RBS Group

Morgan Stanley Financial Services Conference 2013

Tuesday 19 March 2013

Stephen Hester, CEO

Good morning. Thank you very much for giving me the time to present this morning. What I wanted to do this morning was go through a little bit of a stock take on where the restructuring process of RBS has got to and the things that we are now focusing most on.

And I guess it's important particularly as we are coming much closer to the end of the restructuring period, to be clear on what we are trying to achieve at RBS, and this slide is remarkably similar to similar slides that I put up four years ago at the beginning of the restructuring period.

What we are trying to accomplish basically is a really good bank, and we measure that I think in pretty conventional terms starting with customers, our customer franchise, and building the bank around that, going through our risk profile and business balance, and then of course into the translation of that through to shareholders.

I won't read through them, but when you go through the individual points on this list, a clear majority of these we have already accomplished. That doesn't mean to say that we can't do better under every category, but I think that it is a very believable set of accomplishments in the not too distant future.

And recapping on the journey to get us here and the aspects that we've had to work on. In 2009 we set out what we thought was a clear strategy for the bank and also a structure within which to accomplish our restructuring, and a roadmap for the implementation of that restructuring. In essence you can say that we established two parallel tasks and indeed a structure that would enable us to carry out those two parallel tasks within the one bank. And of course the flashy task number one was the restructuring of the bank. A huge restructuring. Risk reduction that went with it. And in addition to simply reducing risk, implementing the strategic realignment that we needed to regain a coherent and strong business mix that could compete into the future. So restructuring clearly was task number one but in parallel to that, less flashy but if anything more important, was our core businesses, our ongoing businesses, which we needed to liberate to support customers, to make sure that the majority of the clean-up was being done in a different structure within the bank. Every one of our core businesses has required retooling to correct their underperformance and to increasingly make them fit to compete successfully in the future.

Of course both of these tasks had a series of milestones so that we could measure progress. And the concept is very much that while these two tasks return RBS to what I sometimes describe as a normal bank, we have set our ambitions higher than that, and so as time and energy and resources and confidence is liberated from progress in the twin tasks of restructuring and retooling our core businesses, we are intent on redeploying those to help move RBS from the normal bank that we are shortly to return to, to a really good bank whose ambitions lay in doing better for customers and for shareholders than simply keeping pace with competitors who had less to do.

So on the journey and looking at these two tasks, where are we on our restructuring journey? Broadly we think that we are nearing conclusion. So let's go through a small number of pieces of evidence of that.

Clearly the biggest part of the restructuring was to get to a sustainable and sensible position on risk. We set out five big picture risk targets four years ago that we felt, if we reached them, would put us in a desirable long-term position on risk. You'll see that we have already accomplished after four years – it was a five year plan – four of the five. And as everyone knows an extraordinary £700 billion reduction in funded balance sheet, and many pieces of good work done, not just in the size of the balance sheet, not just in the way it's funded and in liquidity behind it, but many smaller pieces. I'll come back to the unfinished item here which is the Core Tier 1 Capital ratio.

Underneath the big picture restructuring of the balance sheet, of course we have been seeking to improve what's inside the balance sheet not just its dimensions, and if you look on the two bottom quadrants on this slide you can see the dramatic progress that we also have made in reducing single name concentrations, which were a feature of RBS pre-crisis, and our excess position in commercial real estate. Lots of people of course worry about commercial real estate sensibly because it tends to blow banks up in every cycle that there is but despite people's worries, despite the concerns that this is an asset class that is slow to shift, I think the bottom right quadrant demonstrates that a great deal of progress has been made at RBS in this area.

In parallel with the risk restructuring which we are nearly done on, as I mentioned, the purpose was not just risk, it was to reshape strategically the bank to a much tighter, more coherent set of businesses based upon our competitive strengths, based upon customer franchises, that could prosper into the future.

