UBS Global Financial Services Conference 2011

RBS CONFERENCE PRESENTATION

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Presenter

- **Bruce Van Saun (RBS Group Finance Director)**

JP Crutchley: Okay. In the interest of time, we'll move along. The next session is Royal Bank of Scotland, RBS, in this room. Great pleasure to introduce Bruce van Saun, Group Finance Director of RBS. Bruce joined RBS in late 2009 and has therefore been very instrumental in the heavy lifting associated with bringing the bank back from its brink towards normality, and that's been a very, very consistent trend over the last few sets of quarterly numbers. Before working at RBS, Bruce was on this side of the pond as it were, as CFO of Bank of New York Mellon, and so he's obviously very up-to-date on the status of the US Finance industry as well from that perspective.

To hear about RBS, I'd like to hand it over to Bruce. Thank you.

Bruce van Saun: Thanks JP, and good morning, everyone. It's a pleasure to be here with you today.

I'll flash our cautionary language, which you can read at your convenience, and then let's go over the agenda briefly. I'd like to first start off and talk about our vision for RBS, give you a little progress report on our businesses and how they're performing. I'll then turn the focus towards our Core divisions, set out the drivers that really create the future value for our bank. I'll then review our progress towards our 2013 performance targets, and then I'll wrap up with a few comments about the outlook for the group.

So, 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 RBS, but we want each of our franchises to go from good to great, to coin a phrase.

We have clear financial targets focused around delivering a 15% ROE and a AA category credit rating.

Our targeted business mix should deliver an attractive blend of profitability, stability and sustainable growth. We'll have a disciplined risk culture and a focus on our customers.

The Core bank has four strong business principles. Each one of our businesses must be attractive in its own right. This means having attractive customer franchises, attractive financial metrics including the ability to deliver that 15% ROE, driven by appropriate risk-taking as well as organic growth capacity.

The divisions need to each have strong linkages among each other, such as shared infrastructure, expertise and customers. They need to fit the group's overall profile and provide a series of complementary strengths along the dimensions of geography, our funding requirement, growth, and sustainability.

Finally, there are no sacred cows in the Core. Each business must be individually valuable, and also then again more valuable as part of the overall group.

Our business mix is based on a sustainable model of two-thirds retail and commercial banking, and one-third investment banking. We also want to be balanced from a geographical standpoint. Today we have 55% of our revenues coming from the UK, 25% from the US, 12% from the EU and 10% rest-of-world. Within retail and commercial, 30% of revenues are international.

We believe that this mix and balance should provide support for the group's profitability and its performance through various business cycles, either domestic or global.

So, how do we stack up globally? RBS remains one of the world's largest global banks, measured by market capitalisation, with an attractive reach and balance relative to its peer group. Our metrics have continued to strengthen over the last two years, and to the point where we're now firmly in the pack, whether you compare us on Core profitability, our business mix, our geographical spread, or our capital strength.

Now of course, the state of our home market is important to our fortunes. We've set out some key measures here for the UK economy on this slide. Overall, we expect a continuation of the rebalancing that we've seen of the UK economy with rates gradually rising to 2013. GDP growth returning to trend, and unemployment tracking lower. Households and businesses are slowly emerging from the crisis, providing an improving environment for our UK retail and commercial businesses.

So, let's move on and we'll analyse our business progress. As I'm sure you're all aware, we just announced our Q1 results last Friday and the headline is that steady progress continues. Our Core operating profit was £2.1 billion, which is up £400 million versus the prior quarter, and we delivered an ROE of 15%.

This performance was led by seasonally-strong performance in GBM, our investment bank, continued momentum in our retail and commercial businesses, and a return to profitability in our insurance business. Impairments fell again as a general improvement continued across all businesses, save Ulster.

Core's loan to deposit ratio is now 96%, better than the quote-unquote "gold standard" of 100% that we've set for ourselves. Down on the bottom, you can see that the group's funded balance sheet is down 6% on last year, led by a reduction in Non-Core assets which have decreased over 50% since inception.

