ROYAL BANK OF SCOTLAND GROUP PLC
Form 20-F
March 27, 2013

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 20-F

(Mark One)

o REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE SECURITIES EXCHANGE ACT OF 1934
OR

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2012
OR

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
OR

o SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Commission file number: 001-10306

THE ROYAL BANK OF SCOTLAND GROUP plc
(Exact name of Registrant as specified in its charter)

United Kingdom
(Jurisdiction of incorporation)

RBS Gogarburn, PO Box 1000, Edinburgh EH12 1HQ, United Kingdom
(Address of principal executive offices)

Aileen Taylor, Group Secretary, Tel: +44 (0) 131 626 4099, Fax: +44 (0) 131 626 3081

PO Box 1000, Gogarburn, Edinburgh EH12 1HQ
(Name, Telephone, E-mail and/or Facsimile number and Address of Company Contact Person)

Securities registered or to be registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
	New York Stock Exchange

American Depositary Shares, each representing 2 ordinary shares, nominal value £1 per share	New York Stock Exchange*
Ordinary shares, nominal value £1 per share	New York Stock Exchange
American Depositary Shares Series F, H, L, M, N, P, Q, R, S, T and	New York Stock Exchange
U each representing one Non-Cumulative Dollar Preference Share,	New York Stock Exchange
Series F, H, L, M, N, P, Q, R, S, T and U respectively	New York Stock Exchange
Senior Floating Rate Notes due 2013	New York Stock Exchange
3.400% Senior Notes due 2013	New York Stock Exchange
3.250% Senior Notes due 2014	New York Stock Exchange
3.950% Senior Notes due 2015	New York Stock Exchange
4.875% Senior Notes due 2015	New York Stock Exchange
4.375% Senior Notes due 2016	New York Stock Exchange
5.625% Senior Notes due 2020	New York Stock Exchange
6.125% Senior Notes due 2021	NYSE MKT
6.125% Subordinated Tier 2 Notes due 2022	NYSE MKT
2.550% Senior Notes due 2015	NYSE Arca
Structured HybrId Equity LinkeD Securities (SHIELDS) due	NYSE Arca
January 16, 2014 linked to the S&P 500 Index	NYSE Arca
Leveraged CPI Linked Securities due January 13, 2020	NYSE Arca
RBS US Large Cap TrendpilotTM Exchange Traded Notes due	NYSE Arca
December 7, 2040	NYSE Arca
RBS US Mid Cap TrendpilotTM Exchange Traded Notes due	NYSE Arca
January 25, 2041	NYSE Arca
RBS Gold TrendpilotTM Exchange Traded Notes due February 15,	NYSE Arca
2041	NYSE Arca
RBS Oil TrendpilotTM Exchange Traded Notes due September 13,	NYSE Arca
2041	NYSE Arca
RBS Global Big Pharma Exchange Traded Notes due October 25,	NYSE Arca
2041	
RBS NASDAQ-100® TrendpilotTM Exchange Traded Notes due December 13, 2041	
RBS China TrendpilotTM Exchange Traded Notes due April 18, 2042	
RBS US Large Cap Alternator Exchange Traded NotesTM due September 5, 2042	
RBS Rogers Enhanced Commodity Index Exchange Traded Notes due October 29, 2042	
RBS Rogers Enhanced Agriculture Exchange Traded Notes due October 29, 2042	
RBS Rogers Enhanced Energy Exchange Traded Notes due October 29, 2042	
RBS Rogers Enhanced Precious Metals Exchange Traded Notes due October 29, 2042	
RBS Rogers Enhanced Industrial Metals Exchange Traded Notes due October 29, 2042	

* Not for trading, but only in connection with the registration of American Depositary Shares representing such ordinary shares pursuant to the requirements of the Securities and Exchange Commission.

Securities registered or to be registered pursuant to Section 12(g) of the Act:

None

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act:

None

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of December 31, 2012, the close of the period covered by the annual report:

(Title of each class)	(Number of outstanding shares)
Ordinary shares of £1 each	6,070,765,155
B Shares	51,000,000,000
Dividend Access Share	1
11% cumulative preference shares	500,000
5½% cumulative preference shares	400,000
Non-cumulative dollar preference shares, Series F, H and L to U	209,609,154
Non-cumulative convertible dollar preference shares, Series 1	64,772
Non-cumulative euro preference shares, Series 1 to 3	2,044,418
Non-cumulative convertible sterling preference shares, Series 1	14,866
Non-cumulative sterling preference shares, Series 1	54,442

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

x Yes o No

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

o Yes x No

Note – Checking the box above will not relieve any registrant required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 from their obligations under those Sections.

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

x Yes o No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

o Yes o No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer x Accelerated filer o Non-Accelerated filer o

Indicate by check mark which basis of accounting the registrant has used to prepare the financial statements included in this filing:

o U.S. GAAP

x International Financial Reporting Standards as issued by the International Accounting Standards Board

o Other

If "Other" has been checked in response to the previous question, indicate by check mark which financial statement item the registrant has elected to follow.

o Item 17 o Item 18

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

o Yes x No

SEC Form 20-F cross reference guide

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Presentation of information

In this document, and unless specified otherwise, the term 'company' or 'RBSG' means The Royal Bank of Scotland Group plc, 'RBS', 'RBS Group' or the 'Group' means the company and its subsidiaries, 'the Royal Bank' means The Royal Bank of Scotland plc and 'NatWest' means National Westminster Bank Plc.

The company publishes its financial statements in pounds sterling ('£' or 'sterling'). The abbreviations '£m' and '£bn' represent millions and thousands of millions of pounds sterling, respectively, and references to 'pence' represent pence in the United Kingdom ('UK'). Reference to 'dollars' or '$' are to United States of America ('US') dollars. The abbreviations '$m' and '$bn' represent millions and thousands of millions of dollars, respectively, and references to 'cents' represent cents in the US. The abbreviation '€' represents the 'euro', the European single currency, and the abbreviations '€m' and '€bn' represent millions and thousands of millions of euros, respectively.

