatory SVaR and internal SVaR is the same as that between regulatory VaR and internal VaR.

### *Risks not in VaR*

As discussed earlier, RBS has an established RNIV framework that ensures that the risks not captured in VaR are adequately covered by its capital. In line with regulatory guidelines for external reporting, VaR RNIV values are reported as a subset of the VaR-based regulatory capital charge, whereas SVaR RNIV and stress-based RNIV values are reported as subsets of the SVaR-based charge.

### *Incremental risk charge (IRC)\**

The IRC model quantifies the impact of rating migration and default events on the market value of instruments with embedded credit risk (in particular, bonds and credit default swaps) that are held in the trading book. It further captures basis risk between different instruments, maturities and reference entities. Following the internal ratings-based approach for credit risk, the IRC is calculated over a one-year capital

horizon with a 99.9% confidence level. The dependency of positions is modelled using a single-factor Gaussian copula.

The IRC is mainly driven by three-month credit rating transition, default and correlation parameters. The portfolio impact of correlated defaults and rating changes is assessed by observing changes in the market value of positions using stressed recovery rates and modelled credit spread changes. Revaluation matrices are used to capture any non-linear behaviour.

The transition matrix is estimated using Moody's history of issuer ratings.

The average liquidity horizon by position (weighted by materiality) at the year end was 3.2 months (2015 - 3.2 months). The horizon is determined based on issuer liquidity, position concentration, product type and maturity.

\*unaudited



## **Business review** **Capital and risk management**

### **Market risk** **continued**

#### **Market risk RWAs and minimum capital requirements\***

At 31 December 2016, total market risk RWAs were £17 billion (31 December 2015 - £21 billion). Minimum capital requirements, which represent 8% of RWAs, were £1.4 billion (31 December 2015 - £1.7 billion).

By regulatory approach, the internal model approach accounted for 80% of the total (2015 - 78%). By legal entity, RBS plc accounted for 90% of the total (2015 - 90%).

#### **Model validation\***

RBS uses a variety of models to manage and measure market risk. These include pricing models (used for valuation of positions) and risk models (for risk measurement and capital calculation purposes). They are developed in both RBS-level and lower-level functions and are subject to independent review and sign-off.

For general information on the independent model validation carried out by Model Risk Management (MRM), which applies also to market risk models (including VaR models), refer to page 229. Additional details relating to pricing and market risk models are presented below.

#### **Pricing models**

Pricing models are developed by a dedicated front office quantitative team, in conjunction with the trading desk. They are used for the valuation of positions for which prices are not directly observable and for the risk management of the portfolio.

Any pricing models that are used as the basis for valuing books and records are subject to approval and oversight by asset-level modelled product review committees.

These committees comprise representatives of the major stakeholders in the valuation process - trading, finance, market risk, model development and model review functions.

The review process comprises the following steps:

- The committees prioritise models for review by MRM, considering the materiality of the risk booked against the model and an assessment of the degree of model risk, that is the valuation uncertainty arising from the choice of modelling assumptions.
- MRM quantifies the model risk by comparing front office model outputs with those of alternative models independently developed by MRM.
- The sensitivities derived from the pricing models are validated.
- The conclusions of the review are used by MRM to inform risk limits and by Finance to inform model reserves.

\*unaudited

## Business review **Capital and risk management**

### Market risk **continued**

#### Risk models

All model changes are approved through model governance committees at franchise level. Changes to existing models are subject to MRM review and RBS follows regulatory guidance for assessing the materiality of extensions and changes to the internal model approach for market risk.

MRM's independent oversight provides additional assurance that RBS holds appropriate capital for the market risk to which it is exposed.

In addition to MRM's independent oversight, the model testing team monitors the model performance for market risk through back-testing, which is discussed in more detail on page 357, and other processes.

### Non-traded market risk

As noted earlier, RBS largely manages the key categories of non-traded market risk separately. The categories are: interest rate risk; credit spread risk; foreign exchange risk; equity risk; and accounting volatility risk.

### Risk assessment, monitoring and mitigation

#### Interest rate risk\*

Non-traded interest rate risk (NTIRR) factors are grouped into the following categories:

- Gap risk - which arises from the timing of rate changes in non-trading book instruments. The extent of gap risk depends on whether changes to the term structure of interest rates occur consistently across the yield curve (parallel risk) or differentially by period (non-parallel risk).
- Basis risk - which captures the impact of relative changes in interest rates for financial instruments that have similar tenors but are priced using different interest rate indices, or on the same interest rate indices but with different tenors.
- Option risk - which arises from option derivative positions or from optional elements embedded in assets, liabilities and/or off-balance sheet items, where RBS or its customer can alter the level and timing of their cash flows. Option risk can be further characterised into automatic option risk and behavioural option risk. One example of behavioural option risk is pipeline risk. This is the risk of loss arising from personal

customers owning an option to draw down a loan (typically a mortgage loan) at a committed rate. Changes in interest rates can result in greater or fewer customers than anticipated taking up the committed offer. The risk depends on customer behaviour as the option will not automatically be exercised.