Our capital position improved in the quarter, with our Core Tier 1 ratio increasing 50 basis points to 11.2%. We remain well-capitalised, and I think we're in good position to meet regulatory capital changes and eventual APS exit.

Underpinning our plan was the split of the group into Core and Non-Core segments. For the Core franchise, we remain focused on sustainable value creation, while Non-Core drives risk reduction. We've reported regularly on a consistent progress that we've made across each dimension. That said, we were clear from the start that this is a marathon, not a sprint, and it will take all of the five years to get RBS where we need to take it. The good news, though, is that so far in the third year of execution, we're where we expected to be.

Our core businesses are built on strong customer franchises. Each of our market positions are stable to improving and we're seeing positive trends emerging from customer satisfaction metrics. The strength of our customer franchises can also be measured in terms of deposit growth, and we have strong growth which is currently evident across our UK franchises -- Wealth, GTS, and the US R&C. GBM's careful client targeting is also paying dividends as we maintain top-tier market positions and client relationships.

In insurance, we've become more selective in our customer targeting. We've driven off some unprofitable business while improving our returns.

After a challenging period, the group's brands are starting to see improved perceptions based on trust, reputation and likelihood to recommend. Our upward trajectory in the eyes of our customers underlines the work that we've been doing to put the issues of the crisis behind us. This is also true with staff sentiment. We've seen engagement and morale returning to pre-crisis levels and improving pride in working for RBS.

A key result of these improvements is that our ability to retain and recruit talent to the bank is strengthening.

Our focus on risk reduction remains undiminished with Non-Core the fundamental driver. Progress in reducing funded assets has been excellent. We've seen a £133 billion, or over 50%, reduction in assets in the last two years through a combination of asset run-off , disposals, and my least favourite, impairments. This progress has been nicely spread across all of our asset categories.

The pipeline for disposals remains healthy. We currently have £7 billion of disposals that have been signed, but are not yet complete, and a big pipeline behind that. Key group risk metrics such as our single-name, or so-called tall tree, exposures have also been materially reduced. Our exposure in excess of risk appetite to financial institutions has decreased by over a third, while the exposure to tall corporate has almost halved since the beginning of the plan.

Turning to our funding position, 2010 saw a fundamental shift in our profile. Our loan-to-deposit ratio has undergone a clear improvement from its worst point in 2008. The Non-Core de-levering combined with the strength of our deposit-gathering franchises has been powerful. Deposits were up £14 billion in 2010 alone. The group LDR was 115% at the end of Q1, while the Core LDR is at 96%. On this metric, we now compare favorably with our UK, EU and US peers.

In '08, the group's liquidity reserve was one quarter of the bank's funding requirement. Not terrific. You can see that over there on the right. Since then, we've undertaken a transformational change to our profile, reducing our funding requirement by over 50% and building up our liquidity pool and increasing its quality. Our funding and liquidity pools are now broadly-matched at £150 billion, or 14% of funded assets. We now compare favorably across our peer group on this metric as well.

So, we're ahead of our strategic plan on each of these measures, but we're not complacent. There's still work to do for sure.

Looking at the funding profile, we've made significant progress in terming out our wholesale funding. Underlying this is a successful issuance program in 2010 and a significant reduction in wholesale deposits from banks. We remain confident of achieving our 2013 short-term wholesale funding target of less than £150 billion in line with our liquidity reserves.

Now, let's turn to the drivers of the future value of the Core bank, and I'm going to start off with one of our stars, UK Retail, and we do have several businesses now which I think have very good momentum in benchmarking themselves to world-class standards, UK Retail being the most prominent. They have an excellent customer franchise, and I'd also say there's still excellent opportunities for further growth.

In the first quarter of 2011, UK Retail was above its 2013 ROE and cost to income targets, as asset repricing, volume growth and cost discipline has fed through to the bottom line. The franchise's strength is well-reflected by its mortgage performance, where we were number one net mortgage lender in the UK in 2010, and by its deposit performance where we had a £10 billion gain over the past three years.