Certain information in this report is presented separately for domestic and foreign activities. Domestic activities primarily consist of the UK domestic transactions of the Group. Foreign activities comprise the Group's transactions conducted through those offices in the UK specifically organised to service international banking transactions and transactions conducted through offices outside the UK.

The geographic analysis in the Business Review, including the average balance sheet and interest rates, changes in net interest income and average interest rates, yields, spreads and margins in this report have been compiled on the basis of location of office - UK and overseas. Management believes that this presentation provides more useful information on the Group's yields, spreads and margins of the Group's activities than would be provided by presentation on the basis of the domestic and foreign activities analysis used elsewhere in this report as it more closely reflects the basis on which the Group is managed. 'UK' in this context includes domestic transactions and transactions conducted through the offices in the UK which service international banking transactions.

The results, assets and liabilities of individual business units are classified as trading or non-trading based on their predominant activity. Although this method may result in some non-trading activity being classified as trading, and vice versa, the Group believes that any resulting misclassification is not material.

International Financial Reporting Standards
As required by the Companies Act 2006 and Article 4 of the European Union IAS Regulation, the consolidated financial statements of the Group are prepared in accordance with International Financial Reporting Standards issued by the International Accounting Standards Board (IASB) and interpretations issued by the IFRS Interpretations Committee of the IASB as adopted by the European Union (together 'IFRS'). They also comply with IFRS as issued by the IASB.

RBS Holdings N.V. (formerly ABN AMRO Holding N.V.)
In 2007, RFS Holdings B.V., which was jointly owned by the Group, the Dutch State (successor to Fortis) and Santander (together, the "Consortium Members") completed the acquisition of ABN AMRO Holding N.V.

On 1 April 2010, the businesses acquired by the Dutch State were transferred to ABN AMRO Group N.V., itself owned by the Dutch State. In connection with the transfer ABN AMRO Holding N.V. was renamed RBS Holdings N.V. and its banking subsidiary was renamed The Royal Bank of Scotland N.V. ("RBS N.V."). Certain assets of RBS N.V. continue to be shared by the Consortium Members.

In October 2011, the Group completed the transfer of a substantial part of the UK activities of RBS N.V. to the Royal Bank pursuant to Part VII of the UK Financial Services and Markets Act 2000. Substantially all of the Netherlands

and EMEA businesses were transferred in September 2012. Further transfers are expected to take place during 2013 but are subject to certain authorisations including regulatory approval where necessary. The Group now anticipates that the transfers in China will be completed at a later date.

Presentation of information continued

Non-GAAP financial information
The directors manage the Group's performance by class of business, before certain reconciling items, as is presented in the segmental analysis on pages 424 to 431 (the "managed basis"). Discussion of the Group's performance focuses on the managed basis as the Group believes that such measures allow a more meaningful analysis of the Group's financial condition and the results of its operations. These measures are non-GAAP financial measures. A body of generally accepted accounting principles such as IFRS is commonly referred to as 'GAAP'. A non-GAAP financial measure is defined as one that measures historical or future financial performance, financial position or cash flows but which excludes or includes amounts that would not be so adjusted in the most comparable GAAP measure. Reconciliations of these non-GAAP measures are presented throughout this document or in the segmental analysis on pages 424 to 431. These non-GAAP financial measures are not a substitute for GAAP measures. Furthermore, RBS has divided its operations into "Core" and "Non- Core". Certain measures disclosed in this document for Core operations and used by RBS management are non-GAAP financial measures as they represent a combination of all reportable segments with the exception of Non-Core. In addition, RBS has further divided parts of the Core business into "Retail & Commercial" consisting of the UK Retail, UK Corporate, Wealth, International Banking, Ulster Bank and US Retail & Commercial divisions. This is a non-GAAP financial measure. Lastly, the Basel III net stable funding ratio (see page 108) represents a non-GAAP financial measure given it is a metric that is not yet required to be disclosed by a government, governmental authority or self-regulatory organisation.

Disposal groups
Since 2011, the assets and liabilities relating to the RBS England and Wales and NatWest Scotland branch-based businesses, along with certain SME and corporate activities across the UK ('UK branch-based businesses'), were classified within Disposal groups. Santander's withdrawal from the sale in October 2012 has led the Group to conclude that a sale within 12 months is unlikely; accordingly the balance sheet at 31 December 2012 does not classify the assets and liabilities of the UK branch-based businesses within Disposal groups. IFRS 5 'Non-current Assets Held for Sale and Discontinued Operations' does not permit restatement on reclassification.

Discontinued operations
The Group sold the first tranche (34.7%) of the share capital of Direct Line Insurance Group plc (DLG) in October 2012 via an Initial Public Offering (IPO), consistent with the plan to cede control by the end of 2013. In accordance with IFRS 5, DLG has been recognised as a discontinued operation with consequent changes to the presentation of comparative information. The assets and liabilities relating to DLG are included in Disposal groups as at 31 December 2012.

Share consolidation
Following approval at the Group's Annual General Meeting on 30 May 2012, the sub-division and consolidation of the Group's ordinary shares on a one-for-ten basis took effect on 6 June 2012. Consequently, prior year disclosures relating to or affected by numbers of ordinary shares or share price have been restated.

Glossary
A glossary of terms is provided on pages 494 to 501.

Forward-looking statements

Certain sections in this document contain ‘forward-looking statements’ as that term is defined in the United States Private Securities Litigation Reform Act of 1995, such as statements that include the words ‘expect’, ‘estimate’, ‘project’, ‘anticipate’, ‘believes’, ‘should’, ‘intend’, ‘plan’, ‘could’, ‘probability’, ‘risk’, ‘Value-at-Risk (VaR)’, ‘target’, ‘goal’, ‘objectiv ‘endeavour’, ‘outlook’, ‘optimistic’, ‘prospects’ and similar expressions or variations on such expressions.