Due to the long-term nature of many non-trading book portfolios and their varied interest rate repricing characteristics and maturities, it is likely that net interest income will vary from period to period, even if interest rates remain the same. New business originated in any period will alter RBS's interest rate sensitivity if the resulting portfolio differs from portfolios originated in prior periods, depending on the extent to which exposure has been hedged.

\*unaudited

## Business review **Capital and risk management**

### Market risk **continued**

In order to manage exposures within these limits, RBS aggregates its interest rate positions and hedges them externally using cash and derivatives, primarily interest rate swaps.

This task is primarily carried out by RBS Treasury, to which all businesses except NatWest Markets transfer most of their NTIRR. The main exposures and limit utilisations are reported to the ALCo and the ERF monthly and to the Board Risk Committee quarterly.

### Credit spread risk

The bond portfolios in the non-trading book are high-quality securities that are primarily maintained as a liquidity buffer to ensure RBS can continue to meet its obligations in the event that access to wholesale funding markets is restricted. Additionally other high-quality bond portfolios are held for collateral purposes and to support payment systems.

Credit spread risk is monitored daily through sensitivities and VaR measures. The dealing authorities in place for the bond portfolios further mitigate the risk by imposing constraints by duration, asset class and credit rating. Exposures and limit utilisations are reported to senior management on a daily basis as well as to the Executive Risk Forum monthly and to the Board Risk Committee quarterly.

### Foreign exchange risk

The only material non-traded open currency positions are the structural foreign exchange exposures arising from investments in foreign subsidiaries, branches and associates and their related currency funding. These exposures are assessed and managed by RBS Treasury to predefined risk appetite levels under delegated authority from the ALCo. Treasury seeks to limit the potential volatility impact on RBS's CET1 ratio from exchange rate movements by maintaining a structural open currency position. Gains or losses arising from the retranslation of net investments in overseas operations are recognised in equity reserves and reduce the sensitivity of capital ratios to foreign exchange rate movements primarily arising from the retranslation of non-sterling-denominated RWAs. Sensitivity is minimised where, for a given currency, the ratio of the structural open position to RWAs equals RBS's CET1 ratio. The sensitivity of the CET1 capital ratio to exchange rates is monitored monthly and reported to the ALCo at least quarterly.

\*unaudited

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## **Business review** Capital and risk management

### **Market risk** continued

Foreign exchange exposures arising from customer transactions are sold down by businesses on a regular basis in line with RBS policy.

### Equity risk

Non-traded equity risk is the potential variation in the income and reserves arising from changes in non-trading book equity valuations. Any such risk is identified prior to any investments and then mitigated through a framework of controls.

Investments, acquisitions or disposals of a strategic nature are referred to RBS's Acquisitions and Disposals Committee (ADCo). Once approved by ADCo for execution, such transactions are referred for approval to the Board, the Executive Committee, the Chief Executive, the Chief Financial Officer or as otherwise required. Decisions to acquire or hold equity positions in the non-trading book that are not of a strategic nature, such as customer restructurings, are taken by authorised persons with delegated authority under the credit approval framework.

### Accounting volatility risk

Accounting volatility can be mitigated through hedge accounting whereby RBS can mitigate the profit and loss impact of the derivatives by marking the exposure to market. However, volatility will remain in cases where accounting rules mean that hedge accounting is not an option. Accounting volatility is reported to the ALCo monthly and capitalised as part of the Internal Capital Adequacy Assessment Process.

### **Risk measurement**

The market risk exposures that arise as a result of RBS's retail and commercial banking activities are measured using a combination of value-based metrics (VaR and sensitivities) and earnings-based metrics, as explained in greater detail for each of the key non-traded risk exposure types disclosed in this section.

Following the approval of an enhanced non-traded market risk appetite framework in early 2016, VaR disclosures reflect a more complete economic risk measure for the banking book.

The following table presents 1-day internal banking book VaR at a 99% confidence level, analysed by type of risk.

	2016				2015 (1)*
	Average	Maximum	Minimum	Period end	Period end
	£m	£m	£m	£m	£m
Interest rate	10	19	5	18	19
Euro	3	4	2	4	4
Sterling	10	24	5	21	14
US dollar	3	5	2	2	5
Other	2	2	1	1	2
Credit spread	57	67	42	63	31
Structural FX rate	13	20	10	10	11
Pipeline risk	1	1	—	—	1
Diversification (2)	—	—	—	(19)	(29)
Total	57	72	41	72	33

#### Notes:

(1) Certain 2015 year end numbers have been restated for comparison purposes in light of the enhancement of the risk appetite framework in 2016.

(2) RBS benefits from diversification across various financial instrument types, currencies and markets. The extent of the diversification benefit depends on the correlation between the assets and risk factors in the portfolio at a particular time. The diversification factor is the sum of the VaR on individual risk types less the total portfolio VaR.

