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Rohith Chandra-Rajan

So I think we better kick off really with the second presentation. Thank you all very much for joining us, I'm Rohith Chandra-Rajan in European Banks team at Barclays. I've very pleased to welcome Ewen Stevenson, CFO of RBS. Ewen joined the firm just a few months ago so is fresh in terms of his thinking around RBS.

So with that I will hand it over to Ewen after which, we will have time for some Q&A so with that over to you Ewen. Thank you.

Ewen Stevenson

Thank you Rohith and good morning all. Delighted to be here in New York to have this opportunity to speak with all of you. It's actually my very first external investor presentation since joining RBS in May of this year.

By way of background before I joined RBS, I was an investment banker at Credit Suisse for the last 25 years covering the banking sector for the last 21 years. Latterly, I was Co-Head of Credit Suisse's Global Financial Institutions Group covering the banking sector and also co-head of the investment banking department in EMEA.

So initial impressions of RBS, I would say it's got some really great customer franchises backed by really great people but we recognize that we've got a long way to go to restore trust and to rebuild our equity story.

We're trying to have a relatively simple investment case. At the core of our bank I think are some really great market leading franchises in the U.K. We're number one in commercial and corporate banking, we're number one in private banking, we're number two in retail banking. So in our view when we look at the balance of portfolio businesses we think we've got a much better balance, probably than any other U.K. bank. We think we should be able to achieve returns comfortably above the cost of capital over the medium term.

We do recognize the importance of transparency given our past. We want to be very transparent with the customers, very transparent with regulators, very transparent with all of you. We set out a very, very clear set of metrics back in February. We do expect to be judged by them. We do expect to track them and report regularly against them and we will link our management compensation plans against them.

We’ve started a process of re-orientating our business mix towards the U.K. Approximately 60% of our income in the first half of 2014 is U.K. based. By 2020 we would like that to be at least 80%. We're also shifting our business mix towards retail and Commercial Banking. As I said, the focus on the U.K., we think, should provide us with attractive returns and decent growth over the medium term.

To do this we've reorganized ourselves into three businesses; Personal and Business Banking is the number two franchise in the U.K. Its returns are very good and we expect them to remain so. Commercial and Private banking is number one in both customer segments. Commercial Banking through our RBS, NatWest and Ulster brands and Private Banking through our Coutts brand. This business is already producing returns above the cost of capital. We would expect returns to continue to improve over the medium term.

Corporate and Institutional Banking is the number one large corporate bank in the U.K. It's also a leading corporate and transactional services business in Europe. It's currently producing returns well below the cost of capital so we're reducing capital commitment and we're reducing cost to improve these.

Back in February when we announced our new strategic plan we set out what I think are a very clear set of customer, employee and financial metrics and, as I said, we will continuously report on these and track our progress against them.

On customers we set ourselves the goal of being the number one bank in the U.K. for customer trust, service and advocacy by 2020. On employees, we need to get back to the point where our employees are happy and proud to work for RBS again. And on financial returns for the bank as a whole, as I said, we believe we can produce returns comfortably over the cost of capital over the medium term. We've made good progress, I think, on that objective in the first half of 2014. Return on tangible equity of 7% relative to a very large loss that we reported for 2013.

As part of that, cost:income ratio remains unacceptably high. We're very focused on reducing this. We've told the market we're going to take a billion pounds of operating cost out this year. We're on track to do that. We also want to be considered by any measure, a safe and sound bank. Our Common Equity Tier 1 is rapidly improving. Our leverage ratio we think is well on track to meet any new leverage requirements and we now have very strong funding and liquidity ratios.

To spend some time on our customer journey, as I said, our objective is to be the number one bank in the U.K. for customer trust and advocacy by 2020. We plan to do this by what sounds like a very simple set of steps; product simplification and transparency, enhanced service levels, investment in our distribution channels and improved resilience of our IT infrastructure.

Let me give you some examples.