In particular, this document includes forward-looking statements relating, but not limited to: the Group’s restructuring plans, divestments, capitalisation, portfolios, net interest margin, capital ratios, liquidity, risk weighted assets (RWAs), return on equity (ROE), profitability, cost:income ratios, leverage and loan:deposit ratios, funding and risk profile; discretionary coupon and dividend payments; certain ring-fencing proposals; sustainability targets; regulatory investigations; the Group’s future financial performance; the level and extent of future impairments and write-downs, including sovereign debt impairments; and the Group’s potential exposures to various types of political and market risks, such as interest rate risk, foreign exchange rate risk and commodity and equity price risk. These statements are based on current plans, estimates and projections, and are subject to inherent risks, uncertainties and other factors which could cause actual results to differ materially from the future results expressed or implied by such forward-looking statements. For example, certain market risk disclosures are dependent on choices about key model characteristics and assumptions and are subject to various limitations. By their nature, certain of the market risk disclosures are only estimates and, as a result, actual future gains and losses could differ materially from those that have been estimated.

Other factors that could cause actual results to differ materially from those estimated by the forward-looking statements contained in this document include, but are not limited to: global economic and financial market conditions and other geopolitical risks, and their impact on the financial industry in general and on the Group in particular; costs or exposures borne by the Group arising out of the origination or sale of mortgages or mortgage-backed securities in the US; the continuing economic crisis in Europe; competition and consolidation in the banking sector; political risks; the risk of full nationalisation of the Group and its UK bank subsidiaries; HM Treasury exercising influence over the operations of the Group and any proposed offer or sale of its interest affecting the price of securities issued by the Group; the extent of future write-downs and impairment charges caused by depressed asset valuations; deteriorations in borrower and counterparty credit quality; the value or effectiveness of any credit protection purchased by the Group; changes in interest rates, yield curves, foreign currency exchange rates, credit spreads, bond prices, commodity prices, equity prices and basis, volatility and correlation risks; changes in required contributions to compensation schemes in respect of banks and other authorised financial services firms that are unable to meet their obligations to customers; pension fund shortfalls; the ability to access sufficient sources of capital, liquidity and funding when required; ineffective management of capital or changes to capital adequacy or liquidity requirements; changes in the credit ratings of the Group and the UK Government; the ability to access the contingent capital arrangements with HM Treasury and the conversion of the Contingent B Shares in accordance with their terms; changes in UK and foreign laws, regulations, accounting standards and taxes, including changes in regulatory capital regulations and liquidity requirements; the ability to implement strategic plans on a timely basis, or at all, including the disposal of certain non-core assets and of certain assets and businesses required as part of the State Aid restructuring plan; regulatory or legal changes (including those requiring any restructuring of the Group’s operations) in the UK, the US and other countries in which the Group operates or a change in UK Government policy; changes to the monetary and interest rate policies of central banks and other governmental and regulatory bodies; resolution procedures under current and proposed resolution and recovery schemes which may result in various actions being taken in relation to any securities of the Group; organisational restructuring in response to legislative and regulatory proposals in the United Kingdom (UK), European Union (EU) and United States (US); the implementation of recommendations made by the Independent Commission on Banking and their potential implications and equivalent EU and US legislation; litigation, government and regulatory investigations including investigations relating to the setting of LIBOR and

other interest rates; changes to the valuation of financial instruments recorded at fair value; impairments of goodwill; the ability of the Group to generate sufficient future taxable profits to recover certain deferred tax assets; general operational risks; the Group's dependency on its information technology systems; employee misconduct; reputational risk; the ability of the Group to attract or retain senior management or other key employees; insurance claims; limitations on, or additional requirements imposed on, the Group's activities as a result of HM Treasury's investment in the Group; and the success of the Group in managing the risks involved in the foregoing.

The forward-looking statements contained in this document speak only as of the date of this announcement, and the Group does not undertake to update any forward-looking statement to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

The information, statements and opinions contained in this document do not constitute a public offer under any applicable legislation or an offer to sell or solicitation of any offer to buy any securities or financial instruments or any advice or recommendation with respect to such securities or other financial instruments.

Business review

Description of business

Introduction

The Royal Bank of Scotland Group plc is the holding company of a large global banking and financial services group. Headquartered in Edinburgh, the Group operates in the United Kingdom, the United States and internationally through its principal subsidiaries, the Royal Bank and NatWest. Both the Royal Bank and NatWest are major UK clearing banks. In the United States, the Group's subsidiary RBS Citizens is a large commercial banking organisation. Globally, the Group has a diversified customer base and provides a wide range of products and services to personal, commercial and large corporate and institutional customers.

Following the placing and open offers in December 2008 and in April 2009, HM Treasury owned approximately 70.3% of the enlarged ordinary share capital of the company. In December 2009, the company issued a further £25.5 billion of new capital to HM Treasury. This new capital took the form of B shares, which do not generally carry voting rights at general meetings of ordinary shareholders but are convertible into ordinary shares and qualify as Core Tier 1 capital. Following the issuance of the B shares, HM Treasury's holding of ordinary shares of the company remained at 70.3% although its economic interest rose to 84.4%.

At 31 December 2012, HM Treasury’s holding in the company’s ordinary shares was 65.3% and its economic interest was 81.1%.

The Group had total assets of £1,312.3 billion and owners' equity of £68.1 billion at 31 December 2012. The Group's risk asset ratios at 31 December 2012, were a Total capital ratio of 14.5%, a Core Tier 1 capital ratio of 10.3% and a Tier 1 capital ratio of 12.4%.

Organisational structure and business overview

Organisational change

In January 2012, the Group announced changes to its wholesale banking operations in light of a changed market and regulatory environment. The changes saw the reorganisation of the Group’s wholesale businesses into ‘Markets’ and ‘International Banking’ and the exit from and downsizing of selected activities. The changes ensure the wholesale businesses continue to deliver against the Group’s strategy.

The changes include an exit from cash equities, corporate brokering, equity capital markets and mergers and acquisitions advisory businesses. Significant reductions in balance sheet, funding requirements and cost base in the remaining wholesale businesses will be implemented.