#### Key points

- Total internal non-traded VaR rose from £33 million to £72 million on a period end basis, primarily driven by credit spread risk, which remains the largest contributor to the total VaR.
- The rise in credit spread VaR reflected the increase in the proportion of bonds held within Treasury's liquidity portfolio and the increased volatility in the market data captured in the VaR. (For more information on the liquidity bond portfolio, refer to the Liquidity and funding risk section.)
- Interest rate risk mainly arises from the structural hedges carried out by Treasury. It rose towards the end of the year as the equity structural hedging strategy was adjusted in anticipation of future conduct fines.





## Business review **Capital and risk management**

### Market risk *continued*

#### Interest rate risk\*

NTIRR can be measured from either an economic value-based or earnings-based perspective, or a combination of the two. Value-based approaches measure the change in value of the balance sheet assets and liabilities over a longer timeframe, including all cash flows. Earnings-based approaches measure the potential short-term (generally one-year) impact on the income statement of changes in interest rates.

RBS uses both approaches to quantify its interest rate risk: VaR as its value-based approach and sensitivity of net interest income (NII) as its earnings-based approach.

These two approaches provide different yet complementary views of the impact of interest rate risk on the balance sheet at a point in time. The scenarios employed in the NII sensitivity approach incorporate business assumptions and simulated modifications in customer behaviour as interest rates change. In contrast, the VaR approach assumes static underlying positions and therefore does not provide a dynamic measurement of interest rate risk. In addition, while the NII sensitivity calculations are measured to a 12-month horizon and thus provide a shorter-term view of the risks on the balance sheet, the VaR approach can identify risks not captured in the sensitivity analysis, in particular the impact of duration and repricing risk on earnings beyond 12 months.

#### *Value-at-risk\**

RBS's standard VaR metrics - which assume a time horizon of one trading day and a confidence level of 99% - are based on interest rate repricing gaps at the reporting date. Daily rate moves are modelled using observations over the last 500 business days. These incorporate customer products plus associated funding and hedging transactions as well as non-financial assets and liabilities such as property, plant and equipment, capital and reserves. Behavioural assumptions are applied as appropriate.

The non-traded interest rate risk VaR metrics for RBS's retail and commercial banking activities are included within the non-traded VaR table above. The VaR captures the risk resulting from mismatches in the repricing dates of assets and liabilities. It includes any mismatch between structural hedges and stable non and low interest-bearing liabilities such as equity and money transmission accounts as regards their interest rate repricing behavioural profile.

\*unaudited

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## Business review **Capital and risk management**

### Market risk **continued**

#### Sensitivity of net interest income\*

Earnings sensitivity to rate movements is derived from a central forecast over a 12-month period. A simplified scenario is shown based on the period-end balance sheet assuming that non-interest rate variables remain constant. Market implied forward rates are used to generate a base case earnings forecast, which is then subjected to interest rate shocks. The variance between the central forecast and the shock gives an indication of underlying sensitivity to interest rate movements.

The following table shows the sensitivity of net interest income, over the next 12 months, to an immediate upward or downward change of 25 and 100 basis points to all interest rates. All yield curves are expected to move in parallel with the exception that interest rates are assumed to floor at zero per cent or, for euro rates, at the current negative rate.

The main driver of earnings sensitivity relates to interest rate pass-through assumptions on customer products. The scenario also captures the impact of the reinvestment of maturing structural hedges at higher or lower rates than the base case earnings sensitivity and mismatches in the repricing dates of loans and deposits.

Multi-year forward projections would increase the negative impact of a downward change in rates or, conversely, the benefit of an immediate upward change in interest rates to current market rates. This is because, over time a greater proportion of maturing structural hedges will be reinvested at prevailing rates which may be higher or lower. Also, in the absence of dynamic assumptions relating to further management actions, the variance to the base case income forecast arising from margin compression or expansion on managed rate products will continue to accrue.

However, reported sensitivities should not be considered predictive of future performance. They do not capture potential management action in response to sudden changes in the interest rate environment. Actions that could reduce the net interest income sensitivity and mitigate adverse impacts are changes in pricing strategies on both customer loans and deposits as well as hedging. Management action may also be targeted at stabilising total income taking into account non-interest income in addition to net interest income.