In credit cards we stopped teaser rates because most of our credit card customers didn’t understand what they were being sold. Our view is if you want to build trust you've got to stop doing stuff like that.

Another historical source of frustration for new retail customers was how long it took to get an account open. So we studied the process, we've taken new account opening for 90% of our customers down from five days to one day and alongside that we also now allow customers to get one day access after opening an account to our online bank.

And it's not just the time that we are reducing, we're also very focused on trying to take the complexity out of the offering to our customers. We used to have 23 savings accounts, we used to have 27 current accounts for customers. We've now dramatically reduced that down to only five savings accounts and seven current accounts.

And this simplification does two things for us; one, it provides an enormous opportunity to take our cost but equally we think it improves the customer experience by making the product offering a lot simpler and clearer for them to understand.

We're also in the middle of some fairly significant changes to our distribution network; mobile and digital platforms are growing exponentially, which is great, but we continue to see a strong role for a slimmed down branch network given that we believe that customers are requiring more complex advice such as mortgages; want to come in and meet people in a branch.

On the commercial banking side, we've been investing very heavily in developing the industry expertise of our relationship managers. This expertise, for example, we use to help customers grow their businesses by organizing networking and other customer events for them. Alongside that we're trying to re-empower the relationship managers, we're trying to, for example, improve the customer experience by pushing lending decisions locally.

Alongside our customer agenda we've also got a fairly significant strategic agenda that we're working our way through. You will have seen earlier this morning that we, today, commence the IPO of citizens here in the U.S. RCR, our bad bank, is running down much faster than we anticipated when we set it up at the start of the year.

Assets were down 28% in the first six months or about £8 billion. We're also managing down a number of other legacy securities and asset pools taking advantage of what we see as very attractive valuations for those asset classes at the moment.

For example, here in the U.S. we're running down our U.S. RMBS franchise.. And out of our legacy Dutch bank we're in the middle of monetising a very large portfolio of European government and asset-backed securities.

In our Wealth franchise we've decided to exit Coutts International. The business was producing poor returns, had a very high cost income ratio. We were not the right owner for that business. Instead we wanted to focus on our core U.K. Wealth franchise where we are the number one private bank.

We agreed with HM Treasury earlier this year, a £1.5 billion price to buy out the Dividend Access Share and a few weeks ago we made the first £320 million payment on that. As part of our state-aid agreement with the European Commission we're preparing for the IPO of our challenger bank - Williams and Glyn in 2016. So as we said at the start of the year we intend to focus on our customers and we are.

And we said that we'd de-risk our business and we are.

Now looking at the financials. Our franchises are clearly benefiting at the moment from a recovery in both the U.K. and Irish economies. GDP is recovering strongly in both, and unemployment is falling much faster than we expected.

Their housing markets are both recovering, with each of the respective house price indices up sharply over the last 12 months. We have a very large legacy exposure to Irish residential mortgages. So any improvement in this market helps both our impairments and proceeds from sale.

Commercial real estate valuations are also recovering helping the ongoing rundown our of legacy U.K. exposure.

Pre-crisis we had a market share of approximately 50% in U.K. commercial real estate lending. The risk tolerance today is in the range of 15% to 20%. And with business investment now recovering we're beginning to see good growth in our front book commercial lending in the U.K.

As it's likely that we'll see interest rates rise in the U.K. in 2015, we feel well positioned. On the deposit side we have a substantial volume of non-interest bearing liabilities. We continue to see very good demand deposit flow, 10% year-on-year growth in the first half of 2014. In lending, front book margins are very attractive with only modest pressure on new business spreads. In the U.K, residential mortgages are growing very well and commercial lending is beginning to recover.

In Ireland we're seeing very good new business growth but this is after exceptionally low recent levels and absolute volumes remain weak. We've got a loan-to-deposit ratio now of 96% and a strongly recovering Core Equity Tier 1 ratio. We've got plenty of liquidity and plenty of capital to meet recovering loan demand in the U.K. Our net interest margin is also benefiting from the ongoing rundown of low yielding legacy assets like RCR and our Irish tracker mortgage book.

