RBS

COMPETING IN THE AGE OF AUSTERITY

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Thank you for coming here this morning and listening to us I’m told that normally you’d have someone upbeat like Bob Diamond starting the day, I know he's starting tomorrow’s but I've been instructed that I can’t at least start on my normal gloomy note so that means I'm going to have to go off script and before starting any of my slides say to you that despite the remaining shadows that are wandering round the world both in economic terms and in terms of the final bits of the pass of regulation and political involvement it remains my opinion that the outlook for financial services, at least over the medium term, is positive, is strong, the world needs us, the banks are going to be able to adjust their business models to new realities, produce better than their cost of capital and be worth investing in. So that's about as good as my talk is going to get today and let me now move on to explain to you why I think those comments pertain also and in particular to RBS.

Now as many of you know RBS is in the train of radical restructuring, reflecting both the issues that caused near collapse two years ago and retooling in any event for those elements of the future that will be different than the past and the presentation here focuses on this path that we are now well along to successfully delivering our business plan and to ensure that the resultant restructured core RBS does and can compete well and successfully in what the conference title describes as an age of austerity, I don’t take it quite as gloomily as that but in any event. And starting at the very basics we do have a very clear strategic framework we are operating to, by the way part of that clarity means we’re unafraid to change it if the fact pattern emerges that we either have to or should change it but nevertheless we’re very clear how we’re competing, what shape of bank we are, why that should be attractive and how to operate our businesses within it, both in terms of the markets we’re aiming at, the market positions we’re aiming at, the financial characteristics that we expect to have and the balance among our different businesses in addition to the key aspects of management style. And the way that we get through to this position in the restructuring phase continues to be, I think, well tried and tested for big bank restructurings and that is to say that we have, I won’t describe it as business as usual, but our core bank, the ongoing bank is operating in each of its franchises as usual, every one of those businesses has degrees of heavy restructuring going on to fit them even better for the future to compete even better in a world where less leverage and more margin is required and at the same time we have important specialist teams of people who are working on stripping away and removing those elements of the past that financially weakened us in the non-core activity. Of course the non-core activity effectively has a P/E of one that disappears and the core bank we hope increasingly will demonstrate a scale and sustainability of cash flow that will be attractive on a multiplier basis, although of course neither RBS nor any other banks are yet being valued like that and inevitably across the whole bank are a series of cross cutting initiatives which are listed here. And in terms of timeline we set out a five year plan two years ago, or nearly two years ago which we believed would get us to the point where we recognisably looked like our strategy where we were accomplishing all the key financial parameters we’d set out. We are on plan, we're either on plan or ahead of plan across all of the key matrices that we set out but we're also in the deep execution phase of the plan and like all of these things in a sense the first half of what you do is really where you're digging the trenches and putting down the foundations and beginning to build the walls and then it's in the outer years that you can really piece by piece say, "Yes this was accomplished, that was accomplished, the other is accomplished," but because of the nature of that journey we are, I think the most transparent bank in the universe you'll look at, both in terms of frequency and quantum of reporting so that people don't have to take on trust what we're doing but can measure us and look at it any which way you would like to look at.

Here are the high level targets we put out nearly two years ago, a year and a half ago, where we hit at our worst point, where we are now, where we're targeting for 2013. Inevitably these involved some guesswork both in terms of what we could accomplish and in terms of the constraints of the environment in which we would be operating for something that was guessed at nearly two years ago. I still nevertheless feel pretty good about the broad shape of the targets we've got and still believe that for now they represent a good a shot as any of the rough dimensions that we need to have and note are crucial to this suite of targets and indeed the ones that lie beneath it for our businesses is balancing outputs with inputs both in terms of profitability i.e. we have inputs of capital and cost, as well as making sure that the dimensions of the balance sheet and the way it's fund itself and the risk profile of the bank is indeed supportive of sustainable, high quality, future profitability and growth.

