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RBS presentation by Sir Fred Goodwin
at the UBS Global Financial Services Conference
"Is big better?"
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Alastair Ryan: Ladies and gentlemen, we will make a start. I am delighted to be able to welcome for the eight consecutive year Sir Fred Goodwin, Chief Executive of the UK's largest bank and comfortably a top ten player in deposit-taking in capital markets here in the US as well. Thank you very much indeed.

SIR FRED GOODWIN: Thank you, Alastair, and good afternoon everyone. In each of my previous appearances here I have attempted to address the conference theme or question and about this time on a number of previous occasions I wondered why because it seemed pretty abstract in the context of what was going on in the world. But this year's theme I think is relevant and is one that there are some interesting aspects to, so again in keeping with previous years I will try and answer the question. In this case the question is, is big better?

I am sure nobody is planning to read this slide, but I would draw your attention to it, the usual disclaimers.

In positioning my response to the question, I should come clean and say we would view ourselves as being big and hence my answer to the question is not going to be that big is not better. But rather than leave it there and move on to talk about some other subject, I thought I might just try and produce some substance for that view.

That said, one of the reasons I think the question is a good one is that there are some obvious disadvantages to being big. I don't think it automatically follows that big is better. Quite a lot of complexity can come with size, also quite a lot of inflexibility can come with size. It can make organisations very difficult to manage and very difficult to change.

More threatenly still, I think for many people big can become an objective in and of itself and at that point big is definitely not better. Also I think sometimes in the quest to become bigger you can get diversification to the point that the organisation become rather disjointed and the parts are disconnected from the whole. There is very little holding the organisation together other than perhaps some over-arching mogul or brand or whatever, so in that context I think big also would not be better.

Now each of these are potentially complex subjects that we could discuss at great length and in the time available this afternoon I am not sure that would be a great use of our time. What I would like to do is turn to the flip-side of the equation, which is to identify why in our view there are considerable advantages to being bigger.

The advantages would fall under the heading of diversification in the positive, and I will come on and address why I think that is an advantage. Also I think being bigger brings real benefits of scale, and I go on to give some thoughts on that. Also I think being bigger brings a far greater range of options, far greater optionality to the business, and that is generally advantageous.

Turning to the first of these then, diversification. In simple terms I believe that a larger bank can be active in multiple business segments and geographic areas. Yes, you can be active in multiple business areas, multiple segments if you are a small bank, but it is very difficult to do that at scale, and I will come on to talk about why scale is important in a minute.

So I think it is important to have diversification in the business. Apart from anything else it does reduce your dependency on any one activity or geography because the reality of the world in which we live is that no matter how good you are at any particular business activity, no matter how good the economy in a particular country is, they will inevitably go through cycles which are to varying degrees out-with the control of the individual business, so by having greater diversification I think we can insulate ourselves from that and create a model which supports more consistent growth in both income and profit.

In the case of RBS, as we have become bigger over the last five years or so we have become more diversified by business type. You will be familiar with many of the elements on this graph. The reason that the segments have become bigger is not by accident, diversification has been an integral part of our strategy throughout this period, to make ourselves less dependent on any one of the individual business lines and business activities.

Viewed another way, you can see that the component elements of our income have changed, far less reliance on net interest income, far greater contribution from non-interest income during that period, again not by accident.

Moving into some of the elements, again further diversification within the business. 19 per cent of the total income comes from fees and commissions but that is quite well broken up across money transmission, credit cards and others. Income from trading activities – that used to be known as dealing profits – is 9 per cent of the Group's total income. That proportion has remained pretty constant throughout the period, I think largely helped by the fact that we don't get involved in proprietary trading to any meaningful extent, so it is principally business which we conduct on behalf of our customers.

On the net interest income side of the equation, again quite a bit of diversity built in from the business we do for individuals, the business we do for companies, the deposit-taking business and the lending business. On a topical note, within that business a relatively small proportion of our income comes from lending money to consumers in the United Kingdom, about which there is some angst abroad at the moment.

As we look at the business by geography, again you can see during the last period we have significantly increased the proportion of our business which comes from outside the United Kingdom, again not by accident.

Looking then to the question of scale, why is scale important? I think you need an absolutely distinction between scale and size. You can make yourself bigger simply by bolting on other parts to your business. Scale is only achieved where you are adding customers or products in your existing markets on to your existing platform, and new products coming in, in existing markets, and new customers and markets coming in, all on to your existing platform.

There is a reality to our business that a signature proportion of the cost base is fixed and a significant proportion of the cost base is semi-variable, so in that context the more we can put on to our platforms, the more commonality of platform we can build, the greater the economic benefit which we can derive from scale.