\*unaudited



**Business review** Capital and risk management

<b>Market risk continued</b>					
	Euro	Sterling	US dollar	Other	Total
	£m	£m	£m	£m	£m
<b>2016</b>					
+ 25 basis point shift in yield curves	4	79	11	2	96
– 25 basis point shift in yield curves	(1)	(222)	(11)	(2)	(236)
+ 100 basis point shift in yield curves	9	436	42	13	500
– 100 basis point shift in yield curves	(2)	(337)	(30)	(9)	(378)
<b>2015</b>					
+ 25 basis point shift in yield curves	(6)	48	25	1	68
– 25 basis point shift in yield curves	(7)	(66)	(24)	1	(96)
+ 100 basis point shift in yield curves	(17)	385	94	7	469
– 100 basis point shift in yield curves	(7)	(345)	(79)	2	(429)

**Key points**

- Interest rate exposure remains asset-sensitive, so that rising interest rates will have a positive impact on net interest income.
- The largest change in net interest income sensitivity in 2016 related to the negative impact of a 0.25% fall in interest rates from the base case. Sensitivity increased from £96 million to £236 million, primarily due to lower customer deposit interest rates. When interest rates are already at very low levels, it is assumed that further interest rate cuts will not be passed through to customer depositors and, therefore, net interest income falls.
- Structural hedges reduce income sensitivity to interest rate shocks over a 12-month period because only a relatively small amount of the hedge matures and rolls forward at the lower rate. For example, one-fifth of a five-year hedging programme will mature over a 12-month period.
- Assumptions relating to customer pricing are kept under review and may vary at different levels of interest rates. As a result, the increase in sensitivity between 25 basis points and 100 basis points is not linear.
- Changes in pricing assumptions and increased hedging of customer deposits are the key actions in personal and commercial banking that may reduce interest rate sensitivity.

### Structural hedging\*

RBS has the benefit of a significant pool of stable, non and low interest bearing liabilities, principally comprising equity and money transmission accounts. These balances are usually hedged, either by investing directly in longer-term fixed rate assets or by the use of interest rate swaps, in order to provide a consistent and predictable revenue stream.

After hedging the net interest rate exposure of the bank externally, RBS Treasury allocates income to products or equity in structural hedges by reference to the relevant interest rate swap curve. Over time, the hedging programme has built up a portfolio that provides a basis for stable income attribution to the product and equity structural hedges.

\*unaudited

**Business review** Capital and risk management**Market risk** continued*Product structural hedging\**

Product structural hedges are used to minimise the volatility on earnings related to specific products, primarily customer deposits. The balances are primarily hedged with medium-term interest rate swaps, so that reported income is less sensitive to movements in short-term interest rates. The size and term of the hedge are based on the stability of the underlying portfolio.

The table below shows the impact on net interest income associated with product hedges managed by RBS Treasury. These relate to the main UK banking businesses except Private Banking and RBS International. RBS Treasury allocates income to products or equity in structural hedges by reference to the relevant interest rate swap curve after hedging the net interest rate exposure of the bank externally. This internal allocation has been developed over time alongside the bank's external hedging programme and provides a basis for stable income attribution to the product and equity hedges.

	2016	2015
	£m	£m
<b>Net interest income - impact of product structural hedging</b>		
UK Personal & Business Banking	346	373
Commercial Banking	235	256
Capital Resolution	10	21
Williams & Glyn	44	45
<b>Total</b>	<b>635</b>	<b>695</b>

**Key points**

- The incremental impact of product hedges on net interest income above 3-month LIBOR remained positive in 2016. The average size of the hedge increased from £72 billion in 2015 to £90 billion, split by business broadly in line with the proportion of income as shown above. The increase largely reflected growth in hedged product balances and increased hedging of rate-on sensitive customer deposits. During the year, interest rates remained at or close to historical low levels, as a result of which the average book yield (including 3-month LIBOR) fell from 1.48% to 1.20%. This reflects the impact of maturing hedges being reinvested at lower rates and new hedges added during the year at lower market rates.
- At 31 December 2016, the 5-year swap rate was 0.74% compared with 1.45% one year previously. The market rate matching the amortising structure of the hedge was 0.60%.



\*unaudited

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## Business review **Capital and risk management**

### Market risk **continued**

#### *Equity structural hedging\**

Equity structural hedges are used to minimise the volatility on earnings arising from returns on equity. The hedges managed by Treasury relate mainly to the UK banking businesses (PBB and CPB) and contributed £0.6 billion to these businesses in 2016 (2015 - £0.7 billion), which is an incremental benefit relative to short-term wholesale cash rates. The average size of the hedge was £33 billion in 2016, lower than in 2015 (£41 billion), primarily reflecting the payment of £4.2 billion into the pension fund, an additional £3.1 billion provision for various investigations and litigation matters relating to RBS's issuance and underwriting of residential mortgage-backed securities (RMBS) and the £1.2 billion payment of the final Dividend Access Share (DAS) dividend.

The equity hedge also aims broadly to track a time series of medium-to-longer-term swap rates. Other factors, such as the impact of the sale of fixed-rate securities or additional hedging activity, are not captured in the equity yield. The average book yield (including 3-month LIBOR) rose from 2.3% to 2.4%.

At 31 December 2016, the 10-year swap rate was 1.1% compared with 1.9% one year previously. The market rate matching the amortising structure of the equity hedge was 0.9%.

