RBS

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Unidentified Participant: We are pleased this morning to welcome the Royal Bank of Scotland to present for us. From RBS, we have Bruce Van Saun, CFO, and also Richard O'Connor, Head of Investor Relations. Bruce joined RBS a year ago as CFO. Prior to that, held a number of senior positions, particularly at Bank of New York Mellon, and in particular, most recently vice chairman and CFO. As usual, we'll ask Bruce to present, after which we'll open the floor to Q&A. So with that, I'd like to hand it over to Bruce.

Bruce Van Saun: Okay, great. Little odd being from RBS and standing under a Barclays Capital banner behind a Barclays Capital podium. But we'll go with it. Good morning. It's a pleasure to be here with you today. I'd like to provide a progress report as we move forward with our efforts to rebuild and recover RBS.

First, let me flash our cautionary language, which you should read at your convenience.

The highlights of my message today focus around the following: We are meeting or exceeding all of our plan targets. We had an encouraging first half, led by a rebound in our net interest margin in our Retail and Commercial businesses. Our Investment Bank, GBM, is performing inline with markets and delivered a 24% ROE in the first half. We have made excellent progress with the Non-Core deleveraging and the EU mandated disposals. Our efforts to strengthen the balance sheet shows steady progress. And we have plans to address some of our lagging areas.

So let's move on, and we'll discuss how we're doing against our plan. To refresh some of you, as a Group, we have a diversified and balanced business portfolio. The backbone of our Group is in the UK with our Retail and Commercial franchise, where we have been in business for nearly 300 years. We also have a banking presence in the US, in Ireland, we have a top five global transaction services business and a strong wealth business under the Coutts brand. Together, our R & C businesses are about two-thirds of our Group revenues. The remaining third comes from our Investment Bank, a top-tier franchise in the markets where we compete.

Now, our goal is to regain a reputation as one of the world's most admired and stable universal banks. We not only want to recover at RBS, we want each of our franchises to go from good to great, to coin a phrase. We have clear financial targets focused around a 15% ROE and a AA credit rating. Our business mix should deliver a blend of profitability, stability and sustainable growth. And we will have a disciplined risk culture and a focus on our customers.

Key elements of our plan are the split of the Group into Core and Non-Core segments. Our core franchise is focused on value creation, and Non-Core is focused on risk reduction. We also have several initiatives around culture and risk which extend across the entire group.

Now, the plan spans five years from 2009 through 2013. So we're about one and a half years in. 2009 was a foundation year where we put the capital, the leadership and the risk management culture in place. 2010 has seen us focus on executing the plan and the significant change management that's required. And about three quarters of the way through the year, so far so good.

The report card that you see here shows good marks on our key balance sheet measures like the loan-to-deposit ratio, reduced wholesale funding and leverage and boosting our liquidity reserves. Our core ROE and cost to income are significantly better, although they're somewhat flattered by nonrecurring items.

Drilling a little further into the core first half results, our core operating profit was £4 billion, and our ROE was 11%, excluding the fair value gains on owned debt. This performance was led by momentum in our Retail and Commercial businesses where NIM has improved 23 basis points over a year ago, led by asset repricing. We have a strong cost program in place which is driving an improved cost-to-income ratio. Impairments are stable, and our loan to deposit ratio is 102%. The Group's funded balance sheet is down 2% to date led by a reduction in our non-core assets of £26 billion. We remain very well capitalized with the core tier 1 ratio of 10.5%.

Looking a little more closely at our net interest margin, we were up 11 basis points in the second quarter to 2.03%. That was led by an 8 basis points increase in Retail and Commercial. And we maintain a positive near-term outlook on our NIM, but we do expect that the improvement will moderate somewhat in the second half.

On the expense side, the lower sequential quarterly expenses largely reflect the lower revenues in GBM. I should point out that we are funding a significant change investment program through the benefits of our £2.5 billion cost reduction program. And this will drive lower expenses as the efficiency projects come online.

So I'm going to, on the next few slides, look into several of our businesses. And we have kind of four quadrants that you can follow along, the first one being the UK Corporate and Commercial business. But here we've seen a steady improvement in the net interest margin over the past six quarters. We've seen a very stable impairment trend. There's 8% growth in our corporate and commercial loans, while we've reduced our property loans by 10%. We also have improved the funding gap, given the strong growth in customer deposits. So in this business, we're really firing on all cylinders and looking very strong.