Now in terms of the economic backdrop that we are using to execute to our plans, to think through the targets that we've put up, frankly we don't normally consider ourselves on these issues definitively smarter than the rest of the world so we tend to use economic consensus as our base case and then obviously do war gaming around what would we have done differently or what should we do differently should the outcomes vary from that and so I won't go over the tables on the right you know what the economic consensus is, obviously the most recent tweaking of that has really been markets' gloom on interest rates where I suspect where the yield curves are on interest rates out a few years is probably a little gloomier, i.e. a little lower than most business people think has got a good chance of happening but obviously that will unfold in front of us but nevertheless in keeping with the title of this conference it does seem reasonable to believe that banks like ourselves should be assuming that the next handful of years is not characterised by fast balance sheet growth but rather is characterised by modest interest rates, relatively slow balance sheet growth opportunities and therefore a real need to fall back on inherent quality of franchise on a restoration of margins in the face of the different capital structures that we've all had and on really anchoring the balance sheet and the funding structures and all of these fortunately are part and parcel and at the heart of the plan that RBS first announced nearly two years ago.

Now obviously a huge amount of conversation still ongoing on the regulatory subject and I'm sure that there'll be questions on this during the course of the next two days of all the different speakers, suffice to say as I canter through the big headlines, although there is plenty of work left to do and detail left to work through it feels to me that Basel 3, or put a different way the measures that are making banks safer and less likely to fall is landing in sensible territory, the extremes are being cut off, sensible territory both in terms of meeting political objectives and indeed I would say anyone associated with banks i.e. making banks way safer and more conservatively capitalised than before, objective number one I believe will be achieved but be doing it in a manner that allows the banking industry, and therefore the economies that the banking industry serves, time to adjust business models without cliff edge results whether those be ways of equity raising or other sorts of cliff edge results. So a rational outcome headed for both in terms of time to adjust and in terms of a more conservative destination.

Increasingly as that becomes baked in and obviously there's a way to go on it yet part two of the job will become front and centre and that is to say even if banks are made safer and less likely to fail you still have to have a series of better mechanisms for what happens when failure is upon you and that answer can't be a government writes a cheque and so the series of things where the volume is being turned up on now is an entirely sensible companion piece albeit much more complicated to conceptualise and execute and I've used here the heading 'Resolution Regimes' and under that of course all the different things that people talk about, living wills, too big to fail and so on. My own personal view, not institutional view but my own personal view is that a version of bail-ins is the only sensible response under this heading. There are, of course, many versions and I think that if and when they are introduced they will have to be done with enormous care and over very extended implementation periods so that the capital markets can price and deal with them without cliff edge results but personally I think that really is the only way that one will be able to answer what happens when a bank fails if you don't want governments to put in a cheque and how can you make it orderly and in a way markets can fairly price and deal with.

Now of course parochially in the UK we have a series of other takes going on in the form of the UK Banking Commission that last week published its first issues list looking both at competition in UK banking markets and size and shape of banks in the UK. This obviously is a process which conceptually is wide open in terms of the range of different answers that the Commission could come up with over the next year although obviously in many respects they will be treading ground that either has been trodden already in the UK on competition issues over the last ten years or is being trodden by regulators in other countries globally and so it seems to me that we can take some clues but no certainty, at least some clues from the pattern of debate around the world that we see on these kind of issues anyway.

And then finally it seems to me pretty legitimate that at least for now when you just have to look at underlying bank financial strength ratings and their actual ratings it's undeniable that there remains a level of sovereign halo applicable to banks and so that there should be a bit of extra taxation seems to me pretty hard to resist and that's working its way through, hopefully the right answer there in the medium term is not to need sovereign halos and therefore not to need higher taxes.

Moving then on to the main subject of what I wanted to say, namely looking at RBS and in particular focusing on the bit of RBS that will drive value in the future, our core businesses and we believe that our core businesses, taken together, represent a strong and balanced group where we have excellent…each one of the businesses, there are abiding disciplines, each business either must be today or be capable of being made into something you'd really want in its own right. All of our businesses must be then linked by synergies and then they must make sense in a portfolio position and of course our views on this could change but we believe it does indeed make sense and you can see whether you're looking at geographic balance, whether you're looking at the sort of balance between more stable retail and commercial businesses and the investment banking businesses, whether you're looking at businesses that are rich in deposits or rich businesses that are credit intensive, high ROE, lower ROE, we believe that this is a credible and competitively strong portfolio of businesses that individually are or can be credible and competitively strong. And I'll just wander through three or four of the sub-businesses within that giving you some sense but the flavour would be the same with any one of our divisions that I've picked of how we are adjusting our core businesses and our business models to be successful and compete in this environment where balance sheet and funding issues are more important than before, where margin is critical, given that there isn't a huge amount of balance sheet growth being found, where there are some sins of the past that need to be got through, where cost re-engineering is important in order to support the margin story but where, as is not novel as is true of all businesses all of the time, the starting point is do you inherently have a strong franchise and can you maintain that in the form of your market shares and the way your customers think about you and in tougher times the marginal player gets hurt more and in the times that we're facing ahead again I believe it is a critical attribute of our businesses that they are indeed sustaining leadership positions with their customer bases.