We expect to see further net interest margin benefits as expensive post-crisis funding begins to now mature. And we've got very limited new wholesale funding needs.

These benefits may be partially offset, we think, as we begin an AT1 issuance program that we expect to kick off next year, alongside ongoing modest pressure on new business margins.

We expect that the overall U.K. commercial loan book will begin to turn towards net growth in the coming quarters. We're seeing very positive year-on-year trends in both commercial lending applications and approvals. In the second quarter of 2014 applications for new commercial loans were up 12% year-on-year and gross new lending was up 38%.

Trends in U.K. residential mortgages continue to be positive. We are seeing the benefit of our investment in recruiting and retraining our mortgage advisors for the new regulatory regime for mortgage advice in the U.K.

In mortgages, we achieved 4% growth year-on-year in the second quarter and that compares to only 1% for the market overall. Our flow market share was 10.4% in the last quarter which is well ahead of our 7.9% stock share.

With the recovering macro environments in both U.K. and Ireland we're making good progress in running down our large non-performing loan portfolio. We're now down 20% from the peak and we had a further 9% reduction in the second quarter. RCR, in particular, is performing much better than we expected than when we set it up in 2003, at the end of 2013.

Assets in RCR have been run down much faster than expected. Operating cost and impairments are lower and asset realisations are higher. Much of the benefits in asset realisations and impairments that we're seeing are due to the strong recovery in asset valuations and buyer appetite in Ireland. We now expect final exit costs for RCR to be £1.5 billion lower than when we set it up at the start of the year. But, I would caution with gross assets in RCR still being around £20 billion pounds, we could continue to see considerable potential volatility around final realisation costs for RCR.

In our core loan portfolios we're also benefiting from very low impairments. We're seeing both an absence of large one-off impairments and very limited new impairment flow. So we've updated our guidance for the year to just £1 billion implying around £700 million of impairments losses in the second half. And, again, with £22 billion of balance sheet loan loss provisions still on our books representing over 50% of our tangible net equity we do expect to continue to benefit from the recovering economies.

We had a second quarter in a row of profitability which for us is a relatively rare event and something we were very pleased by. In the first half of 2014 our return on equity improved from 2.2% to 7% relative to the same period last year. This was supported by lower impairments notably in Ireland and lower deleveraging losses but we're still well below our minimum return target of 12%. Cost cutting and capital redeployment will be absolutely critical to improving returns. If we look at the divisions, Personal and Business Banking is performing strongly. It had a return on equity in the first half of 17% and this includes the ongoing drag from our currently low returning Ulster franchise in Ireland.

Commercial and Private Banking is recovering well. It had a return on tangible equity above the cost of equity in the first half at 12.9%. This is still below our 15% target for that business but we do expect to see steadily improving returns in the medium term.

Corporate and Institutional Banking had a profitable first half, albeit this benefits from a very strong seasonally first quarter. However, overall CIB returns remain unacceptable. So we are focused on reducing both capital and cost in the business to improve returns. And for the bank overall, I think the coming quarters results will be sensitive to a number of non-recurring items. These include the downsizing of RCR, the timing or restructuring charges and expected sizable conduct and litigation costs.

Our cost structure was built for a bank more than double our current size in terms of assets. It's really not fit for purpose now. So we've committed to reduce this operating cost structure to £8 billion by 2017, in line with our objective to meet a 55% cost:income ratio in that year. The longer-term aspiration beyond that is to reduce it further to 50%. A sizable part of this cost reduction will come as a result of disposals, such as Citizens and Williams and Glyn, and the elimination of cost over time as we run down RCR. But we're targeting the core reduction in operating costs of some £2.2 billion over that period which is equivalent to about 20% of a “clean” 2013 run-rate.