The next key business is our UK Retail. This has been another stellar performer. Our net interest margin has risen steadily, reflecting asset repricing. Our mortgage loans and our customer deposits have both grown nicely. We have positive operating leverage in the business, which is restoring the overall profitability of the business. And our customer account growth has been robust, i.e., we're gaining market share.

Now, the US business is a little behind the UK businesses, but it's also getting into the act with a similar storyline. So NIM has been improving nicely. Impairments are trending favorable. The deposit mix is shifting more to demand accounts. And we're ahead of our market share targets that are in the plan.

So moving on to GBM, our Investment Bank, this business is designed to deliver around £2 billion of quarterly revenue, subject, of course, to the normal seasonality and market volatility. The first half was well within peer group performance, and it was in line with our expectations. We've made wholesale changes to the business model with greater product and customer focus, less balance sheet and capital usage and much better risk management. So the proof is in the results. GBM has leading market share in many fixed income and currency areas which has helped drive stable and superior returns.

A very interesting part of the slide is over on the top right where you can see the dramatic change in the business from the old GBM to the new core GBM. There you see much less balance sheet usage, lower headcount and costs and a much better ROE. Granted, last year, there was exceptional market conditions. We had a great first half to last year, which flatters that number a bit. But still, as I said, in the first half of this year, we're still at a 24% ROE for the business.

If you put this in context, down at the bottom right, in terms of overall importance to the group, you see that GBM represents about a third of our income and our risk weighted assets and about 18% of our people. So clearly an important activity. It's also tightly bound to our other businesses. And we achieve a meaningful amount of revenues from cross selling. But we think there's untapped potential to do even more there.

Next, moving on to Non-Core and our EU disposal plan, progress here has been excellent, which lowers the overall execution risk around RBS. Our Non-Core segment has seen an £84 billion or 33% reduction in assets over the past six quarters, through a combination of asset runoff, disposals and, of course, impairments. We target a £30 billion balance at the end of 2013, and we have a positive outlook for the rundown activity in the second half of 2010, given a nice pipeline that we have.

On the EU disposals, we've announced the branch and the Global Merchant Services sales agreements. We closed a partial sale of the RBS Sempra assets. And we have the balance of the Sempra assets in an advanced stage of negotiations. So stay tuned on that.

I'll offer some comments on insurance later, but Insurance disposal is likely to be a second half 2012 event.

Now, on the balance sheet, we continue to strengthen the group balance sheet through debt deleveraging. And all our key ratios remain strong. Our capital position remains very strong relative to our UK peers. And we did place in the top quartile under the recent CEBS stress test of the EU banks. I'd also add that we believe we're well positioned against both the substance and the pace of the Basel capital proposals.

Importantly, our deleveraging has driven significant improvement in our funding picture, with short-term wholesale funding down almost £150 billion or 40% from the worst point. We target bringing short-term funding in line with £150 billion liquidity portfolio by 2013. Now, our confidence in hitting these targets arises from the plan for continued Non-Core deleveraging which permits us to reduce the short-term funding. We've also been able to take important strides in turning out the structure of our wholesale funding. And overall, I'd say we've made very good progress here, but there's still more to do.

One thing that has been pleasing, I think the stress test did unlock the market somewhat for issuance. It's also probably combined with the rate outlook. But the markets have been open. And we've been issuing quite a bit of paper in the past month or so. So we've tried to get ahead of the curve on debt issuance this year. We're now at £26 billion with recent transactions announced in the past couple of days against the full-year target of £25 billion. So another thing, if you look at the issuance profile, we actually have very good balance between doing public deals, private issues. We spread it around among currencies, around tenors, and we've also commenced issuance under a new covered bond program that went effective in April of this year.

One thing that comes up so many times in conversation is, what are we doing about what I would call our two lagging units, namely our Insurance business as well as our Irish business. And so I have a couple of slides on the action plan for those, starting off with Insurance. I guess the first thing to say is we're dealing with an industry-wide phenomena in the UK of higher bodily injury claims. And those affect the loss reserves on our prior year policies.