Global Banking & Markets (GBM) and Global Transaction Services (GTS) divisions have been reorganised as follows:

- The ‘Markets’ business maintains its focus on fixed income, with strong positions in debt capital raising, securitisation, risk management, foreign exchange and rates. It will serve the corporate and institutional clients of all Group businesses.

- GBM's corporate banking business has been combined with the international businesses of the GTS arm into a new ‘International Banking’ unit and provides clients with a 'one-stop shop' access to the Group’s debt financing, risk management and payments services. This international corporate business will be self-funded through its stable corporate deposit base.

- The domestic small and mid-size corporates previously served by GTS are now managed within RBS's domestic corporate banking businesses in the UK, Ireland (Ulster Bank) and the US (US Retail & Commercial).

Our wholesale business retains its international footprint ensuring that it can serve our customers' needs globally. We believe that, despite current challenges to the sector, wholesale banking services can play a central role in supporting cross border trade and capital flows, financing requirements and risk management and we remain committed to this business.

The Group’s activities are organised on a divisional basis as follows:

UK Retail offers a comprehensive range of banking products and related financial services to the personal market. It serves customers through a number of channels including: the RBS and NatWest network of branches and ATMs in the United Kingdom, telephony, online and mobile. UK Retail remains committed to delivering ‘Helpful and Sustainable’ banking and to the commitments set out in its Customer Charter - the results of which are externally assessed and published every six months.

UK Corporate is a leading provider of banking, finance and risk management services to the corporate and SME sector in the United Kingdom. It offers a full range of banking products and related financial services through a nationwide network of relationship managers, and also through telephone and internet channels. The product range includes asset finance through the Lombard brand.

Wealth provides private banking and investment services in the UK through Coutts & Co and Adam & Company, offshore banking through RBS International, NatWest offshore and Isle of Man Bank, and international private banking through Coutts & Co Ltd.

International Banking serves the world’s largest companies with a leading client proposition focused on financing, transaction services and risk management. International Banking serves as the delivery channel for Markets products to corporate clients and serves international subsidiaries of both International Banking and clients from UK Corporate, Ulster Bank and US Retail & Commercial through its international network.

Ulster Bank is a leading retail and commercial bank in Northern Ireland and the Republic of Ireland. It provides a comprehensive range of financial services through both its Retail Banking division, which provides loan and deposit products through a network of branches and direct channels, and its Corporate Banking division, which provides services to businesses and corporate customers.

US Retail & Commercial provides financial services primarily through the Citizens and Charter One brands. US Retail & Commercial is engaged in retail and corporate banking activities through its branch network in 12 states in the United States and through non-branch offices in other states.

The divisions discussed above are collectively referred to as Retail & Commercial.

Business review continued

Markets is a leading origination, sales and trading business across debt finance, fixed income, currencies and investor products. The division offers a unified service to the Group's corporate and institutional clients. The Markets' sales and research teams build strong ongoing client partnerships, provide market perspective and access, and work with the division's trading and structuring teams to meet the client's objectives across financing, risk management, investment, securitisation and liquidity.

Direct Line Group is a retail general insurer with leading market positions in the United Kingdom, a strong presence in the direct motor channel in Italy and Germany and a focused position in UK SME commercial insurance. The Group operates under highly recognised brands such as Direct Line and Churchill and is comprised of five primary segments: motor, home, rescue and other personal lines, commercial and international.

In the UK, Direct Line Group utilises a multi-brand, multi-product and multi-distribution channel business model that covers most major customer segments for personal lines general insurance. The Group also has a focused presence in the commercial market. The Group occupies leading market positions in terms of in-force policies and has the most highly recognised brands in the UK for personal motor and home insurance including Direct Line and Churchill. Other primary Direct Line Group brands include Privilege and Green Flag; NIG, a provider of insurance solutions to UK SMEs and Direct Line For Business ("DL4B"), the Group's direct commercial brand. The Group is also a major provider of insurance through a number of strategic partnerships. In Italy and Germany the Group operates under the Direct Line brand. It is planned for control of DLG to be ceded by the end of 2013.

Central Functions comprises Group and corporate functions, such as treasury, finance, risk management, legal, communications and human resources. The Centre manages the Group's capital resources and Group-wide regulatory projects and provides services to the operating divisions.

Non-Core division manages separately assets that the Group intends to run off or dispose of. The division contains a range of businesses and asset portfolios primarily from the legacy GBM businesses, higher risk profile asset portfolios including excess risk concentrations, and other illiquid portfolios. It also includes a number of other portfolios and businesses including regional markets businesses that the Group has concluded are no longer strategic.

Business Services supports the customer-facing businesses and provides operational technology, customer support in telephony, account management, lending and money transmission, global purchasing, property and other services. Business Services drives efficiencies and supports income growth across multiple brands and channels by using a single, scalable platform and common processes wherever possible. It also leverages the Group's purchasing power and is the Group's centre of excellence for managing large-scale and complex change. For reporting purposes, Business Services costs are allocated to the divisions above. It is not deemed a reportable segment.

Business divestments

To comply with the European Commission State aid requirements the Group agreed a series of restructuring measures to be implemented over a four year period from December 2009. These measures supplement the Strategic Plan previously announced by the Group. These include the divestment of Direct Line Insurance Group plc, the sale of 80.01% of the Group's Global Merchant Services business (completed in 2010) and the sale of substantially all of the RBS Sempra Commodities joint venture business (largely completed in 2010), as well as the divestment of the RBS branch-based business in England and Wales and the NatWest branches in Scotland, along with the direct SME customers across the UK.

In 2010, the Group reached agreement with Santander UK plc (‘Santander’) on the sale of certain UK branch-based businesses broadly comprising the RBS branch-based business in England and Wales and the NatWest branch-based business in Scotland, along with certain SME and corporate activities across the UK. However, in October 2012, the Group announced that it had received notification of Santander’s decision to pull out of its agreed purchase of these businesses. Santander's decision followed extensive work by both parties to separate the businesses into a largely standalone form and to prepare the businesses, customers and staff for transfer. RBS is continuing to work to fulfil its obligations to divest these businesses.