So when we look at, for example, the UK corporate business we can see, and again each of these slides is roughly similar in its layout I won't try and go through the detail. In the top left quadrant that we continue to hold a strong position whether measured by satisfaction or indeed market share in the minds of our customers that's the bedrock from which all else can be built. On the right hand side you can see we continue to make perhaps surprising success but very good success in creating a business that is balance funded and as many of you know where we believe the gold standard for banks is in the one to one loan to deposit ratio and unlike many banks we have the natural deposit strength that will allow us to accomplish that and you can see how we're making great strides in that goal in this particular business. Bottom left goes back to my sins of the past bit, we did get vastly overexposed in real estate, we will do real estate in the future but we won't do it in a vastly overexposed way and you can see we're making steady progress at reducing that concentration whilst most importantly, even before we have any relief on the liability side which I hope we will have eventually, the margin strengthening coming mostly from the asset side is beginning to work through to the direction that we need to hit our ROE targets.

We can say all of the same things with respect to our retail business here in the UK. Again franchise strong, despite the battering that we got in the press among others, customer satisfaction levels good at least relative, some growth going on, balance funding becoming a reality for us we are able to grow our deposits as fast as we're growing our balance sheet. We are transforming and changing the business and the bottom left quadrant just picks one example obviously of increasing internet growth in terms of people's transaction, online banking, and that is leading to improvements in P & L, even ahead of some of the cyclical issues around liability margins and impairments that should allow that story to continue.

Similarly in our retail and commercial businesses in the United States where in the north east 12 states we have a top five position, number two in Massachusetts as an example. Again exactly the same four quadrant approach to what we're doing, can we anchor ourselves in customers' estimation, in our market shares? Yes we can. That franchise is stable and at the moment a net gainer in some of the key things we're trying to do with customers. We are trying to improve its economics in particular we have a very deposit-rich franchise, we're working quite hard on the mix of liabilities so that even in a low interest rate world we've been able to make some margin gains. It's already match funded so we don't have that issue and then clearly the important P & L momentum both through work on costs and margins showing a little bit through on the right hand side but of course, as with all of our businesses and as I will refer to later, some headwinds that we have to deal with.

And then finally in my list of examples, although we do of course have other strong divisions, but I just have to go light on time today, the one third or so of our group that is represented by investment banking where as we all know, at least in reported terms, that is a more volatile series. Our investment bank clearly started with significant challenges arising out of RBS near collapse it therefore probably had more restructuring than any of its peers and what I'm pleased to say is that coming out of that restructuring is a bank that a) is fundamentally changed in risk terms, despite all the choppy markets has traded through them well, has not had any days of trading risk where the risk concentrations in credit terms have been very substantially reduced and on the way to being eliminated, where the new management team is settling down and doing a good job and despite the history to date we've been tracking the industry in the kind of results that we've had whilst enjoying some aspects of our financials that put us at the more efficient ends in cost/income ratio for example but this will continue to be a volatile, hard to predict quarter by quarter income stream which is why its balance is important as part of the group but it's also important to note that at least in the case of our investment bank 100% customer-oriented business, no remaining prop desks on their own or private equity funds or anything like that, huge and significant synergies with all sorts of other bits of our group whether on a cost or the sharing of clients or even the moving of funding around and risk management and so on and so something that I believe it can be a net positive contributor to the group.