We have raised pricing. We've sharpened our underwriting, and we've improved our claims handling to combat this effect. And we're starting to see the early signs of a turnaround as the slide on the top right would indicate. We're also highly focused on lowering our expense base to regain cost leadership in the industry. So we are confident that the new management team has developed an appropriate turnaround plan. And we do expect to see better second half performance and a very solidly profitable 2011.

Now, the story for Ireland really boils down to the weak Irish economy as well as overexposure that we had to commercial property development lending. Now, strategically, you might have seen that we announced the development portfolio is moving to Non-Core, or we moved it to Non-Core on July 1st, so we will not be in that activity prospectively. We're going to run down that book. So therefore, if you look at the top right, the asset portfolio will tilt much more towards mortgages and corporate loans going forward. And we think that's a better focus for us prospectively.

We've done a very good job actually here in Ireland in managing our profit before impairment loss. We've aggressively reduced the expense base. We had two bank platforms there that we moved together, created a lot of efficiencies. We've also improved our NIM through asset repricing. We've also been able to grow our market share. And our loan-to-deposit ratio has improved dramatically. So there's some good things going on currently in the Irish business. They're really swamped by the picture on impairments.

We do like our position in the business longer term, but we expect to see the losses continue into 2011, given the state of the economy and the amount of overbuilding that took place.

Now, to sum up, I'd say, look, we've laid out our vision for 2013. And that's a beacon for all of our efforts. So a year and a half into this plan, we've had a new management team in place, a new board in place. And, you know, the strategy still works. We're still very committed to the strategy, and we're going through the implementation of that strategy, and it's delivering, I think, very good results. So you see good progress along the dimensions that we list here on the slide. And we believe that our capability to deliver this plan makes RBS an attractive investment opportunity.

So that's it for my prepared remarks. I'm happy to open it up for some questions.

Unidentified Participant: Okay. You probably know the drill by now. There will be a microphone. If anyone has questions, please put your hand up, and hopefully I will see you. Okay. There's one at the front here to get started.

Unidentified Participant: With the UK's announced austerity plans and the expectations for slower growth, particularly over the next year or two, and the fact that the plan was put together prior to these political changes in the UK, has that impacted your perspective on achieving the five-year goals? Or how has it impacted that, I guess I should say.

Bruce Van Saun: Yeah. Good question. I'd say actually if you looked at the initial assumptions in the plan, the environment has been better than what we had assumed, which is partially why our performance so far has been better. So I think the recession in the UK was a little less severe than originally we had assumed. The decline in housing prices was less. It was maybe 15% peak to trough, and we had assumed worse than that. So I think there's been some slightly favorable developments at this point. We had never assumed that there was going to be a very strong recovery. So whatever the blue chip consensus forecast was for the UK, our own internal forecasts were generally 50 basis points behind that in terms of GDP growth. So I think even with this austerity, it's going to track pretty well along to our original assumptions. So I do think a gradual recovery is probably a good thing for the UK because it means interest rates stay lower, and they move up gradually, which I think, given the amount of overleveraging that took place in the UK, both on personal and corporate balance sheets, having a chance to delever and adjust and service the debt is helped by being in that type of a rate environment.

So I think the question, as it relates to our plan, is if interest rates stay lower for longer, what does that mean to net interest income? Because as you can see from the presentation, we've had the NIM hit a low point of 172 in the second quarter of last year. It's up to 203, so up 30 basis points in the span of four quarters. That's really driven on the asset side where we've been able to reprice loans given the higher cost of funding and other things that are being passed on to customers.

At some point, you run through that, and your whole book has been repriced. And then what the assumption was, that there is a (inaudible) passing from kind of the asset side to the liability side. As rates start to go up, we can alleviate some of the compression that we've had on the deposit side. And so originally, I think we thought that would take place in mid-2011. And if that pushes out, and that doesn't happen until 2012, there could be a pause, I think, in the NIM progression.

But I still think there is good upside in the medium term on the NIM. We get probably a -- if you did a pro forma of ABN and RBS going back maybe five, seven years, with the -- kind of peak NIM was probably low 230s. And so we're still at 203. So the business mix has shifted a bit, but I still think there's a reasonable amount of running room on a NIM. But it is going to require that interest rates accelerate at some point.

Unidentified Participant: And one quick followup. You did mention that the capital was in line or exceeds the Basel proposal. But maybe a quick comment on the liquidity requirements that Basel came out of with net stable funding ratio in particular.