Also in October 2012, the Group sold via an initial public offering 520.8 million ordinary shares in Direct Line Insurance Group plc, representing 34.7% of the total issued share capital. This is consistent with the European Commission’s requirement to cede control by the end of 2013 and complete full divestment from the Group by the end of 2014.

Recent developments

Liability Management Exercise

In January 2013, The Royal Bank of Scotland plc completed a cash tender offer for approximately £2 billion principal amount of certain US Dollar, Euro, Sterling, Swiss Franc and Singapore Dollar denominated senior unsecured securities.

Markets & International Banking Executive changes

On 6 February 2013, the Group announced that John Hourican, Chief Executive, Markets & International Banking, will leave the Group once he has completed a handover of his responsibilities. With effect from 1 March 2013, Suneel Kamlani and Peter Nielsen will be co-heads of the Markets division and John Owen will continue to lead the International Banking division and will all report directly to the Group Chief Executive.

Sale of Direct Line Insurance Group plc ordinary shares

On 13 March 2013, the Group announced a further sale of its stake in Direct Line Insurance Group plc. The further sale resulted in RBS selling 251.4 million shares, raising gross proceeds of £505 million. The Group now holds 48.5% of the issued ordinary share capital of Direct Line Insurance Group plc.

Executive director

Joe MacHale will step down from the Board on 4 May 2013.

Business review continued

Competition

The Group faces strong competition in all the markets it serves. Banks' balance sheets have strengthened whilst loan demand remains subdued as many customers continue to delever and the UK economy has remained weak. Competition for retail deposits remains strong as institutions continue to target strong and diverse funding platforms for their balance sheets.

Competition for corporate and institutional customers in the UK and abroad is from UK banks and from large foreign universal banks that offer combined investment and commercial banking capabilities. In addition, the Group's Markets division faces strong competition from dedicated investment banks. In asset finance, the Group competes with banks and specialist asset finance providers, both captive and non-captive. In European and Asian corporate and institutional banking markets the Group competes with the large domestic banks active in these markets and with the major international banks.

In the small business banking market, the Group competes with other UK clearing banks, specialist finance providers and building societies.

In the personal banking segment, the Group competes with UK clearing banks and building societies, major retailers and life assurance companies. In the mortgage market, the Group competes with UK clearing banks and building societies. The ambitions of non-traditional players in the UK market remain strong, with new entrants active and potentially seeking to build their platforms by acquiring businesses made available through restructuring of incumbents. The Group distributes life assurance products to banking customers in competition with independent advisors and life assurance companies.

In the UK credit card market large retailers and specialist card issuers are active in addition to the UK banks. In addition to physical distribution channels, providers compete through direct marketing activity and the internet.

In Wealth Management, The Royal Bank of Scotland International competes with other UK and international banks to offer offshore banking services. Coutts and Adam & Company compete as private banks with UK clearing and private banks, and with international private banks. Competition in wealth management remains strong as banks maintain their focus on competing for affluent and high net worth customers.

Direct Line Group competes in personal lines insurance and, to a more limited extent, in commercial insurance. There is strong competition from a range of insurance companies which now operate telephone and internet direct sales businesses. Competition in the UK motor market remains intense, and price comparison internet sites now play a major role in the marketplace. These sites have extended their scope to home insurance and other lines. Direct Line Group also competes with local insurance companies in the direct motor insurance markets in Italy and Germany.

In Ireland, Ulster Bank competes in retail and commercial banking with the major Irish banks and building societies, and with other UK and international banks and building societies active in the market. The challenging conditions in the Irish economy persist and many of the domestic Irish banks have required State support and are engaged in significant restructuring actions.

In the United States, RBS Citizens competes in the New England, Mid-Atlantic and Mid-West retail and mid-corporate banking markets with local and regional banks and other financial institutions. The Group also competes in the US in large corporate lending and specialised finance markets, and in fixed-income trading and sales. Competition is principally with the large US commercial and investment banks and international banks active in the

US. The economic recovery in the US is proving weaker than expected and loan demand is weak in Citizens' markets.

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Business review continued

Risk factors

Set out below is a summary of certain risks which could adversely affect the Group; it should be read in conjunction with the Risk and balance sheet management section of the Business review (pages 66 to 252). This summary should not be regarded as a complete and comprehensive statement of all potential risks and uncertainties. A fuller description of these and other risk factors is included on pages 459 to 471.

- The Group's businesses, earnings and financial condition have been and will continue to be negatively affected by global economic conditions, the instability in the global financial markets and increased competition and political risks including proposed referenda on Scottish independence and UK membership of the EU. Together with a perceived increased risk of default on the sovereign debt of certain European countries and unprecedented stresses on the financial system within the Eurozone, these factors have resulted in significant changes in market conditions including interest rates, foreign exchange rates, credit spreads, and other market factors and consequent changes in asset valuations.

- The actual or perceived failure or worsening credit of the Group's counterparties or borrowers and depressed asset valuations resulting from poor market conditions have adversely affected and could continue to adversely affect the Group.

- The Group's ability to meet its obligations' including its funding commitments depends on the Group's ability to access sources of liquidity and funding. The inability to access liquidity and funding due to market conditions or otherwise could adversely affect the Group's financial condition. Furthermore, the Group's borrowing costs and its access to the debt capital markets and other sources of liquidity depend significantly on its and the UK Government's credit ratings.

- The Group is subject to a number of regulatory initiatives which may adversely affect its business, including the UK Government's implementation of the final recommendations of the Independent Commission on Banking's final report on competition and possible structural reforms in the UK banking industry, the US Federal Reserve's proposal for applying US capital, liquidity and enhanced prudential standards to certain of the Group's US operations.

- The Group's business performance, financial condition and capital and liquidity ratios could be adversely affected if its capital is not managed effectively or as a result of changes to capital adequacy and liquidity requirements, including those arising out of Basel III implementation (globally or by European or UK authorities), or if the Group is unable to issue Contingent B Shares to HM Treasury under certain circumstances.