And bringing some of the essential targets together on this slide what we have put out for each of our divisions is a three-way triangulation of ambition. Of course we can make this more sophisticated but to try and keep it simple return on equity better than our cost of capital for every one of our businesses and the group as a whole, being able to do that from a gold standard one to one loan to deposit ratio and having cost/income ratios that trend towards the top end of efficiency in each of the segments which of course is different as each of these businesses compete in somewhat different segments and you can see, relative to our 2013 targets we've made credible progress I would say on every one of these three measures and that gives me confidence that although there are external changes still about, there is still capital structure to be finalised and so on, that we can produce a group that individually and in the aggregate meets these kind of financial disciplines. And of course at a group level those financial disciplines will add up to one to one loan to deposit ratio to leverage, we believe, under 20 times to less maturity transformation and much stronger liquidity reserves and longer term funding and the removal of excess risk concentrations and a few of those points are made here and we continue to make very good progress in that regard such that I won't talk about significantly later but the vexed subject of reliance on government funding programmes and so on we are absolutely clear we're happy for them to end as scheduled and we don't foresee difficulties in financing ourselves normally as they roll off.

So just trying to move from a divisional view into a line item view and again trying to think through in a, let's call it, a tougher world of not a world of austerity, in a world where we see economic recovery as being there but in a way where headwinds are still being experienced there are clearly on a line item basis, as well as on a business basis, some things we have to focus on, think about, make sure we make progress on and sometimes worry about and one of the most important of those subjects is net interest margin. We have been successful in beginning to rebuild that. We do believe that that process can continue throughout our businesses. There are different levers that we're pulling, however, we are working on the assumption that asset margins will have to stay at higher levels in history in order to make up for liability margins that do not get back to history through a combination a) of the path of interest rates but b) of the risk pricing and less maturity transformation the banks will be doing than in the past and certainly I would say to you that I think that if the current market forward curves are either right or interest rates are even worse than that in terms of staying low for longer, I think that that does cause a transitional issue for many banks including us because it does mean that some of the liability margin rebuilding that we'd have been expecting in let's say 2012 and outward will be delayed and that would either simply delay some element of the path of return to the margins we're needing or else require us to go back to the asset side of the equation which currently is stable in terms of new business margins and have another crack there. So I think that there is a timing issue. I think there isn't an endpoint issue because we do have the levers to pull. There is a timing issue if the world goes into Japanese-style interest rates for an extended period I think it's premature to make that judgement, I know what the levers would be I think there would be a timing issue associated with it.

In terms of revenue growth well obviously a small element of this can come I believe from balance sheet expansion but that's not going to be a key driver and so combination of a little bit of balance sheet expansion and margin rebuilding we talked about. And then non-interest income and again I don't think that there are any great dramas here, I don't think there are any wonderful goldmines to be discovered that no one has known about or thought about before but certainly what we have is because we have leading franchises in big customer-driven markets where the industry structure allows rational behaviour and where our businesses by and large have not been managed as well as they should have been in the past we do believe that there is sufficient opportunity through a whole series of what I'd call bog standard good management to improve our performance and make the necessary income gains to achieve the ROE goals that we have and again I'm not going to go through the stuff that's written on these slides you can do that yourselves in more detail later.

And similarly I have three slides here, I won't go through the detail but pointing out that it isn't just an income story there is in many senses a symbiotic relationship between the cost side and the income side absolutely throughout our business. We have a whole series of things we're doing to our cost base, a) cutting it, b) reinvesting in it and that reinvestment can be in pursuit both of lower risk, i.e. better systems, better information, less likely to make mistakes. It can be supporting lower costs because we have more straight through processing and in favour of revenue activities as we become more nimble, more able to segment our customer and more able to bring and change products to market quicker, more able to allow customers to bank with us online and globally and so on and so forth. So right throughout our business is actually arguably the biggest investment programme our business has ever had, paid for by the cost efficiencies we believe we can get out of the business and again some of this is detailed on these slides using different examples from our divisions which I will leave you to read afterwards but the net result of that, we believe and hope in our core businesses, obviously all the non-core has to be swept away and the divestments have to be swept away in our core businesses very roughly we think we can not only do these big investments but take out enough cost to keep costs roughly flat in nominal terms and down in real terms thereby leaving any revenue gains to give us operating leverage at the operating profit level.

And then the final bit before you get down to the bottom of the P & L obviously is impairments where the pass has already started of them coming down. Some bits will come down faster than others, depending on the nature of our business and of course will be sensitive to economic outlook but for now our expectation would be that as the world's economy is normalised that we will get back, perhaps not quite to where our average figures were over the last decade which are presented here, because they are slightly flattered by the fact that we were growing our balance sheet very fast so they're backward looking but nevertheless in that direction which again is supportive of the sorts of returns we need to support our higher equity base.