Bruce Van Saun: Yeah. I think all banks are a bit concerned about kind of the implementation of that test. So I do think the concepts behind it, liquidity coverage ratio and net stable funding ratio, are valid concepts to make the system safer. But the devil's in the details. So the assumptions around the kind of the withdrawals and then which collateral is liquid and can be used for funding purposes, that needs to be sorted out. So I think the regulators have bought some time to push that out to 2015 or 2018, to kind of get agreement on those details. And I think time is narrative because of the critical role the banks play in society, maturity transformation. And there could be a lot of second order consequences if that's done too abruptly or poorly conceived.

Having said that, in the UK, the UK has followed what they refer to as super equivalence. So any local regulator can do something more than what the global standard is. And so in the UK, we already have the -- we're subject to a net stable funding ratio target which kind of bumps up a bit each year, which we're comfortably inside ahead of that target level. But it will be something that we have to manage. And so some of what you see in terms of the amount of issuance that we have and the terming out of that wholesale funding is to make sure that we stay ahead of kind of where the bar is in the UK, which, at this point, is getting ahead of the rest of the global landscape.

Unidentified Participant: Just wanted to -- I'm just looking at slide 8, which is your strategic plan. You know, you'll be familiar with the slide. And so your return on equity that you did in the first half of the year -- sorry, in Q2 -- was 15% on the core. And your target is to exceed 15% by 2013. So I just wanted to know how you wanted us to think about the fact that whatever that is, six months, I guess, into the execution phase, your ROE is already kind of where you want it to be in three and a bit years' time. So does the target go up? Or are you kind of overearning a bit or --

Bruce Van Saun: Yeah. Well, I did say, in the remarks, that if you look through that 15% in the first half, and you adjust it for fair value of owned debt and some of the kind of funnies that net out slightly positive, the underlying was probably 11%. And so, you know we still have room to go. To get to 15%, it really assumes that the retail and commercial businesses get to a full earnings capacity. So you'd need to see higher NIM still from here. You'd need to see, I think, some of the operating improvements between how we cross sell. So fees would be stronger. Expenses would be more efficient. But probably the most important, you'd see impairments come back to more through the cycle levels than where they are today.

So assuming Retail and Commercial powers forward, which I think seeing the early signs of the investment program we have and seeing the economy strengthen and the businesses responding and our ability to reprice on the asset side, I'm feeling increasingly confident that we have the momentum in the retail and commercial side. That's the key driver. But you'd need GBM also to stay stable. Since in the plan year, in 2009, GBM had such a strong year, we don't actually need a lot of growth off of that year. We just need them to be stable and to continue to perform well and, you know, maintain their market share in the areas that we're competing. Those, I think would be the keys. And I think at this point, we feel pretty good about that. But it is going to take, you know, I think a couple years from here before we are really earning that 15%.

Unidentified Participant: So in the past, in the recent past, I know that you've sort of told the market and investors that, in terms of what you were going to do with the tier 1 securities and the capital structure, that it really made sense to wait until there is more clarity around the new capital rules. Now we have that clarity, you know, what are you guys thinking about in terms of tendering, calling those securities at the first call date, you know, the sort of potential coupon switch back on for a lot of those securities in 2012? Maybe just some guidance as to what your current thoughts are around some of those issues.

Bruce Van Saun: Yeah. And I'd say we're not at the point of full clarity. I'd describe it as the situation is clarifying. So there's now general agreement on how the framework operates. That needs to be ratified, of course, at the G-20 meeting in November. But it is starting to shed light on where we're going. You know, we do have the stop on the coupons that extends into 2012. So there's not a lot that I think we would be doing in front of that. And, you know, there's grandfathering of the tier 1 and tier 2 securities. So that will have kind of some value as you plan at capital structure longer term.

So I guess you'd probably want a more concrete answer. I'd say at this point, it's interesting, and it's stuff that we can start to build into our models and do some kind of scenario analysis and talk to the regulators about kind of what their thoughts are. But it's probably premature to give you a hard answer on that.