- As a result of the UK Government's majority shareholding in the Group it can, and in the future may decide to, exercise a significant degree of influence over the Group including on dividend policy, modifying or cancelling contracts or limiting the Group's operations. The offer or sale by the UK Government of all or a portion of its shareholding in the company could affect the market price of the equity shares and other securities and acquisitions of ordinary shares by the UK Government (including through conversions of other securities or further purchases of shares) may result in the delisting of the Group from the Official List.

- The Group or any of its UK bank subsidiaries may face the risk of full nationalisation or other resolution procedures and various actions could be taken by or on behalf of the UK Government, including actions in relation to any securities issued, new or existing contractual arrangements and transfers of part or all of the Group's businesses.

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The Group is subject to substantial regulation and oversight, and any significant regulatory or legal developments could have an adverse effect on how the Group conducts its business and on its results of operations and financial condition. In addition, the Group is, and may be, subject to litigation and regulatory investigations that may impact its business, results of operations and financial condition.

- The Group's ability to implement its Strategic Plan depends on the success of its efforts to refocus on its core strengths and its balance sheet reduction programme. As part of the Group's Strategic Plan and implementation of the State Aid restructuring plan agreed with the European Commission and HM Treasury, the Group is undertaking an extensive restructuring which may adversely affect the Group's business, results of operations and financial condition and give rise to increased operational risk.

- The Group could fail to attract or retain senior management, which may include members of the Group Board, or other key employees, and it may suffer if it does not maintain good employee relations.

- Operational and reputational risks are inherent in the Group's businesses.

- The value of certain financial instruments recorded at fair value is determined using financial models incorporating assumptions, judgements and estimates that may change over time or may ultimately not turn out to be accurate.

- The Group's insurance businesses are subject to inherent risks involving claims on insured events.

- Any significant developments in regulatory or tax legislation could have an effect on how the Group conducts its business and on its results of operations and financial condition, and the recoverability of certain deferred tax assets recognised by the Group is subject to uncertainty.

- The Group may be required to make contributions to its pension schemes and government compensation schemes, either of which may have an adverse impact on the Group's results of operations, cash flow and financial condition.

Business review continued

Key financials

for the year ended 31 December	2012 £m	2011 £m	2010 £m
Total income	17,941	24,651	26,622
Operating loss before tax	(5,165)	(1,190)	(154)
Loss attributable to ordinary and B shareholders	(5,971)	(1,997)	(1,125)
Cost:income ratio	99%	70%	66%
Basic and diluted loss from continuing operations per ordinary and B share (1)	(53.7p)	(21.3p)	(2.9p)

at 31 December		2012 £m	2011 £m	2010 £m
Funded balance sheet (2)		870,392	977,249	1,026,499
Total assets		1,312,295	1,506,867	1,453,576
Loans and advances to customers		500,135	515,606	555,260
Deposits		622,684	611,759	609,483
Owners' equity		68,130	74,819	75,132
Risk asset ratios	- Core Tier 1	10.3%	10.6%	10.7%
	- Tier 1	12.4%	13.0%	12.9%
	- Total	14.5%	13.8%	14.0%

Notes:
(1) Prior year data have been adjusted for the sub-division and one-for-ten consolidation of ordinary shares, which took effect in June 2012.
(2) Funded balance sheet represents total assets less derivatives.

Overview of results
The results of RFS Holdings B.V., the entity that acquired ABN AMRO, are fully consolidated in the Group’s financial statements. The interests of the State of the Netherlands and Santander in RFS Holdings are included in non-controlling interests. Legal separation of ABN AMRO Bank N.V. took place on 1 April 2010. As a result, RBS presents the interests of the Consortium Members in ABN AMRO as discontinued operations.

Business review continued

Summary consolidated income statement for the year ended 31 December 2012

	2012 £m	2011 £m	2010 £m
Net interest income	11,402	12,303	13,782
Fees and commissions receivable	5,709	6,379	8,193
Fees and commissions payable	(834)	(962)	(1,892)
Other non-interest income	1,664	6,931	6,425
Insurance net premium income	—	—	114
Non-interest income	6,539	12,348	12,840
Total income	17,941	24,651	26,622
Operating expenses	(17,827)	(17,134)	(17,456)
Profit before insurance net claims and impairment losses	114	7,517	9,166
Insurance net claims	—	—	(85)
Impairment losses	(5,279)	(8,707)	(9,235)
Operating loss before tax	(5,165)	(1,190)	(154)
Tax charge	(469)	(1,127)	(703)
Loss from continuing operations	(5,634)	(2,317)	(857)
(Loss)/profit from discontinued operations, net of tax			
- Direct Line Group	(184)	301	(176)
- Other	12	47	(633)
(Loss)/profit from discontinued operations, net of tax	(172)	348	(809)
Loss for the year	(5,806)	(1,969)	(1,666)
Non-controlling interests	123	(28)	665
Other owners' dividends	(288)	—	(124)
Loss attributable to ordinary and B shareholders	(5,971)	(1,997)	(1,125)
Basic and diluted loss from continuing operations per ordinary and B share (1)	(53.7p)	(21.3p)	(2.9p)

Note:
(1) Prior year data have been adjusted for the sub-division and one-for-ten consolidation of ordinary shares, which took effect in June 2012.

Business review continued

Results summary
2012 compared with 2011
Operating loss before tax
Operating loss before tax for the year was £5,165 million compared with £1,190 million in 2011.

Total income
Total income decreased by 27% to £17,941 million in 2012, principally reflecting own credit adjustments partially offset by movements in the fair value of the Asset Protection Scheme (APS) and higher net gains on the redemption of own debt.

Net interest income
Net interest income declined by 7% to £11,402 million largely reflecting lower interest-earning asset balances. Group net interest margin (NIM) was up 3 basis points despite very low interest rates and strong deposit competition.