We've committed to deliver a billion pounds this year and we're on track to deliver that. With the annualisation of 2014 cost savings into 2015, and some additional cost savings costs will continue to decline into 2015. And I should remind you at this point at the end of the fourth quarter, there will be the annual U.K. bank levy that we have to incur which is expected to be around £300 million for us.

We're making good progress in rebuilding our Core Equity Tier 1. From a relatively weak 8.6% at the end of last year, it's improved by 150 basis points with 10.1% at the end of the second quarter. A significant part of this has been achieved with an accelerated rundown of RWAs in both RCR and CIB. RWAs for the bank were down 9% in the first six months of this year. We're continuing to commit to our targets to be at around 11% at the end of next year and north of 12% by the end of 2016.

We think with the ongoing rundown of RCR and CIB, and the expected deconsolidation of Citizens will give us plenty of headroom to both grow our core U.K. loan book and meet our 2016 target of £300 billion of RWAs. And we're confident of meeting these targets for 2015 and 2016 despite substantial expected restructuring charges and elevated conduct and litigation costs.

On leverage, our ratio improved 30 basis points in the first half to 3.7% and we've got substantial capacity to improve this ratio. Our balance sheet will continue to reduce and as I said earlier, we expect to start an AT1 issuance program next year.

We are repositioning our capital very quickly towards our higher returning divisions. Our target is to have CPB and PPB contribute at least 65% of our divisional capital allocation. Up from 51% at the end of 2013.As part of that commitment and drive to higher returns, we're very focused on reducing RWAs in Corporate and Institutional Banking. RWAs allocated to that business fell by some £19 billion in the first half or down 13%.

This did benefit, in part, due to the weakness of the dollar versus sterling. We expect to achieve a further significant reduction in the second half of this year but that's probably going to be at a slower pace than what we saw in the first half.

As you'll all be well aware we continue to incur ongoing conduct and litigation related expenses. In the second quarter we took an additional £150 million for PPI provisions and a further £100 million for interest rate hedging product provisions.

Our balance sheet provision for litigation costs and regulatory fines was £2.4 billion at the end of the second quarter and, as I said, we do expect elevated costs being incurred over the coming quarters particularly from investigations into the global FX markets and then here in the U.S. around residential mortgage related fines and litigation. The timing and size of these remain very uncertain.

So in conclusion, if this was a school report I was giving myself I would say “good, but we'll do better.” I think we've made some very good progress against our customer objectives of being the number one bank in the U.K. for customer trust, service and advocacy but we recognize that we've really got a long way to go with our customers to restore trust with them.

We are clearly benefiting from good and improving macro conditions in Ireland and the U.K. With the principal benefit today of that being seen in lower impairments and higher asset realisations as we shift out of legacy loan and securities portfolios.

I think we're well positioned for ongoing recovery in the U.K. including the interest rate environment that we expect. We have a very low loan-to-deposit ratio, plenty of capacity to lend and a very large current account base positions us well for a rate rise.

I know we've got to get our operating costs down. And we're making very good progress against that and we'll continue to. We need to continue to strengthen our Core Equity Tier 1 ratio but, again, in the first half of 2014, I think we made very good progress on that. I think the last thing that I would observe is in the coming quarters we do recognize that there's likely to be considerable potential volatility in our results, driven by impairment and asset realisation trends driven, by the timing of planned restructuring costs and driven by anticipated elevated conduct and litigation costs.

Thank you, if I could now go back to Rohith.

Rohith Chandra-Rajan:

Thanks very much for that Ewen. We'll now move to the audience response questions which kind of give you an opportunity to express some views about some of the issues around RBS and just a quick recap of how that's going to work I'll read you the questions and the options to the answers and you'll have keypads hopefully in front of you that you have ten seconds or so to respond and then we'll give Ewen the opportunity to respond to your responses.