This slide simply recaps on the quite dramatic changes of mix that we have wrought from a strategic standpoint as well as from a risk standpoint, both in the balance of the business as between retail and commercial, and investment banking. A dramatic change which I think is a positive for shareholder value. But also along many other dimensions in the more detailed boxes on this slide in both wholesale and retail showing geographic changes to our business, changes in clients targeted of course in products, and the business disposals that we've made.

Many people think that this was all just about risk reduction. It was, we needed to stop going bust and restore the strength but it was just as much about re-establishing strategic coherence from a bank that had become overstretched and was not fit for purpose strategically.

So what's left to do, what's left to finish on the restructuring job? Well, in financial terms the most important thing is to get to the end game in capital terms. And you'll see on the left hand side of this slide the really dramatic changes, not just at RBS but of course across the industry in regulation and required capital. So on an 'apples to apples' basis RBS' Core Tier 1 ratio, which in the depths of the crisis was 4%, is up to 13.2%.

We actually only stated at 10.3% because the difference is changes in regulatory approach to certain assets and risk models and risk weighting. But there has already been a tripling of the amount of capital per unit of risk that RBS is holding.

As you all know, when this Basel 2.5 presentation is put onto a Basel III basis in common with other banks, we have some further work to go. Our ambition is to get to the low tens in terms of our Basel III ratio, I think that will be the final stopping point for us, and we hope that we can do the vast majority of that over the next two years. We take a lot of comfort from the tripling that we have already accomplished in the last four years.

We also set out on this slide the key ingredients of the rest of that travel: shrinkage in Markets and Non-Core, mitigation in CRDIV, expected loss and DTAs where we are probably more leveraged into recovery than some other banks, and of course attributable profit beginning to come through.

What else is to finish on the restructuring job? We need to finish the job in Non-Core. I'm not too worried about doing that, although obviously it requires work, but so far we have done everything we said we would in this area.

Then I think the final area is to have greater confidence that the turn has been seen in Ireland, which as everyone knows has been a source a considerable losses to a number of banks, including ourselves. We have seen the turn in our Non-Core parts of Ireland. We did not see that yet in Core. We are optimistic that 2013 could see a decisive turn in Ireland, there are various green shoots that encourage us in this, but of course we're only two months into the year, so this will be an important thing to watch as we go through this year.

I think the final bit of the restructuring story has moved away from financial and risk restructuring onto regulatory and conduct matters. I suspect there are very few banks in the world, certainly none in the UK, whose management team don't spend more time on these issues than anything else at the moment. Pretty much all of the issues are shared right across the industry, but they are wrenching ones both in reputational terms, in financial terms and in terms of the message of: a) our industry needing to improve itself; and b) the uncertainties that are still out there in terms of regulatory action and interpretation, which I don't think any of us can at this point cap off.

But nevertheless I hope the few pieces of evidence that I've just put out for you demonstrate the belief we have that the restructuring element of the RBS story is nearing successful conclusion. One or two years I think should see us on top of the remaining issues that I have put out there and the progress we've made so far give us confidence that we can get on top of them, although we must always note these are still important difficult things to do, the outside world can make them more difficult, we can trip up over things or slip on banana skins, and so it's not in the bag until it's done. But we feel a fair amount of confidence about the progress made.

The parallel task, as we talked about and as the restructuring nears completion, the piece that will of course receive more and more scrutiny is RBS going forward, what we call our Core businesses, how they look, where they are on their journey, and they of course are the thing that will power shareholder value into the future.

So what do they look like if we just take a spot check today or look at performance in 2012? In 2012 despite what certainly in all of our markets was a difficult year, a flat year in economic terms, where our customers continued to be under pressure, we generated operating profit of between £6 billion – £7 billion, depending on whether you include Ulster or not.

It's worth thinking about those two things because we have some dilutive actions ahead of us. We have to sell the remainder of Direct Line, the insurance holding, we have to sell some of our branches in the UK, we're downsizing our Markets business. And all of these are done in order to accelerate capital build and therefore will be dilutive to shareholders. So if you like that dilution is largely offset by what we believe is a recovery from the loss making position in Ulster that can take place during the same period.