Scale can be achieved not just by acquisition, scale can also be built organically. Indeed, one of the most obvious examples of that within our business has been what has happened in our Corporate Markets business. We have had no acquisitions affecting Corporate Markets over the last five years or so. It is a time when our total income has grown by 14 per cent per annum throughout that period. We have added customers, we have improved the relationships, we have leveraged some of the capabilities we had at the start of that period, acquisition finance, project finance, securitisation, all areas where we would now be amongst the Top Five banks globally.

We have also within Financial Markets sought to build scale in some of the existing product areas and to add new products on which fitted, which were if you like contiguous with our existing manufacturing platform. And we have extended that platform, still leveraged off of the same infrastructure. We have extended it into Europe and into the United States. There have been significant benefits. There has been a significant increase in the scale benefit in Corporate Markets developed and extended organically.

We have also increased the benefits of scale which we enjoy through acquisition. I know that the print may be a little small there on the slide, but the message is relatively simple, that the vast bulk of acquisitions which we have made over the last five years have been acquisitions which leverage existing capability and existing platforms and bring straightforward and direct benefits of scale. A very limited number of acquisitions we have made actually develop a platform, which we will in due course leverage by increasing the scale which we put through it.

A simple worked example of this is the Churchill Insurance business, which we bought during 2003. Churchill was in essentially the same business as Direct Line. We built Direct Line from scratch. Direct Line was the number one motor insurer in the UK but had quite a small position in home insurance. Churchill was bigger in home insurance than motor.

By bringing the two businesses together and putting Churchill on to the RBS manufacturing platform, by putting it on to the Direct Line pricing engine, by giving it the Direct Line product capability, by giving it access to capital, it having been starved of capital by its previous owner, by putting it on to the same IT platform and combining Head Office functions, we took a business which made £86 million in 2002 - a business which we acquired in the middle of 2003 - and by September 2005 the business was making over £200 million per annum profit. A very simple example of the benefits of scale being applied to a business which we acquired in activities in a market in which we are already operating.

A similar tale here in the United States. Citizens back in 2000 was many things but significant on a national scale it was not. Through a series of acquisitions, mostly notably of the Mellon retail banking franchise and latterly through the acquisition of Charter One, we have moved to a position where it has now got real scale in all the markets in which it operates and in all of the activities in which it operates. You can see down at the bottom of this slide there the attendant income benefit which has been derived from that, and this is by no means a finished article as yet.

Another way to look at the benefit of scale is the efficiency of the platform. Have we brought that platform together in a way which is efficient? Just to give you a sense and also perhaps point up to some of the benefits which seem to accrue from scale, if you compare Citizens cost:income ratio, and again I would emphasise this is not the finished article, we would intend to improve on that cost:income ratio, we are still in a good place relative to the large-cap, mid-cap and small-cap competitors.

An important element and something you would spent the afternoon on in of itself would be the manufacturing platform and how we brought those benefits of scale around. As I say, it is not just a question of adding different businesses into the Group, to drive these benefits out you need to leverage platforms, leverage the fixed cost base, leverage the semi-variable cost base, and manufacturing is the vehicle through which we do it. It is an afternoon's presentation in itself and I am not going to go into here today.

That said, to pick out one element of it, even just Group Purchasing. Even by just buying things together, and this is all at one level extraordinarily mundane, but at another level you are procuring something like paper at 20 per cent below the industry average cost feels like quite a good place to be and quite a good benefit to have. Procuring our media or procuring our advertising at 10 per cent below the industry average and procuring IT equipment at 20 per cent below are real benefits which have been harnessed through that manufacturing platform.

The cost of funds is another benefit, fairly self-evidently, and there is a not surprising correlation between credit ratings and cost of funds and the size of the business. There you will see on the slide, by virtue of being bigger, we enjoy a better credit rating than we did historically and a credit rating which stands comparison with our peers.

Finally, in terms of the big is better or is big better question? And a response to why we think it is, the options which it gives the business. Being in a greater range of businesses but nevertheless businesses which are related with one another and being in different geographies does in and of itself present further options and greater options for growth. It also gives us some of the scale and resources that we need to pursue those options. That said, some of the options which we enjoy are developed – we actively develop them ourselves – and some come along by 'happen stance', simply by virtue of being operational in the way and at the scale which we are.

An example of an option we have created for ourselves, none more obviously than the one here in the United States. Having had the Citizens business, by growing that business we have created far greater options for ourselves. Our options for Citizens are no longer confined to New England or Rhode Island in fact, where they were confined to at the time when this all started out back in 1988 or so.