\*unaudited

**Business review** Capital and risk management

## Sensitivity of available-for-sale and cashflow hedging reserves to interest rate movements\*

The table below shows the estimated sensitivity of equity reserves to interest rate movements, on a pre-tax basis. The scenarios shown are simplified scenarios in which all rates across the yield curve have been moved up or down instantaneously by 25 basis points and 100 basis points and taxation effects have not been estimated. In this analysis, interest rates have not been floored at zero. Note that a movement in the AFS reserve would have an impact on CET1 capital but a movement in the cash flow hedge reserve would not be expected to do so. Volatility in both reserves affects tangible net asset value.

	+25 basis points	-25 basis points	+100 basis points	-100 basis points
2016	£m	£m	£m	£m
Available-for-sale reserve	(36)	35	(150)	135
Cashflow hedge reserve	(417)	422	(1,641)	1,714
Total	(453)	457	(1,791)	1,849
2015				
Available-for-sale reserve	(63)	63	(255)	255
Cashflow hedge reserve	(462)	467	(1,817)	1,896
Total	(525)	530	(2,072)	2,151

**Key points**

- The asymmetry in results between the upward and downward interest rate shocks reflects the changing sensitivity of derivative valuations to the same interest rate movement at different levels of interest rates (i.e. convexity).
- The reduction in the sensitivity of the available-for-sale reserve primarily results from the reduction of Capital Resolution exposures.

\*unaudited

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**Business review** Capital and risk management**Market risk** continued

## Foreign exchange risk

The table below shows structural foreign currency exposures.

	Net investments in foreign operations	Non-controlling interests (NCI)	Net investments in foreign operations excluding NCI (1)	Net investment hedges	Structural foreign currency exposures pre-economic hedges	Economic hedges (2)	Residual structural foreign currency exposures
	£m	£m	£m	£m	£m	£m	£m
2016							
US dollar	(595)	—	(595)	(28)	(623)	—	(623)
Euro	6,085	(4)	6,089	(582)	5,507	(2,289)	3,218
Other non-sterling	3,366	761	2,605	(1,491)	1,114	(625)	489
Total	8,856	757	8,099	(2,101)	5,998	(2,914)	3,084
2015							
US dollar	1,172	—	1,172	(134)	1,038	(1,038)	—
Euro	6,562	(127)	6,435	(573)	5,862	(1,963)	3,899
Other non-sterling	3,599	(524)	3,075	(2,364)	711	—	711
Total	11,333	(651)	10,682	(3,071)	7,611	(3,001)	4,610

## Notes:

(1) Non-controlling interests (NCI) represents the structural foreign exchange exposure not attributable to owners' equity.

(2) Economic hedges mainly represent US dollar and euro preference shares in issue that are treated as equity under IFRS and do not qualify as hedges for accounting purposes. They provide an offset to structural foreign exchange exposures to the extent that there are net assets in overseas operations available.

**Key points**

- Structural foreign currency exposure at 31 December 2016 was £6 billion before and £3 billion after economic hedges, respectively, £1.6 billion and £1.5 billion lower than at 31 December 2015.
- The reduction in the residual structural foreign currency exposure was driven by provisions for RMBS and dividends received from EU subsidiaries. These reductions were partly offset by appreciation of the US dollar and the euro against sterling in 2016.
- Changes in foreign currency exchange rates affect equity in proportion to structural foreign currency exposure. For example, a 5% strengthening in foreign currencies against sterling would result in a gain of £0.3 billion in equity (2015 - a £0.5 billion gain). A 5% weakening in foreign currencies against sterling would result in a loss of £0.3 billion in equity (2015 - a £0.4 billion loss).

### Equity risk

Equity positions are carried at fair value on the balance sheet based on available market prices where possible. In the event that market prices are not available, fair value is based on appropriate valuation techniques or management estimates.

The table below shows the balance sheet carrying value of non-traded book equity positions.

	2016	2015
	£m	£m
Exchange-traded equity	33	25
Private equity	357	534
Other	146	136
	536	695

The exposures may take the form of (i) equity shares listed on a recognised exchange, (ii) private equity shares defined as unlisted equity shares with no observable market parameters or (iii) other unlisted equity shares.

	2016	2015
	£m	£m
Net realised gains arising from disposals	295	60
Unrealised gains included in Tier 1 or Tier 2 capital	53	301

Note:

- (1) Includes gains or losses on available-for-sale instruments only.



**Business review** Capital and risk management**Market risk** continued

## Structured credit portfolio

The structured credit portfolio is no longer material.

**Calculation of regulatory capital\***

RBS capitalises non-traded market risk as part of the Pillar 2A Internal Capital Adequacy Assessment Process (ICAAP). The approach combines both earnings based and economic value based methodologies, in accordance with regulatory guidelines. The calculation captures the principal sources of non-traded market risk – interest rate risk, credit spread risk, structural foreign exchange risk and accounting volatility risk.

Pillar 1 capital must be held for non-trading book foreign exchange exposures, as outlined under CRR Articles 455 and 92(3)c. Structural foreign exchange exposures are excluded from the calculations as outlined under CRR Article 352(2); such exposures are considered under Pillar 2A.