But a pretty good level of profitability given where the economies are now already. 10% Return on Equity in our Core businesses, including Ulster, over our costs of capital excluding Ulster, and what we describe as the gold standard having been accomplished in terms of the way we fund ourselves entirely with deposits. Cost/income ratio that isn't where our ambitions lie, but I think is competitive with global banks.

And so I guess our simple claim is that we have restored the Core businesses of RBS, each with their nuances and pluses and minuses and jobs to do, to in-line performers relative to our competitors in each of the segments in which we operate.

You can see that we think that the business mix is now coherent and represents something on which we can build, whether looked at by geography or in terms of our balance by business line, and each of our businesses enjoys largely strong competitive positions. Over 90% of our key product markets we are in the top five in, and plenty of connectivity around our Group. So that's the snapshot of where we have got our core businesses.

To do that in the last four years we first – and this of course is a message forever – needed to make sure we at least sustained a core customer market position that we had, that from which all else flows. Our ambition ultimately clearly is to do more than sustain, but during the period of noise of our restructuring we feel pretty good that we did in fact sustain these positions. Most of you I think are familiar with them.

By the same token, in order to sustain them we needed to focus on serving our customers well. That had to be job number one for the Core businesses. We believe that we have done and 'okay' job at that, every one of our businesses has got some things that they can point to that are better than four years ago. Have we gone faster in serving customers well than our competitors, have we broken out of the pack? No. That is a job ahead of us but is certainly an ambition that we hold. But I think there are many, many proof points and pieces of evidence behind why we have been able to sustain, in a period of great noise and disruption, the very important and valuable customer positions that we have.

Part of that of course, a particular focus on a political dimension has been the ability to support our customers financially. This I put up here really just as a way of noting the whole way that we have gone about the restructuring of RBS was to leave our Core businesses relatively unconstrained in their ability to support customers, and therefore to sustain value for shareholders into the future. The heavy lifting, whether it be in capital reduction and balance sheet reduction or other things, was done in Non-Core off on the side, and so that has allowed our Core businesses to support customers despite the deleveraging of the Group as a whole.

You'll see here as an example that actually our lending to UK businesses and homeowners increased nearly 4% in the last four years in an economy faster than the economy itself performed. That was made up of mortgage market share that went up substantially as people withdrew or shrank in that market, and business market share that basically stood still – it's probably our biggest area of market share – because people weren't giving up market share there, but nevertheless where we were able to in difficult conditions sustain our support for customers. I think that the data on this slide is evidence of that.

But as we were focusing on serving customers, supporting customers, sustaining the market positions we had, we were very conscious that all of our ongoing Core businesses need retooling. Of course that's a process you could say never ends, but it was a particular process needed for us because many of our businesses had been starved in years during the financial boom in favour of dollars being spent on acquisitions, and so there are a lot of changes that we are in the process of making.

Part of that, and relevant for every bank I'm sure that gets up here and presents to you, is to make some room on the cost base, especially in times when revenues are hard to find with our customers not growing very fast and we have, I think, a pretty decent record in terms of being able to take cost out of our ongoing businesses. You can see in this top chart the nominal costs, and then if you were to adjust for inflation what that represents in real terms.

What we have done with that is not simply offset weak revenue trends to create the profitability we talked about, but we have used a significant amount of the cost that we've taken out to fund a retooling of our business. This is ongoing but you can see in the bottom left chart of this slide that what we would term investment spending in our business has very substantially increased in order to change our businesses in the ways that will give them a platform to serve customers well into the future, and to hopefully serve shareholders well. Some of you in the audience here may have attended the Retail 'deep dive' that we gave for some investors yesterday which highlighted the £700 million investment programme in that business which is ongoing.

And of course part of the retooling of our business has been the need to make substantial management changes. You'll see that some 65% of our top 300 have changed in the last four years, and just over half of that we've managed to do through the most desirable way, which is internal promotion; and just over half through hopefully improving our overall mix in the light of our smash and bringing people in from the outside.