We're in the midst of an £800 million investment program over five years, designed to take us up to that world class level of performance. The program will focus on improving customer service and our product offering while also making us more efficient.

UK Corporate is another very strong business. We have market-leading position in the UK and a strong ROE progression which hit 16% at the end of Q1. The franchise has really undergone a rebalancing in the last two years. Our property loans have declined and our commercial loans have grown. The net effect has been a 12% fall in risk-weighted assets. The balance sheet has been further strengthened by a £13 billion increase in deposits as well as a 33% reduction in our concentrated exposures.

As with UK Retail, we're making investments here as well. £300 million investment program, which is designed to drive improvement across client delivery data and risk platforms. The business is operating in a challenging environment today with relatively sluggish growth, but it has good opportunities ultimately for growth as the economy strengthens given high levels of customer satisfaction as well as a very strong market share position, particularly with SME's, the small and middle size of the market.

We have two combined on this slide, Wealth and GTS, which represent capital-light, high-return businesses where we see good upside potential. Looking first at Wealth, the Coutts brand remains valuable. It is well-recognised in the market. We've put a new management team in place. They've begun to sharpen the focus of the business. They're trying to balance off the footprint between mature and growth geographies. This new strategy is underpinned by a new IT platform, which is being rolled out over the course of this year.

Key recent highlights in the business, include a solid increase in loans and deposits, and in client assets managed.

GTS is also under new leadership. They continue to focus on improving the cross-sell to our other business customers, and also cost-effectively delivering value-added technology to our clients. The Q1 results were negatively impacted by the sale of the GMS business and a one-off impairment, however, we're optimistic for stronger results here as the year progresses.

GBM, our investment bank, had a resilient year in 2010 in the face of a challenging external environment. We had revenues close to the £8 billion per annum target that we set and we delivered an ROE of 17%. Q1 saw us off to a good start to the year. GBM benefited from a rebound in investor activity, that drove £2.4 billion of revenues and a 21% ROE for the quarter. Each of the key business lines in GBM continues to maintain their market position.

Having said that, regulatory challenges lie ahead for investment banks including GBM. Basel III will add an additional £60 billion in risk-weighted assets to the business. So, like our peers, we're examining various strategies to mitigate the impacts on the future returns of the business.

More on that as we work through it, but I'd say the good news here is that we start from a good place in terms of our financials and the quality of our franchise.

The US franchise at Citizens is steadily improving. Our operating profit has been up in the last five quarters. It's seen a $640 million annualised swing. This return to profitability is built on a strong customer franchise. We have growing customer numbers. We have good levels of customer satisfaction versus our peer group.

Citizens is rebalancing its loan book to a better mix between retail and commercial loans. The renewed focus on non-CRE commercial business is providing us with some solid growth opportunities as the US economy strengthens. Our pipeline for new commercial loans has tripled since last year, granted off a pretty low base, but it gives us confidence that Citizens' improving performance so far this year is likely to continue.

A major underperformer in 2010 was our insurance business. We've put in new management there as well, you see a little theme. The underperformers are getting new management, and we've embarked on a turnaround plan with the results now starting to show through. Q1 saw the business return to bottom-line profitability. It had a 7% ROE. So, there's clearly more to go over the rest of 2011 and 2012, but this was a big step in the right direction.

Our plan focused on improving all aspects of the business, pricing, underwriting, claims processing, the size of the expense base, in order to get the business back to a 15% to 20% ROE performer.

Note that we are focusing on less risky drivers in the motor business. As a result, we take some -- we're taking some top line contraction now, but we should benefit from continued better performance on claims.

We also have a recent management change in Ulster bank, and Ireland continues to be a very tough issue for us. We continue to lose significant money given the weak economy and the fall in asset values. I guess if you look underneath that though, the underlying franchise is a pretty good one. We have the number three market position in Ireland, across Northern and the Republic of Ireland, and a lot of our competition is significantly weakened or has vaporised. So, on the things that we can control, we're actually doing a pretty good job.