As I've repeatedly stressed throughout my remarks I don't think any bank can afford to run itself as single-mindedly on P & L or even ROE as before, there is a vital companion piece which is how do you fund yourself and what does your balance sheet look like and then what also what does your E look like against it and that will continue to be absolutely central in what we do permanently as well as in our turnaround phase.

I mentioned before I think that funding will be an absolutely crucial aspect for banks, a crucial strategic as well as tactical aspect going forward and we are blessed with strong natural deposit bases that allow us credibility in operating at a one to one loan to deposit ratio and again this slide works through the sorts of what I call funding gap that we have in each of our businesses, how we're closing it and the sorts of deposit power that we have from that.

In addition to that of course, unlike some banks, we still have a shrinking bit to us which is the non-core business and there is a clearly published schedule of how we're winding that down, through what mechanisms, we've done teach-ins on it, we may be a bit better or a bit worse than the schedule, hopefully a bit better but broadly this is our best guidance for now and in addition to eliminating excess risk concentrations and excess management stretch, this process also is the route to refinancing any remaining government programmes and to ensuring that our funding mix becomes stable and strong for the bank as a whole and is a key complement to that. It's going well and the accompanying EU disposals, the most distracting ones of which having been executed this summer, that whole process is going well of peeling back the bits of the onion that with RBS got rotten from the past.

And a word before leaving the subject of capital structure I do think that there is some risk that people become too obsessed with what the regulators do on individual ratios although we all can see through Basel 3 the direction we're going in this regard but I think that what everyone has to remind themselves is that ultimately it would be unusual for regulators to set where banks' capital structure lies, what regulators should be doing and normally do is set a minimum place where it lies and for any bank like us the key setter over the medium term of our financial picture as a whole of which an individual ratio is but one component is the market and we need to successfully compete against a certain number of the world's key largest banks that's different in each of our markets. We need to offer our counterparties, our depositors, our creditors, our customers, a credit standing that allows us to be competitively successful and them not to worry, well you can translate that perhaps into credit rating targets as we have in the double A category and we need to maintain overall a capital structure that hits those targets or gets us to the point where we hit those targets without sovereign halo and that will be, in my view, the key determinant of where we move the different buttons on the graphic equaliser of different ratios and profitability and franchise strength and balance sheet and so on in order to hit that creditworthiness with simply where the regulators are as representing the outer edges of an envelope that we can't go beyond but not the setters of that envelope. And so in that sense I do believe that banks like ours will in steady state be strongly cash-generative, pay good and strong dividends but I would not be in the category of people that are seeing some one-off golden pot from the banking industry as everyone releases capital down to the regulatory minima and says, "Wonderful let's now run as leveraged as the regulators will let us, even if that's less than before," I think that's unlike and it's certainly unlikely from an RBS standpoint.

So in conclusion clearly we, at RBS, are on a transition, we're on a transition to peel back a bunch of things that weakened us which, if you like, is a one-off adjuster to NAV, we're on a transition to prove that our ongoing businesses have the characteristics we believe they have in quality of earnings and in being able to remodel their economic characteristics to meet a more conservatively capitalised and reliant on stronger margin world and as quarter by quarter those two activities unfold we believe the investment case in RBS will become ever stronger and clearer with good potential from here and the characteristics that I would say to you RBS most definitively will have and I believe quarter by quarter are being proven and showing through are a business which starts with top tier market franchises, inherently high quality, stable, good businesses that you would want to have, balanced in a complementary way by geography, by growth, by risk profile, by business cycle and with synergies where the return characteristics should be attractive, the volatility should be much better then before its risk, built on strong foundations of conservatism and delivered in what we believe will be an open, transparent and investor-friendly manner. That's what we're up to, we believe we're on course to do it. There are of course banana skins out there, I'm sure we'll slip on some of them but hopefully we'll regain our footing when that happens. Thank you very much.