Non-interest income
Non-interest income decreased to £6,539 million from £12,348 million in 2011. This included movements in the fair value of the APS resulting in a £44 million charge (2011 - £906 million), net gain on redemption of own debt of £454 million (2011 - £255 million) and a loss on own credit adjustments of £4,649 million (2011 - £1,914 million gain). On a managed basis non-interest income decreased by £928 million in 2012 principally driven by lower net fees and commissions, largely due to weaker consumer spending volumes in the UK together with legislation changes in the US, and a fall in insurance net premium income, primarily due to lower written premiums in Direct Line Group.

The APS, which the Group exited from during the year, was accounted for as a credit derivative and movements in the fair value of the contract were recorded in income from trading activities. The APS fair value charge was £44 million in 2012 bringing the cumulative charge for the APS to £2.5 billion.

Liability management exercises undertaken by the Group during 2012 resulted in a net gain of £454 million (2011 - £255 million).

The continuing strengthening RBS's credit profile resulted in a £4,649 million accounting charge in relation to own credit adjustments versus a gain of £1,914 million in 2011. This reflected a tightening of more than 340 basis points in the Group's credit spreads over the year.

Operating expenses
Operating expenses increased to £17,827 million from £17,134 million in 2011. This included Payment protection Insurance (PPI) costs of £1,110 million (2011 - £850 million), Interest Rate Hedging Products redress and related costs of £700 million, regulatory fines of £381 million, integration and restructuring costs of £1,550 million compared with £1,059 million in 2011, bank levy of £175 million compared with £300 million in 2011 and write-down of goodwill and other intangible assets of £124 million, principally as a result of exits from selective countries and lower revenue projections by Markets. On a managed basis operating expenses fell by 6% to £14,619 million, with staff costs down 6% as headcount fell by 9,600 to 137,200. The decline in expenses was largely driven by Non-Core run-down and lower variable compensation (particularly in Markets), including variable compensation award reductions and clawbacks following the settlements reached with UK and US authorities in relation to attempts to manipulate LIBOR. The run-off of discontinued businesses in Markets and International Banking, following the restructuring announced in January 2012, and simplification of processes and headcount reduction in UK Retail also yielded cost benefits.

To reflect current experience of PPI complaints received, the Group increased its PPI provision by £1,110 million in 2012 compared with £850 million in 2011, bringing the cumulative charge taken to £2.2 billion, of which £1.3 billion (59%) in redress had been paid by 31 December 2012.

Following an industry-wide review conducted in conjunction with the Financial Services Authority, a charge of £700 million has been booked for redress in relation to certain interest-rate hedging products sold to small and medium-sized businesses classified as retail clients under FSA rules.

On 6 February 2013, RBS reached agreement with the Financial Services Authority, the US Department of Justice and the Commodity Futures Trading Commission in relation to the setting of LIBOR and other trading rates, including financial penalties of £381 million. The Group continues to co-operate with other bodies in this regard and expects it will incur some additional financial penalties.

Integration and restructuring costs of £1,550 million increased by £491 million versus £1,059 million in 2011, primarily driven by costs incurred in relation to the strategic restructuring of Markets and International Banking (M&IB) that took place during 2012.

The UK bank levy is based on the total chargeable equity and liabilities as reported in the balance sheet at the end of a chargeable period. The cost of the levy to the Group for 2012 was £175 million compared with £300 million in 2011.

Impairment losses
Impairment losses were £5,279 million, compared with £8,707 million in 2011, with Core impairments falling by £464 million and Non-Core by £1,696 million, mostly in the Ulster Bank and commercial real estate portfolios. There was also the non-repeat of the sovereign debt impairment in 2011. On a managed basis Impairment losses fell to £5,279 million from £7,439 million in 2011.

In 2011, the Group recorded an impairment loss of £1,099 million in respect of its AFS portfolio of Greek government debt. In 2012, the vast majority of this portfolio was exchanged for Greek sovereign debt and European Financial Stability Facility notes; the Greek sovereign debt received in the exchange was sold.

Risk elements in lending represented 9.1% of gross loans and advances to customers excluding reverse repos at 31 December 2012 (2011 - 8.6%).

Provision coverage of risk elements in lending was 52% (2011 - 49%).

Tax
The tax charge for 2012 was £469 million (2011 - £1,127 million). The high tax charge in the year reflects profits in high tax regimes (principally US) and losses in low tax regimes (principally Ireland), losses in overseas subsidiaries for which a deferred tax asset has not been recognised (principally Ireland), the reduction in the carrying value of deferred tax assets in Ireland in view of continuing losses, the reduction in the carrying value of deferred tax assets in Australia following the strategic changes to the Markets and International Banking businesses announced in January 2012 and the effect of the two reductions of 1% in the rate of UK corporation tax enacted in March 2012 and July 2012 on the net deferred tax balance.

Loss per share
Basic and diluted loss from continuing operations per ordinary and B share was 53.7p per share compared with 21.3p per share in 2011.

2011 compared with 2010
Operating loss before tax
Operating loss before tax for the year was £1,190 million compared with £154 million in 2010.

Total income
Total income decreased 7% to £24,651 million in 2011, principally reflecting own credit adjustments offset by lower net interest income, lower trading income in Markets and Non-Core, a fall in insurance net premium income, movements in the fair value of the APS and lower net gains on the redemption of own debt.

Net interest income
Net interest income fell 11% to £12,303 million largely driven by the run-off of balances and exit of higher margin, higher risk segments in Non-Core. Group NIM was 14 basis points lower, reflecting the cost of carrying a higher liquidity portfolio and by the impact of non-performing assets in the Non-Core division. However, R&C NIM was up 6 basis points, with strengthening asset margins in the first half of the year offsetting the impact of a competitive deposit market.