For example, Ulster Bank had 3% growth in deposits in the last quarter, strong net gains in customer numbers across the footprint. We've undertaken a radical restructuring of both the balance sheet and the cost base at Ulster Bank. The loan-to-deposit ratio has fallen by over 30 percentage points, and our costs have been pared back 15% in the past year.

Over time, I think this operating progress will be more evident as our credit costs fall.

The next slide digs in a little deeper on the Ulster portfolio, and the most significant losses to date are over on the right in the Non-Core development lending book. That's now 75% non-performing. Our provision coverage is up to 46%, and I'd say the only bright spot here is that we're moving rapidly through the impairment pain.

Over on the left, on the Core book, the residential loan portfolio of £22 billion is the one we're watching carefully, continues to show some adverse migration with a weak economy and unemployment going up. Our non-performers started the year at 7.5% and ended the quarter at 8.4%. We have a high provision coverage ratio at 38% of that book, so the future impairment path is likely to be determined by the NPA migration.

So, how does this pull together versus our plan? As you know, we have a return on tangible equity target for our Core businesses of greater than 15% by the end of 2013. This chart right here will illustrate how we think we're going to get there, and we've overlaid here the 2010 divisional return on tangible equity, and you can see the UK Core, GTS, Wealth, Retail and Corporate, are all at or exceeding the 15% by the end of the first quarter, but we need to drive continued momentum from these businesses.

GBM as indicated has performed well. We simply need them to maintain resilience in light of the regulatory changes that they face. The US, Ireland and Insurance have all lagged, but therein there's significant upside potential if we can get them performing where we think they can, although insurance will ultimately be divested.

Of course, a headwind, the last point on the bottom there of unknown dimension relates to the required capital framework under Basel and also the related ICB framework, which we'll clarify over coming months.

On the right side of the slide, we put some illustrations up of the roadmaps that we have for each of the businesses to get to that targeted 15% ROE, and they're really based, what the essence of it is, as GDP strengthens, R&C businesses tend to see normalising NIMs as rates rise, normalising impairment levels, a little bit of loan and deposit growth, so that takes us a pretty good way to where we need to get to. But, also we have these management initiatives and all this investment spending to improve these businesses to world-class standards, and that also carries us the rest of the way there.

So, as we continue to progress through this, our year three of the five-year recovery plan, capital management decisions will become increasingly important. The key foundation block of course for giving us flexibility is to maintain our earnings recovery. But, with that in hand, we'd have the chance potentially to resume dividend and coupon payments on preferred shares and hybrids in the second quarter of 2012. We then are looking to exit the APS scheme in October 2012 after we've hit the required minimum fee.

After that, we then have to consider where our capital sits relative to regulatory minimums, and in relation to our ratings objectives, but clearly we'll take a shareholder-friendly approach and we'll seek to restore the dividend and repurchase shares when we're able to do so.

Another thing that focuses attention is the government's big stake in RBS and what's going to happen with that. There's a few facts here on this slide, and obviously the government's expected to sell down that stake over time, given its size. The 83% stake is held by an asset manager set up by the UK government called UKFI. There's A shares and B shares, but the blended in price is just a tad under 50p.

Now, while we've been grateful for the support of the government, there's real benefits from moving ownership to private shareholders in a timely fashion. These benefits include some listed here, will increase the group's free-float. I think that impacts trading in the shares somewhat. It improves our overall investment case and it broadly removes some of the stigma from government ownership. The government also benefits because they'll recoup some of their outlays and it will help the fiscal situation of the government.

So, I think we have good alignment on that. There'll be more on this topic later in the year, once the ICB issues its final paper in September.

Okay. So, let me summarise, and then I'm happy to take some Q&A.

I think if you look at RBS and what we're trying to accomplish, RBS offers a foundation of top-tier market franchises, a very well-balanced portfolio. We offer the potential for solid profitability, attractive returns and low volatility, underpinned by a super-strong balance sheet, improving standalone strength, and a very investor-friendly approach, as you can see from our market-leading disclosure practices and the thickness of our quarterly documents.