Non-traded equity risk is captured in credit risk RWAs.

The capital calculations under ICAAP are also used for economic capital purposes.

Linkage to balance sheet*								
The table below analyses RBS's balance sheet by trading and non-trading business.								
	2016			2015				
		Trading	Non-trading		Trading	Non-trading		
	Total	business	business	Total	business	business		
	£bn	(1)	(2)	£bn	(1)	(2)		
		£bn	£bn		£bn	£bn	£bn	Primary risk factor
<b>Assets</b>								
Cash and balances at central banks	74.3	0.1	74.2	79.9	—	79.9		Interest rate
	17.3	6.9	10.4	19.0	11.2	7.8		Interest rate



Net loans and advances to banks								
Net loans and advances to customers	323.0	18.1	304.9	308.0	17.4	290.6	Interest rate	
Reverse repos	41.8	37.7	4.1	39.9	38.6	1.3	Interest rate	
Debt securities	72.5	24.5	48.0	82.5	35.9	46.6	Interest rate, credit spreads	
Equity shares	0.7	0.2	0.5	1.4	0.7	0.7	Equities	
Derivatives	247.2	244.2	3.0	262.5	260.0	2.5	Interest rate, credit spreads	
Settlement balances	5.5	5.4	0.1	4.1	3.9	0.2	Settlement risk	
Other assets	16.4	—	16.4	18.1	—	18.1		
<b>Total assets</b>	<b>798.7</b>	<b>337.1</b>	<b>461.6</b>	<b>815.4</b>	<b>367.7</b>	<b>447.7</b>		
<b>Liabilities</b>								
Deposits by banks	33.3	20.7	12.6	28.1	20.0	8.1	Interest rate	
Customer deposits	353.9	13.2	340.7	346.0	11.4	334.6	Interest rate	
Repos	32.3	27.3	5.0	37.4	35.2	2.2	Interest rate	
Debt securities in issue	27.3	4.4	22.9	31.1	7.1	24.0	Interest rate	
Settlement balances	3.6	3.5	0.1	3.4	3.3	0.1	Settlement risk	
Short positions	22.1	22.1	—	20.8	20.8	—	Interest rate, credit spreads	
Derivatives	236.5	234.6	1.9	254.7	252.4	2.3	Interest rate, credit spreads	
Subordinated liabilities	19.4	—	19.4	19.8	—	19.8	Interest rate	
Other liabilities	20.9	—	20.9	20.0	—	20.0		
<b>Total liabilities</b>	<b>749.3</b>	<b>325.8</b>	<b>423.5</b>	<b>761.3</b>	<b>350.2</b>	<b>411.1</b>		

## Notes:

(1) Trading businesses are entities that primarily have exposures that are classified as trading book under regulatory rules. For these exposures, the main methods used by RBS to measure market risk are detailed under traded market risk measurement on page 354.

(2) Non-trading businesses are entities that primarily have exposures that are not classified as trading book. For these exposures, with the exception of pension-related activities, the main measurement methods are sensitivity analysis of net interest income, internal non-traded VaR and fair value calculations. For more information refer to pages 366 to 373.

(3) Foreign exchange risk affects all non-sterling denominated exposures on the balance sheet across trading and non-trading businesses, and therefore has not been listed in the above tables.

\*unaudited

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## Report of Independent Registered Public Accounting Firm

### Members of The Royal Bank of Scotland Group plc

We have audited the accompanying consolidated balance sheet of The Royal Bank of Scotland Group plc and subsidiaries (together, the "Group") as at 31 December 2016, and the related consolidated statements of income, comprehensive income, changes in equity and cash flows for the year then ended, and the notes 1 to 42 and the information identified as 'audited' in the Capital and risk management section of the Business review ("financial statements"). These financial statements are the responsibility of the Group's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Group as at 31 December 2016, and the consolidated results of its operations and cash flows for the year then ended, in conformity with International Financial Reporting Standards ("IFRS") as adopted for use in the European Union and IFRS as issued by the International Accounting Standards Board.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Group's internal control over financial reporting as of 31 December 2016, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework) and our report dated 23 February 2017 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP  
London, United Kingdom  
23 February 2017



**Report of Independent Registered Public Accounting Firm to the members of The Royal Bank of Scotland Group plc**

We have audited the accompanying consolidated balance sheet of The Royal Bank of Scotland Group plc and its subsidiaries (together "the Group") as at 31 December 2015 and the related consolidated income statements, consolidated statements of comprehensive income, consolidated statements of changes in equity and consolidated cash flow statements for the years ended 31 December 2015 and 2014, the accounting policies and the notes 1 to 42 and the information identified as 'audited' in the Capital and risk management section of the Business review ("consolidated financial statements"). These consolidated financial statements are the responsibility of the Group's management. Our responsibility is to express an opinion on the consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such 2015 and 2014 consolidated financial statements present fairly, in all material respects, the financial position of The Royal Bank of Scotland Group plc and its subsidiaries as at 31 December 2015 and the results of their operations and their cash flows for the years ended 31 December 2015 and 2014, in conformity with International Financial Reporting Standards ("IFRS") as adopted for use in the European Union and IFRS as issued by the International Accounting Standards Board.