The options are no longer confined simply to retail banking. We have got a card issuing platform, we have got a merchant acquiring platform and, most significantly of all, we are now moving to develop the corporate banking opportunities which having the corporate banking business we have here, coupled with the Citizens franchise on the ground, the opportunity which those assets allow us to develop is quite significant optionality for the Group.

At the other end of the spectrum you could say 'happen stance' opportunities, options which come along more opportunistically. The most obvious one there is our relationship with the Bank of China, where through the strategic partnership which we formed and the small equity stake which we have taken we have now opened up a whole series of options for ourselves within China both in areas of business co-operation and in areas of infrastructure co-operation. And obviously we are looking forward to the IPO of Bank of China about which much is being reported at this time.

So is getting bigger making us better? Well, you have guessed the answer. I would put forward the notion that it is, and that it has, and nowhere more so than in growth. I think the most important thing about being bigger is that it is being achieved by growth and growth on a basis and growth in terms which are economically attractive to the business.

Over the last five years we have grown our income a lot but, most importantly, the figure highlighted down at the bottom of the slide there, the growth has by far been dominated by organic growth. In simple terms and for all practical purposes we have organically grown a NatWest since 2000. At £8.7 billion to £8.8 billion, that is roughly what NatWest made at the time we took it over, or that was what its income was at the time we took it over. So we have organically grown a NatWest and that growth has been pretty well spread through the period.

These figures on this slide you may be familiar with. These figures have also been published - the figures with acquisitions stripped out and at constant currency - and again you will see a clear underlying trend of strong organic growth in income and strong organic growth in operating profit.

The 2005 results you would have seen. I will not go back over these again other than to just highlight again that organic continued and it came on top of the strong Tier 1 capital ratio and a strong return on equity.

In the United States, some of the Citizens growth in that slide was certainly influenced by the fact that we had not owned Charter One for the full previous year, but the corporate markets growth was all organic. Our growth in Europe was all organic. Our growth in Asia Pacific was all organic.

On this slide, the efficiency of the Group cost:income ratio. You have seen it before. That compares extremely favourably. Some of the growth has been achieved in a manner which has enabled us to bring our cost:income ratio down from about 60 per cent to just over 40 per cent.

We have also done it while growing our earnings per share. Here on this slide is our growth compared to all of our competitors over that five year period. We have also done it while improving our return on equity.

We have also done it while generating capital. Here on this slide is the gross capital generated in the business in each of those years and here are some of the uses of the capital. Some of it had to go to support organic growth and some of it has been returned to Shareholders in the form of the dividends and, of course, there were the AVS shares where we returned capital to Shareholders and acquisitions which consumed some. We have achieved very significant capital generation through a period of growth that I have just highlighted.

So, in conclusion, I would suggest in addressing the question is big better, size in and of itself does not matter and size in and of itself is unimportant. What matters is diversification - your ability to deliver superior growth and income and earnings is dependent on diversification. Scale matters; scale matters a lot more than size, and having options is important.

In the final, final conclusion I guess I would state what was hopefully obvious from the presentation itself, which was that RBS is diversified, RBS has scale, RBS has options. So I think from an RBS perspective I would leave you with the thought that big is better. Thank you very much for listening.

I will now be happy to try and answer any questions which there might be!

QUESTION: Perhaps if I kick-off, Sir Fred. Does the UK and the traditional Citizens footprint in New England still provide you with material growth opportunities? Clearly your market shares in both those geographies are very strong, driven by your historic rates of growth. Can you still look forward to decent growth rates from those sort of legacy parts of the business?

SIR FRED GOODWIN: Absolutely! Obviously the Citizens footprint now extends well beyond New England and New England would be almost the minority now of the footprint. But even in New England, where we have been for a very long time, we are generating very meaningful returns. The interesting part, if you want to look at individual product market shares, they are still relatively modest.

In the United Kingdom, for all that we have been growing as strongly as we have been, you have got to look at some of the product shares, shares of deposits would be about 8 per cent, shares of mortgages would be about 9 per cent, long term savings would be - we would struggle to get to 5 per cent of the market notwithstanding 2005 having been a record year for bancassurance sales. The list goes on and on! We are one of the biggest players but actually market share across a number of the products is still relatively modest. (A pause)

Anyone else?

QUESTIONER: Well, perhaps then if I could just ask one more? You mentioned the opportunities to take Citizens up into your corporate business and your Greenwich Capital business, trying it out down in the US. Could you scale that for us, how much of a cost commitment it is, how much your revenue opportunities, and how long does it take?

SIR FRED GOODWIN: I think it is certainly a significant opportunity. We would not be anticipating anything in terms of costs that would get special mention. I think we would look to build the business out organically through adding the resource in. We have got the platform. It is more a question now of adding on the resource in the form of people and relationship managers.