So look, it's really a marathon, not a sprint, as I said earlier. But, we're pleased with our progress to date and I think we remain very optimistic that ultimately we're going to get where we want to get to. So with that, I'm happy to open it up and take some questions.

JP Crutchley: Okay, we'll go to the floor with questions. While hands are coming up maybe I could just kick-off with one. You didn't mention much about the regulatory backdrop in the UK, Bruce, which is clearly one of the issues the entire sector is working its way through. I was wondering if you could just say a few words on how challenging you find that side of the business?

Bruce van Saun: Sure. You know, I think it's no secret that given what happened in the UK, the FSA has become a fairly aggressive regulator in trying to make sure that what happened previously doesn't happen again. So, we have to work through that and I think they've worked well within the confines of Basel to try and influence where the ultimate Basel proposals come out. There was a need for change, in terms of capital levels, and liquidity and funding frameworks, and so direction of travel on that is all, we're sympathetic to that and a lot of that is reflective in the plan that I just talked about.

There's obviously the beauty in the details here, and so the details matter, and so there's ongoing discussions to try and shape that to something that offers the full benefit of safety and soundness in the system without unnecessarily raising costs to society and increasing the cost of credit, which would have a negative impact on economic growth.

Interestingly, when the coalition government was formed in the UK, there was a desire to wrestle with the role of banks in society and so a commission was set up which has been ongoing. There was an interim report that came out in April and that grabbed some headlines but I think in general, at this point as it relates to safety and soundness, there's an endorsement of direction of regulatory travel with one additional element potentially, which is called subsidiarisation. This is trying to ring-fence UK retail since there's an implicit government taxpayer support around that aspect of the business, so it should carry potentially more capital and be in some way protected from what riskier activities take place elsewhere in the group, such as investment banking. Again, on that one, the proof is going to be in the details. I think that one could end up being very expensive and having a very minor benefit to safety and soundness, or if constructed well I think it could be additive to safety and soundness, and potentially not have significant adverse cost consequences.

So, I think the commission is working through that, and they're anxious to hear what the banks think, and so again we're in an active dialogue and we'll wait for the report to come out in September.

Unidentified Participant: Yes, my question is also regarding the UK. On slide five, you have some charts showing an expected ramp in UK economy and a ramp down in unemployment. Since unemployment currently has been rising, the government's continuing to lay off workers, inflation has been going up, and the Pound has been strengthening versus the Dollar, probably retarding exports, why -- can you give us some detail as to why you expect a significant recovery in the UK economy?

Bruce van Saun: Yes, I wouldn't call it a bounce back recovery. It's certainly a very gradual recovery. If you look at the stats on inflation, for example, some of that is believed to be temporal. So, there was a big back increase as part of the government's fiscal rectitude program, which is captured in the data. And then, some of the same things we're wrestling with globally in terms of commodity price spike, and the kind of flow-through impact on some of the stats, has been hitting the UK. Actually, the stats earlier in the year had inflation starting to come down, so there was a print of a 4% number when it had been heading towards 5%. So, I think the jury's out on that but it looks like the trend line is that that's coming back down, and some of those were temporal factors. That's basically the Bank of England's forecast, and that would be our own economists' forecasts.

The unemployment has stayed around 8%. It never got to the levels that you see in the US. There will be, I think, some little saw-toothed bits and starts around some of the numbers currently, but the expectation is that as some of the employment gets pushed off the public sector roles, that the private sector is going to pick up and we'll see job creation net-net in the private sector. And so, I don't think anyone's really calling for unemployment to dramatically move for the next 12 months, but then ultimately as the economy continues to strengthen, to go down. So, I don't think we're outside the mainstream in terms of UK forecasts, if we're talking about the next 24 to 36 months.

Unidentified Participant: What’s your exposure to government bonds in peripheral Europe and how they amount in relation to market trends?