Note 42 to the consolidated financial statements was added for the inclusion of consolidating financial information in respect of The Royal Bank of Scotland plc in accordance with Regulation S-X Rule 3-10.

/s/ Deloitte LLP

London, United Kingdom

25 February 2016 (24 March 2016 for the consolidating financial information in Note 42)

Presentation of information





## Consolidated income statement for the year ended 31 December 2016

	Note	2016 £m	2015 £m	2014 £m
Interest receivable		11,258	11,925	13,079
Interest payable		(2,550)	(3,158)	(3,821)
<b>Net interest income</b>	<b>1</b>	<b>8,708</b>	<b>8,767</b>	<b>9,258</b>
Fees and commissions receivable		3,340	3,742	4,414
Fees and commissions payable		(805)	(809)	(875)
Income from trading activities		974	1,060	1,285
(Loss)/gain on redemption of own debt		(126)	(263)	20
Other operating income		499	426	1,048
<b>Non-interest income</b>	<b>2</b>	<b>3,882</b>	<b>4,156</b>	<b>5,892</b>
<b>Total income</b>		<b>12,590</b>	<b>12,923</b>	<b>15,150</b>
Staff costs		(5,124)	(5,726)	(5,757)
Premises and equipment		(1,388)	(1,827)	(2,081)
Other administrative expenses		(8,745)	(6,288)	(4,568)
Depreciation and amortisation		(778)	(1,180)	(930)
Write down of goodwill and other intangible assets		(159)	(1,332)	(523)
<b>Operating expenses</b>	<b>3</b>	<b>(16,194)</b>	<b>(16,353)</b>	<b>(13,859)</b>
<b>(Loss)/profit before impairment (losses)/releases</b>		<b>(3,604)</b>	<b>(3,430)</b>	<b>1,291</b>
Impairment (losses)/releases	<b>11</b>	(478)	727	1,352
<b>Operating (loss)/profit before tax</b>		<b>(4,082)</b>	<b>(2,703)</b>	<b>2,643</b>
Tax charge	<b>6</b>	(1,166)	(23)	(1,909)
<b>(Loss)/profit from continuing operations</b>		<b>(5,248)</b>	<b>(2,726)</b>	<b>734</b>
Profit/(loss) from discontinued operations, net of tax	<b>18</b>	—	1,541	(3,445)
<b>Loss for the year</b>		<b>(5,248)</b>	<b>(1,185)</b>	<b>(2,711)</b>
<b>Attributable to:</b>				
Non-controlling interests		10	409	60
Preference shareholders		260	297	330
Paid-in equity holders		244	88	49
Dividend access share	<b>7</b>	1,193	—	320
Ordinary shareholders		(6,955)	(1,979)	(3,470)
		(5,248)	(1,185)	(2,711)
<b>Per ordinary share</b>				
Basic and diluted (loss)/earnings from continuing operations	<b>7</b>	(59.5p)	(27.7p)	0.5p
Basic and diluted loss from continuing and discontinued operations	<b>7</b>	(59.5p)	(17.2p)	(30.6p)

The accompanying notes on pages 402 to 483, the accounting policies on pages 385 to 401 and the audited sections of the Business review: Capital and risk management on pages 218 to 374 form an integral part of these financial statements.

**Consolidated statement of comprehensive income for the year ended 31 December 2016**

	2016	2015	2014
	£m	£m	£m
Loss for the year	(5,248)	(1,185)	(2,711)
<b>Items that do not qualify for reclassification</b>			
Loss on remeasurement of retirement benefit schemes	(1,049)	(73)	(1,857)
Tax	288	306	314
	(761)	233	(1,543)
<b>Items that do qualify for reclassification</b>			
Available-for-sale financial assets	(94)	44	807
Cash flow hedges	765	(700)	1,413
Currency translation	1,263	(1,181)	307
Tax	(106)	108	(455)
	1,828	(1,729)	2,072
<b>Other comprehensive income/(loss) after tax</b>	1,067	(1,496)	529
<b>Total comprehensive loss for the year</b>	<b>(4,181)</b>	<b>(2,681)</b>	<b>(2,182)</b>
<b>Attributable to:</b>			
Non-controlling interests	121	370	246
Preference shareholders	260	297	330
Paid-in equity holders	244	88	49
Dividend access share	1,193	—	320
Ordinary shareholders	(5,999)	(3,436)	(3,127)
	(4,181)	(2,681)	(2,182)

The accompanying notes on pages 402 to 483, the accounting policies on pages 385 to 401 and the audited sections of the Business review: Capital and risk management on pages 218 to 374 form an integral part of these financial statements.