The area we are particularly focusing on is a piece below the Fortune 1,000 but above SMEs, where we would see a market place which was formerly inhabited by a dozen or so banks in this country which is now down to being the domain of about three.

One of the reasons why, or the principal reason why, we would feel able to pursue the opportunities there is firstly because of our scale and skill in corporate banking, but to serve those companies properly you also need representation on the ground which we now have within the Citizens footprint. So for that combination of reasons we would see that as being quite a significant opportunity, but it is not one which we would expect to disturb, if you like, normal delivery of income and profit.

QUESTION: As there are no other questions, I wanted to know if you could share your thoughts on all the rumours going on, on UK banking consolidation, including RBS?

SIR FRED GOODWIN: What is going on in UK banking consolidation? Not an awful lot at the moment. We are certainly not looking to buy anything in the UK. There is very little there which we would see as being attractive or that we would be allowed to buy.

There have been some rumours, which you would have read in the same way as we have, about some of the NAB subsidiaries, there have been some rumours about Bradford & Bingley, and there have been some rumours about Alliance & Leicester, but I don't know that I could shed any particular light on it. Those would seem to be the main or the most frequently mentioned potential targets.

As in many markets though the prices would seem pretty high, so I am not sure who a buyer would be - that would be allowed to buy these businesses in terms of creating, and some of the market shares that would be involved if it was an incumbent in the UK market trying to take over - I am not sure who would be allowed to buy them and I am not sure I can think of someone from overseas where they could buy them and generate enough synergies to make the premium and the price worthwhile.

That's not very helpful I know, but that is the best I can manage. There has been a lot of talk but not a lot of action!

QUESTION: Could you talk about the asset quality in the US as well as in the UK, the current trends you are seeing and expectations for this year and next?

SIR FRED GOODWIN: I have got Larry Fish with me who runs our US business. If I start off with the UK and by the time we have done that somebody may be will have a microphone and Larry can pick off the US piece. He is just down at the front here!

In the UK, steady as we go I think. We saw a marked step up. No, actually I need to go back and split it into two parts. Everything to do with corporate credit in the UK is very strong indeed and corporate for this purpose would extend down to and include SMEs. If I can find some wood to touch here - I think this is wood and I will hold on to it! - credit quality is extremely good.

As you move across into the personal domain, we saw a marked increase in credit costs during late 2004, early 2005. In some of those trends we saw a very sharp uptake. The sharp uptake has ameliorated somewhat, has levelled off somewhat, and at this stage we would be hoping that we are getting close to the worst, or the worst may have passed, but I think it would be someone extremely brave at this point who would predict that we are absolutely passed the peak.

But the rate of growth has been slowing down. You would want to watch very carefully what happens with unemployment and I think there is still a propensity for things to get worst rather than better. But, touch wood, I think it has turned out so far rather better than many commentators thought it might. It is also I think relevant to note that the passage even of six months of time is quite significant in terms of the life span of unsecured credit.

The typical life of an unsecured loan is about three years and so if you pass off another six months without it getting into arrears it means that repayments have been getting made for that six months, so the amount of the exposure has come down.

Everything and anything to do with mortgages will include a very low level of arrears and at any time you can practically count on one hand the number of repossessions and sales which there have been. But the asset value of properties is still such that there is nothing there to worry about; the average LTD across our whole book would be below 50 per cent.

So on credit quality, the focus is very much on unsecured personal debt. It may well be that the high water mark was in the early part of last year, but it would be a brave man that said that for sure.

Larry, do you want to talk to the US!

MR. LARRY FISH: Good afternoon, everybody. Can you hear this? I am not sure where the question came from?

SIR FRED GOODWIN: At the back of the room there!

MR. FISH: But credit quality in the States for almost all banks is outstandingly good, consumer delinquencies are at record lows, commercial charge-offs are at low levels and banks are growing down reserves, and that usually means the end of a cycle rather than the beginning.

Specifically to Citizens, however, on the consumer side we do not do sub-prime, we do not do near-prime and we do very little unsecured consumer lending. So we have always had a very good track record with regard to consumer lending. On the commercial side, we don't lend out of region and 85 per cent of our commercial loans are secured. So knock-on-wood, at other times in the cycles we have fared very well and I hope we will do it again. But I think overall the credit cycle is about as good as it is going to get in the States at the moment.

SIR FRED GOODWIN: Thank you, Larry. (A pause)

Anything else? (A pause) Okay. Thank you.

A SPEAKER: If there are no further questions, there is a break-out session starting immediately after this in the Carnegie Room which is one level down. Thank you very much indeed, Sir Fred. (Applause)

(The proceedings then terminated).