All of this work focusing on our customers, retooling the business, cutting costs, focusing on risk has solidified the performance of our business from a shareholder perspective. A slightly busy chart, I appreciate, on the left hand side looking at our Core businesses as a whole, looking at the way that operating profit has increased. The quality of that profit has improved in terms of the mix between the more volatile markets' profit and total profit, and also our Return on Equity and our loans to deposit ratio, which are the other key aspects that we were aiming for. And then the boxes on the right and in the centre illustrating by division, using slightly hard to follow colour coding, the businesses which in terms of Return on Equity and funding balance are already in our target zone. Our biggest businesses are already there. Those which are close to in touch of, which we have colour coded amber, and I guess really Ulster, the only one red, where we're making still losses.

So these are the proof points, I hope, behind the two jobs that we set out to do to bring us to the normal bank position. The restructuring job we hope nearing successful conclusion. The retooling of our Core businesses so that at least they are now performing in-line with other banks who had had less to do.

In terms of expression of that along milestones, there have been a number of important ones, if you like, in capital structure terms: returning on preference share coupons last year; exiting the Asset Protection Scheme; repaying vast amounts, in fact all government liquidity support, various EU mandated sales completed with, of course, the branch sale yet to come.

I call this 'Path to 2015'. That isn't trying to say that there are precise dates, each of these elements and future milestones has different dates associated with them, but as I said over the next couple of years, this year and next year, I believe that we can get the majority of the done; and key milestones in that regard is the capital ratio, the last piece of our risk restructuring, to get to the right place, the finishing of the job in Non-Core; the further restructuring of our Markets business lifting at the point that we have both profits and adequate capital the dividend block which will require a negotiation with the government and EU, and then of course that should be the entry ticket to the government's ability to privatise us sensibly. We are more than conscious that privatisation doesn't just require a willing seller, it requires some willing buyers.

So as we see in a different dimension the challenges that we need to overcome in the next two years. Finishing the job as I have said on restructuring, reaching a better a place on conduct regulation. I think every bank would say that it's important for all us, vital for all of us. RBS probably has a particular burden of what I euphemistically call here public policy requirements to work through at the same time as sustaining both customer and then shareholder appeal.

Of course all banks are under pressure in terms of what we're asking from our people, that we've asked a particular amount, and that remains an enduring element of future focus for us as a management team.

And I think we all have to recognise for all banks that the economies, at least of the Western world, continue to be in a mode of struggling for growth. For so long as our customers struggle for growth, we too will. So our base assumption is that revenue growth for most banks that look like us, will remain hard to find until our customers are finding it themselves, and therefore that puts even more accent on the other activities that we're doing in terms of risk reduction, in terms of cost reduction, in terms of retooling the businesses, and effectively serving our customers in a flat and tough environment.

I mentioned – and I simply will finish on this note – that the restructuring even if it nearing conclusion of RBS, simply gets us to be a normal bank again. None of us are in business to run a normal bank, we are all in business to try to run a really good bank. There are of course multiple dimensions to this; it's a task that maybe never ends and maybe should never end. I simply put two slides up to finish on this note.

The first one that you see in front of you is really to note that I think as we have all discovered, painfully, people who run banks and people who invest in banks in the last four years, that running a really good company of any sort, in our case a really good bank, actually is not just about its financial dimensions. In fact it's not even about its financial dimensions, although they are important.

What our industry, the banking industry, has to do if it wants to make the journey from normal to really good, is what all companies in all industries do that become or stay really good, and that is to build everything around serving customers well. We do that a lot of the time, we don't do it enough of the time, our industry as a whole.

To acknowledge that that is our primary purpose, to acknowledge that serving customers well in an industry that is as vital and all encompassing as financial services, involves being an important part of the community in which your customers occupy, and of course to make sure that the values of your business are as prominent and as important as its financial dimensions.

So this is a huge element of what we are trying to recapture as our people's energy and confidence and time is released from the restructuring job, to move our bank forward along these dimensions; and to make sure that we finish the job in making RBS look like this – the slide I opened with and the side I close with.

With that, thank you very much for listening. I'm happy to take, if we have any time now, any questions, or obviously then in the breakout groups.