## Consolidated balance sheet as at 31 December 2016

	Note	2016 £m	2015 £m
<b>Assets</b>			
Cash and balances at central banks	8	74,250	79,404
Loans and advances to banks	8	30,138	30,646
Loans and advances to customers	8	351,950	333,892
Debt securities subject to repurchase agreements	29	18,107	20,224
Other debt securities		54,415	61,873
Debt securities	13	72,522	82,097
Equity shares	14	703	1,361
Settlement balances		5,526	4,116
Derivatives	12	246,981	262,514
Intangible assets	15	6,480	6,537
Property, plant and equipment	16	4,590	4,482
Deferred tax	22	1,803	2,631
Prepayments, accrued income and other assets	17	3,700	4,242
Assets of disposal groups	18	13	3,486
<b>Total assets</b>		<b>798,656</b>	<b>815,408</b>
<b>Liabilities</b>			
Deposits by banks	8	38,556	38,296
Customer accounts	8	380,968	370,298
Debt securities in issue	8	27,245	31,150
Settlement balances		3,645	3,390
Short positions	19	22,077	20,809
Derivatives	12	236,475	254,705
Provisions for liabilities and charges	20	12,836	7,366
Accruals and other liabilities	21	6,991	7,749
Retirement benefit liabilities	4	363	3,789
Deferred tax	22	662	882
Subordinated liabilities	23	19,419	19,847
Liabilities of disposal groups	18	15	2,980
<b>Total liabilities</b>		<b>749,252</b>	<b>761,261</b>
Non-controlling interests	24	795	716
Owners' equity	25, 26	48,609	53,431
<b>Total equity</b>		<b>49,404</b>	<b>54,147</b>
<b>Total liabilities and equity</b>		<b>798,656</b>	<b>815,408</b>

The accompanying notes on pages 402 to 483, the accounting policies on pages 385 to 401 and the audited sections of the Business review: Capital and risk management on pages 218 to 374 form an integral part of these financial statements.

The accounts were approved by the Board of directors on 23 February 2017 and signed on its behalf by:

Howard Davies  
Chairman

Ross McEwan  
Chief Executive

Ewen Stevenson  
Chief Financial Officer

The Royal Bank of Scotland Group plc  
Registered No. SC45551

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## Consolidated statement of changes in equity for the year ended 31 December 2016

	2016	2015	2014
	£m	£m	£m
<b>Called-up share capital</b>			
At 1 January	11,625	6,877	6,714
Ordinary shares issued	198	159	163
Conversion of B shares (1)	—	4,590	—
Preference shares redeemed (2)	—	(1)	—
At 31 December	11,823	11,625	6,877
<b>Paid-in equity</b>			
At 1 January	2,646	784	979
Redeemed/reclassified (3)	(110)	(150)	(195)
Additional Tier 1 capital notes issued (4)	2,046	2,012	—
At 31 December	4,582	2,646	784
<b>Share premium account</b>			
At 1 January	25,425	25,052	24,667
Ordinary shares issued	268	373	385
At 31 December	25,693	25,425	25,052
<b>Merger reserve</b>			
At 1 January	10,881	13,222	13,222
Transfer to retained earnings	—	(2,341)	—
At 31 December	10,881	10,881	13,222
<b>Available-for-sale reserve</b>			
At 1 January	307	299	(308)
Unrealised gains	282	31	980
Realised (gains)/losses	(376)	27	(333)
Tax	25	(16)	(67)
Recycled to profit or loss on disposal of businesses (5)	—	—	36
Recycled to profit or loss on ceding control of Citizens (6)	—	9	—
Transfer to retained earnings	—	(43)	(9)
At 31 December	238	307	299
<b>Cash flow hedging reserve</b>			
At 1 January	458	1,029	(84)
Amount recognised in equity	1,867	712	2,871
Amount transferred from equity to earnings	(1,102)	(1,354)	(1,458)
Tax	(193)	98	(334)
Recycled to profit or loss on ceding control of Citizens (7)	—	(36)	—

Transfer to retained earnings		9	34
At 31 December	1,030	458	1,029
<b>Foreign exchange reserve</b>			
At 1 January	1,674	3,483	3,691
Retranslation of net assets	1,470	(22)	113
Foreign currency (losses)/gains on hedges of net assets	(278)	(176)	108
Tax	62	(11)	(30)
Recycled to profit or loss on disposal of businesses (8)	(40)	4	
Recycled to profit or loss on ceding control of Citizens (8)		(962)	
Transfer to retained earnings		(642)	(399)
At 31 December	2,888	1,674	3,483
<b>Capital redemption reserve</b>			
At 1 January	4,542	9,131	9,131
Conversion of B shares (1)		(4,590)	
Preference shares redeemed (2)		1	
At 31 December	4,542	4,542	9,131
For notes to these tables see page 383.			

**Consolidated statement of changes in equity for the year ended 31 December 2016**

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