QUESTIONS & ANSWERS

Chairman

I think we're going to have time for maybe three questions or so, so if I could get the ball rolling and then we can open it up to the floor. So thank you very much Stephen I think you've given everybody a lot to think about there. It's quite interesting your comments about the Basel ratios and capital levels because clearly everybody in the room's thinking about what level banks are going to look to run at and your points on the market are clearly very valid I think. It looks like the average in the room thinks that an eight to 9% level is a more appropriate one. If we were to push the envelope and say that your target was more like a greater than 9% would you still feel comfortable that you could get to a 15% ROE in that regard?

Stephen Hester

Yes I mean first of all the point I made earlier on is that 1) what we're aiming for is a triangulation. All banks need to aim for a triangulation of several different measures that come together to give a certain creditworthiness and I think it's too easy to get over-fixated on one measure or another because these things often work together and your core tier one ratio is only one measure and also it's impacted by the nature of your assets and their particular RWA intensity but, for example, if you were a mortgage bank you might have a great core tier one ratio but in this day and age you won't be able to run the same leverage that you did before and therefore that might be the constraining issue. So I don't think we should get quite as hung up as people are on this issue but I am very clear that the financial services industry is mature, is capital intensive, is reasonably consolidated which process will if anything continue and therefore has the wherewithal to rationally adjust its business models to return more than the cost of capital whatever that business model has to adjust to.

Chairman

Thank you.

Question 2

I'm assuming you've had some discussions with your regulators on potential new risk weightings that are coming, I'm curious as to what the potential impact on your capital levels will be and does that still factor in your 8%, so the target ratio for your core tier one capital?

Stephen Hester

Well all we've put out there is greater than 8% and frankly your guess is as good as mine as to where…or in fact the audience's guess which I guess lay two, two and a half percentage point range above eight is as good as mine for now. These things will triangulate over the next couple of years and I think as the import of your question suggests there is still more work to do both in terms of what the regulatory target ratios are and in terms of the intensity of RWAs particularly on the market risk side where there's still important detail to go through which hasn't quite been landed and so I don't think it's possible to pinpoint this but more importantly than that goes back to a point I made in my presentation too many investors and analysts today are saying, "What will the regulators ask so that's the answer," I don't believe that's the answer. I think we need to be saying, "Where will creditors get themselves to and what will creditors need?" Proxy perhaps what will the rating agencies need? And the world doesn't know that today. People are still in a state of some confusion over what risk banks represent, what climate they will be operating in, things like bail ins become very important and that kind of legislation and so I do think that we have still an evolution over two or three years until there is a settled view for given banks of what picture you have to present to investors to have a given creditworthiness. So I really think that the tramlines of where you're likely to be have narrowed but they're not capable of pinpoint landing and won't be for two or three years.

Question 3

Maybe I can ask a question even though I'm not miked up while people think up questions, you talked about a low interest rate environment and specifically about levers you could pull if we in fact remain in a low interest rate environment, maybe you can elaborate a little bit more when you said it's not time yet to pull those levers but suggested they're there? Maybe you could elaborate a little bit more on what kind of levers you can pull if we remain in a low interest rate environment>

Stephen Hester

Well I suppose put simplistically the biggest of those levers has to be the asset side that if you were unable to rebuild your liability margins which is what banks do as interest rates normalise then the only place you get in an interest margin and you will need some more of that is from assets and personally I believe that there is enough discipline in the markets and there are enough constraints on funding in that scenario higher asset pricing or higher asset margins would be possible there would just be a time delay as it worked through. Now of course in addition to that you have to work at every other line you can. You're going to have to nibble at everything so you're going to have to go back at costs, you're going to have to go back at items of non-interest income and see whether there are sources of fee income that can compensate but it gets to the same place you're still taking it from your customer base but fundamentally the one thing that we know about financial services is it's capital intensive and will be more so than for a long time and we simply won't be able to deploy capital if we can't earn adequate returns and the world needs banks to deploy capital and so I take great encouragement, I suspect as you go across the major banks in this conference for the next two days they all have similar investor bases even if we cast aside those of us who've got some state shareholding to sell down, they have similar ROE goals and they're going to behave, I think, in similar ways in terms of discipline that in order to deploy the extra capital the world wants us to and we want to, we have to improve the business model returns and all of us have that requirement and I think there is a market structure that will allow it albeit perhaps with a number of years of adjustment required and depending on the level of adjustment that is being asked for.

Chairman

Any more questions? Okay, great. Well join me in thanking Mr Stephen Hester. Thank you.