Unidentified Participant: Just a quick followup too. It seems, based on sort of the price action that we've seen in the market since the release came out on Sunday night, that the market is reading the language in this release to sort of mean that there is a very significant incentive, both from a capital standpoint and also potentially from sort of a, you know, regulatory relation standpoint, if you will, to call at the first call date. Is that sort of, you know, the view that you get and just based on conversations that you've had and also based on your reading of the release? Or do you think it's going to be sort of up to each individual bank based on where funding costs are at specific call dates and sort of that whole equation?

Bruce Van Saun: Yeah. I'd say the latter. I think it's, at this point, still individual bank by bank looking at, you know, how much they have and how much capital accretion they think they're going to have as time goes forward. So, you know, you could draw conclusions from what you see in the market. You could look at kind of the equity prices as well and say, gee, maybe the market thinks that certain banks won't have to raise capital and might be in a capital surplus and can put dividends in place and buy back stocks. And those stocks are creeping up. But I think all of that is just kind of educated guesswork at this point.

Unidentified Participant: Maybe just sticking with the educated guesswork, if you do meet all your targets, and you say you're comfortable with the Basel III, I guess, at the early look. You don't see any sort of big negatives there. I mean, is the situation where you might, at some point in the future, be sitting on a lot more capital you require. And I wonder what other options there might be. And are there any implications for the APS, an early exit from that, and it's all, you know, even a sort of potential buyback of the government's holding. I mean, are there any other options out there on the range of things that you guys are thinking about? Or is that just pushy thinking?

Bruce Van Saun: Again, I think we've said all along that the APS was necessary for the institution and the kind of lack of granularity in the credit portfolio and some of the composition of the credit portfolio, which, you know, we've paid for now to be in the APS £2.5 billion, whether we leave tomorrow or whether we leave at the end of 2012, it'll cost us, actually the way the fees work, £2.6 billion to stay in through the end of 2012. It costs us £2.1 billion to stay through the end of 2011. So I think pretty consistently we've said if the world seems a better place, and we likely exit, you know, sometime after 2011 and possibly by the end of 2012. So I'd say that's one of the first things that we'd like to consider, is exiting the APS. Beyond that, you know, the EU stop has limitations on what we can do for the capital account for pretty much through most of 2012. So our ability to reinstitute the dividend or tender for certain securities is impacted by the EU stop.

But, you know, I do think if we hit this plan, and now the Basel proposals are phased in where they're phased in, there's certainly a scenario where we will have the capital to do shareholder friendly capital management actions, which we'd have to think about repurchasing stock, potentially the B shares, and/or putting the dividend back in place. So there's complications around that, as you know, with respect to the B share special dividend, right? And that could affect our thinking between whether buyback is more advantageous or whether putting the dividends straightaway is more advantageous. But, you know, I think we have time to sort those things out. And obviously, we'll be talking to the regulator. And you can rest assured that we will take actions that are shareholder friendly. We're incented to do that.

Unidentified Participant: And just, we've heard from a couple of your competitors who are at lead regulated by the FSA. And there's a slight, I'd say, difference in view possibly about how the FSA may go about the super equivalence, whether the FSA will continue to take a harsher view on most issues or whether, with Basel III, the FSA might move back more in line with other regulators. Have you got any thoughts you can share with us on that?

Bruce Van Saun: Look, I think given what happened in the UK and the kind of overleverage in the economy and the fragility of its banking system through the last turn, I think it's entirely understandable why the FSA is going about this in a serious way and trying to keep the bar reasonably high. I do think, when you go into a room among your colleagues, you're going to have people who are higher and then people that are talking their own book who wanted to be weaker and spread out over a longer period of time. But I think when it all comes together, there's certainly, I think, a self-interest in the part of the UK not to have too much distance between where they are and where the rest of the playing field is, because I think ultimately that would, you know, weaken the UK banking system, put the UK banks at a competitive disadvantage and potentially, therefore, also negatively impact the UK economy. So I think they're smart people. I think they understand that. But I do think, as the details are negotiated, I think the UK is going to be one of the probably more conservative and aggressive regulators in terms of trying to keep the bar high.

Unidentified Participant: Okay. If there's no more questions, I might suggest we move to the breakout room in Liberty 3 because we can get back on schedule, we have slipped a little bit. So I thank you very much to Bruce for being here today and to Richard. And as I say, Liberty 3 for anyone who wants to pursue further questions with the management team. Thank you.