So the first question is really around perception on RBS generally. So what would cause you to become more positive on RBS shares; the options being reduction in the U.K. government's ownership, greater certainty on conduct costs and regulatory requirements. Strengthened capital position and resumption of dividends, faster reduction in RBS capital resolution balance sheet. Number five, evidence of successful restructuring in the core business and finally clarity on Scottish independence?

And we should have the answers coming up on screen. So, I guess, Ewen, that's the opportunity to talk about one of the key issues at the moment?

Ewen Stevenson:

Yeah, Rohith, there's probably two topics you wanted me to talk about, one was the IPO of Citizens, the other was Scottish independence but neither of which I really want to spend a lot of time talking about today.

I actually had five as being what I thought was the single most important thing for us. You know, I do realize a lot of those other things are important but I do think that they are sort of one-off in nature. I think, you know, if I put a multiple on five and that really does drive value for us. Just on Scottish independence, given that I know you'd like me to say something, look, obviously we are trying very, very hard to maintain a position of political neutrality. We want the voters of Scotland to have their say but equally you'd understand that we're doing all of the sensible contingency planning that we would need to do around an event like that.

The vote continues to move around as you've seen in the polls. I personally have been tracking spread betting as probably the best indicator and as of this morning there was a 30% chance of a yes vote and a 70% chance of a no vote.

Rohith Chandra-Rajan:

And just on the other kind of the number two answer, there is a lot of uncertainty, and that's actually in your presentation on those two issues. So in terms of kind of near-term conduct costs and sort of the non-return regulatory landscape in the U.K., I'll invite you to comment a little bit more on both of those issues.

Ewen Stevenson:

Well look, on near-term, conduct and litigation costs are uncertain. As I said the two big issues for us are FX and U.S. mortgage related. It feels like on both now the regulators want to begin to start to make some progress on settling with us. We would hope that sometime over the next, call it by the end of next year, we'll have settled those major items. We do sincerely hope that culturally we're changing our behavior so that we're not creating new issues.

On regulatory requirements I would say the biggest single regulatory issue out there that we're spending time on at the moment is U.K. ringfencing which will have a significant impact on our business. We'll have to create both the ringfenced bank and a non-ringfenced bank. The ringfenced bank will have to be independent, independently capitalised, independently managed and governed independently, so that is quite a big fundamental shift in terms of the way that we're set up today. We need to be there by 2019, but we obviously need to be thinking about it today.

Rohith Chandra-Rajan:

Thanks and if we move on to the second question which is focused on the U.K. government ownership just in terms of your sense of timing on when the U.K. government will begin to sell down its stake in RBS. So the options are 2014, 2015, 2016, 2017, and 2018 or after?

So it looks like this year is very unlikely so not surprising I guess; 2015 or 2016. I guess it's not your decision, it's not RBS's decision.

Ewen Stevenson:

Again we're very careful with what we say publically on this one. Obviously all we can do is make the bank a better investment story, improve the share price. I think at the bank we think it's extremely unlikely there would be a decision to privatize ahead of the election which is in May of next year. Beyond that I think we recognize when you look at all of the stuff on our corporate agenda we've got a lot to do to get the equity story back into being a great equity story. But it's not in our control. The bank management and the board would be fully supportive of any privatization event.

Rohith Chandra-Rajan:

Thank you, then moving to question three, what do you see as the biggest areas of uncertainty around RBS hitting it's medium-term target of a 9% to 11%. Return on tangible equity and the options there being uncertainty on required capital levels, the potential for U.K. bank ringfencing or implications of market reviews, implementation of the already announced cost reduction program. Thirdly, balance sheet size and scale of potential losses in RBS capital resolution. Number four, increasing competition in U.K. banking and finally returns in Corporate Institutional Banking division?

So that again is …

((Crosstalk))

Ewen Stevenson:

…around exactly what I would have -- I mean, I think two and six are very linked, as I was saying before. You know, Retail and Commercial bank sit inside the ringfence; Corporate and Institutional bank, sits outside the ringfence. As I think I was pretty clear in my presentation, we're not happy with the returns in that business. Ringfencing adds a further degree of complexity to returns. I agree.