Bruce van Saun: Most areas we have pretty modest exposure, with the exception of Greece. So, if you look at the countries undergoing restructurings, we certainly have a big exposure to Ireland but it's really in loan books. There's maybe 100 million of sovereign holdings in Ireland, so it's very small. Same thing in Portugal, we have some loans in Portugal. Not a big amount, and a very small sovereign holding in Portugal, and this is all in our quarterly documents. You can look this all up. The one exception is Greece, where we had about £1.5 billion gross exposure and we have I think about £600m of that or 40% is marked through available-for-sale accounting, so it hasn't flushed through the P&L. But, it's certainly out of our book value per share. So, the net is £900m. In the back?

Unidentified Participant: Is there anything more you can share with us about PPI, the PPI exposure that may be coming down the way, and on a separate topic, given the overall government ownership, are you more or less precluded from doing any acquisitions specifically in the US? Because it seems like Citizens hasn’t really grown, so what's your overall plan for Citizens?

Bruce van Saun: Okay. The first one, on PPI, I'm not sure if all of you saw that, but yesterday before the open, HSBC put out their release and they took a provision. Barclay's did as well. We did ours after the close, and so our announcement was £850 million, of an incremental provision that we'll take in Q2. We had already had a provision of £100m and we had already paid £100m against claims to date. So, roughly our gross number is about

£1,050m. I think Barclay's gross number, they had a pre-existing provision of £200m, and they took a billion incremental, so they're at £1.2m billion, and Lloyd's as I'm sure you all know took £3.2 billion provision since they were the biggest in the market in terms of selling that product.

So, in hindsight, that was a -- I'd say a difficult chapter for the banks and not their finest moment in terms of the interaction with the customers. This was a highly profitable product that not all customers needed, and so there needs to be recompense towards that. So, we're in sync with that. I think the legal situation was as much about the FSA potentially changing the rules after the fact and its so-called retrospection was really the issue that the banks were fighting against, but ultimately once Lloyd's decided not to fight any longer after the court handed out its ruling, that basically meant the rest of the banks had to fall in line like dominos after that.

So, this will play out over the next couple of years, as customers come forward and they have to show evidence that they were mis-sold the product, and it has to be evaluated. Each case individually, and it's hard to estimate that because you don't know exactly how many customers will show up. I think there's a presumption that for most that do show up, there'll be a fairly high ratification of their cases. But, that's why there's still some uncertainty about the actual number, but we think at this point that's a reasonably good guess.

On Citizens, I'm sure you're aware, but when we reached settlement with the EU over the state aid provided by the government to RBS, we had a limitation on any acquisitions that we can do for a period of three years, which really takes us through late 2011 into 2012 probably. So, we're very focused on fixing the franchises and investing for organic growth, and not looking towards acquisitions. In fact, we're really selling things, not buying things. I do think once we get the bank to a safer, more normal position, bolt-on acquisitions have always been a viable element to a bank's growth strategy and we'll look to do that in selective areas. It's pretty hard to do that in the UK since the market is so concentrated, but areas like Citizens to do some things, modest and in footprint, once we have the model down in Citizens and good traction and like the way we're running it, I think we could continue to do some of that.

If you step back and look at Citizens, that balance and diversity chart that I showed you, having a US franchise like Citizens is additive to that because it does add to retail and commercial, i.e., it dilutes the size of the investment bank in terms of the overall pie, which I think is a good thing. It makes us less UK-centric. So, I also think that's a good thing in terms of balance and diversity. And, the US market, frankly, is less consolidated and if we needed to -- if we wanted to employ some excess capital there for attractive situations, we could do that, but again I do take your point. With the UK government, they're not going to want to see us run out and do a massive acquisition in the US at this point. So, I think it would all be something that would be tactical as opposed to highly strategic.

JP Crutchley: I think on that note, we'll draw things to a closing, just in time. There will be a breakout session if you want to continue the discussion. In the meantime, could we just thank Bruce in a huge way, thank you.

Bruce van Saun: Thank you.