Rohith Chandra-Rajan:

Can you talk a little more, any more, about plans for improving the returns in Corporate and Institutional?

Ewen Stevenson:

Firstly observationally, I used to work for an investment bank. I know the challenges of running a global FICC franchise, all of them are returns challenged at the moment. Our approach at the moment is to continue to try and shrink the business, simplify the business. I think we're making very, very good progress and taking costs out, taking RWAs out of the business. I don’t think we've totally solved the end-game shape of that business.

Rohith Chandra-Rajan:

Thank you and the next question is then on a broader perception of the RBS strategy. So which of the follow best presents your view of RBS's strategic plan? It's the right size, the right business mix, you prefer more focus on the U.K. Personal Business Banking segment or more focus on the U.K. Commercial and Private Banking or more on the U.K., on the Corporate Institutional, Banking side and then finally the strong operational performance already this year suggests that timing and/or targets will already be exceeded.

Ewen Stevenson:

I'm surprised at the -- well, not surprised at the 2%. Actually a bit surprised at the strength of one given the 2% but also I'd say I think people underestimate the strength and balance we have because of U.K. Commercial and Private

Banking. Again, if you think about a post-leveraged world I would argue those banks that are very heavily U.K. personal focused are going to suffer a competitive disadvantage because of the low RWA density because of mortgages. I think our business is a much more robust, solid business together.

I think the other thing too is when we look at technology it does feel like Personal Banking could be an area that five, ten years out does get attacked by the Google's and Facebook's of the world. Again, U.K. commercial banking relationships, I think, are much stronger and interlinked, much harder to break. We do have the number one franchise so I sort of put two and three together.

Rohith Chandra-Rajan:

Thank you and then the final question is really one about the broader U.K. banking landscape. So what do you see as the key features of U.K. banking environment over the next two to three years; competition rates, pace of loan growth, credit quality or regulation?

Ewen Stevenson:

Yep, agree again. I had four meetings with the regulators last week. We have a very, very heavy regulatory agenda and actually in some ways it's a good thing I must say. If you're a big bank like us, a big incumbent bank, I think a lot of the thrust of regulation is making it very, very tough for anyone other than a big incumbent bank. Very high entry costs are getting erected, very high capital liquidity funding constraints when you look at the challenger banks in the U.K, and it's very hard for them to compete effectively. So while we all sit in banks and regulation is tough on us, I think the end point is good for us ultimately.

Rohith Chandra-Rajan:

Thank you very much. We do have time for probably one or two quick questions from the floor.

Unidentified Audience Member:

Given – I'm a little surprised by the amount of focus in recent weeks on the Scottish vote and response by investors generally given that change. Can you talk practically about what would actually happen, you know, what would happen in the first two or three years do you think inside RBS if there were a yes vote?

Ewen Stevenson:

Well, to give you a sense of some of the things that we're contingency planning around, I mean, just actually we are a Scottish domiciled institution today. Most of our global markets operation is held by the Scottish entity. Our Scottish entity doesn't have the technology to deal in another currency. It's a sterling- bank. We don't know what the currencies going to be or could be under a yes vote. So there's sort of medium-term things that we think about. We know the rating agencies, for example, have said that they would rate Scotland lower than the U.K. That potentially has medium-term ratings implications for us and we need to think about that and what that does to our business. And then practically in the very, very near-term it's a sort of behavioral issue of do customers just get concerned? There's no reason to be concerned. If you can't have currency controls, you mean sterling for the next 18 months through March 2016 as the currency but you can't control people if they want to get nervous taking their money out of the bank trying to move it.

So, again, we need to do contingency planning around adverse liquidity events. And all of that being done in the context of remaining apolitical in terms of the discussion.

Rohith Chandra-Rajan:

Thanks very much for that Ewen. I'm afraid we are out of time so thank you very much.