Non-interest income

Non-interest income decreased to £12,348 million from £12,840 million in 2010. This included movements in the fair value of the APS resulting in a £906 million charge (2010 - £1,550 million), gain on redemption of own debt of £255 million (2010 - £553 million) and a gain on movements in own credit adjustments of £1,914 million (2010 - £242 million gain). On a managed basis non-interest income decreased by £3,374 million in 2011 principally driven by lower trading income in Markets and Non-Core, and a fall in insurance net premium income. Volatile market conditions led to a reduction in Markets trading income, driven by the deterioration in global credit markets as sovereign difficulties in the eurozone grew. Non-Core trading losses increased by £690 million, reflecting costs incurred as part of the division’s focus on reducing capital trading assets.

A gain on the movement in own credit adjustments of £1,914 million was recorded in 2011 as Group credit spreads widened. This compares with a smaller gain of £242 million in 2010.

The APS is accounted for as a credit derivative and movements in the fair value of the contract were recorded in income from trading activities. The APS fair value charge was £906 million in 2011. The cumulative charge for the APS was £2,456 million as at 31 December 2011.

Business review continued

Operating expenses
Operating expenses decreased to £17,134 million (2010 - £17,456 million) of which integration and restructuring costs were £1,059 million compared with £1,032 million in 2010. On a managed basis operating expenses fell by 7% to £15,478 million, driven by cost savings achieved as a result of the cost reduction programme and Non-Core run-off, largely reflecting the disposal of RBS Sempra and specific country exits. Staff costs fell 9% driven by lower Markets and International Banking variable compensation as a result of its decrease in revenues, and in Non-Core, given the impact of a 32% reduction in headcount and continues business disposals and country exits.

A charge of £850 million was booked in relation to PPI claims following the British Bankers' Association decision, in May 2011, not to appeal the findings of the Judicial Review.

Integration and restructuring costs remained broadly flat at £1,059 million, reflecting significant Markets restructuring in 2011.

The Finance Act 2011 introduced an annual bank levy in the UK. The levy is based on the total chargeable equity and liabilities as reported in the balance sheet at the end of a chargeable period. The cost of the levy to the Group for 2011 was £300 million.

Insurance net claims
Insurance claims were £85 million lower in 2011, reflecting the dissolution of the Group's bancassurance joint venture at the end of 2010.

Impairment losses
Impairment losses fell to £8,707 million from £9,235 million in 2010, with Core impairments falling by £260 million and Non-Core by £1,557 million, despite continuing challenges in Ulster Bank and corporate real estate portfolios. This was partially offset by impairments taken on the Group's available-for-sale bond portfolio, as a result of the decline in the value of Greek sovereign bonds. On a managed basis impairment losses fell to £7,439 million from £9,256 million in 2010.

An impairment of £1,099 million was taken on the Group's AFS bond portfolio in 2011 as a result of the decline in the value of Greek sovereign bonds. As of 31 December 2011, the bonds were marked at 21% of par value.

Risk elements in lending represented 8.6% of gross loans and advances to customers excluding reverse repos at 31 December 2011 (2010 - 7.3%).

Provision coverage of risk elements in lending was 49% (2010 - 47%).

Tax
The tax charge for 2011 was £1,127 million (2010 - £703 million). The high tax charge for the year reflects profits in high tax regimes (principally US) and losses in low tax regimes (principally Ireland), losses in overseas subsidiaries for which a deferred tax asset has not been recognised (principally Ireland and the Netherlands) and the effect of the two reductions of 1% in the rate of UK corporation tax enacted in March 2011 and July 2011 on the net deferred tax balance.

Loss per share

Basic and diluted loss from continuing operations per ordinary and B share was 21.3p per share compared with 2.9p per share in 2010.

Business review continued

Analysis of results

Net interest income

	2012	2011	2010
	£m	£m	£m
Interest receivable (1)	18,530	21,036	22,352
Interest payable	(7,128)	(8,733)	(8,570)
Net interest income	11,402	12,303	13,782
Yields, spreads and margins of the banking business	%	%	%
Gross yield on interest-earning assets of the banking business (2)	3.13	3.23	3.29
Cost of interest-bearing liabilities of the banking business	(1.55)	(1.68)	(1.47)
Interest spread of the banking business (3)	1.58	1.55	1.82
Benefit from interest-free funds	0.34	0.34	0.21
Net interest margin of the banking business (4)	1.92	1.89	2.03
Gross yield (2)			
- Group	3.13	3.23	3.29
- UK	3.49	3.57	3.40
- Overseas	2.56	2.77	3.14
Interest spread (3)			
- Group	1.58	1.55	1.82
- UK	1.84	1.82	1.99
- Overseas	1.25	1.22	1.58
Net interest margin (4)			
- Group	1.92	1.89	2.03
- UK	2.04	2.04	2.17
- Overseas	1.74	1.69	1.84
The Royal Bank of Scotland plc base rate (average)	0.50	0.50	0.50
London inter-bank three month offered rates (average)			
- Sterling	0.82	0.87	0.70
- Eurodollar	0.43	0.33	0.34
- Euro	0.53	1.36	0.75

Notes:

(1) Interest income includes £565 million (2011 - £627 million; 2010 - £588 million) in respect of loan fees forming part of the effective interest rate of loans and receivables.

(2) Gross yield is the interest earned on average interest-earning assets of the banking book.

(3) Interest spread is the difference between the gross yield and the interest rate paid on average interest-bearing liabilities of the banking business.

(4) Net interest margin is net interest income of the banking business as a percentage of average interest-earning assets of the banking business.

(5) The analysis into UK and overseas has been compiled on the basis of location of office.

(6) Interest receivable and interest payable on trading assets and liabilities are included in income from trading activities.

(7)

Interest income includes amounts (unwind of discount) recognised on impaired loans and receivables. The average balances of such loans are included in average loans and advances to banks and loans and advances to customers.

Business review continued

		2012			2011		
		Average balance £m	Interest £m	Rate %	Average balance £m	Interest £m	Rate %
Assets							
Loans and advances to banks	- UK	33,656	248	0.74	29,852	277	0.93
	- Overseas	40,342	245	0.61	41,716	403	0.97
Loans and advances to		277,321	11,326	4.08			
customers	- UK				293,777	11,970	4.07
	- Overseas	151,692	4,862	3.21	171,938	5,857	3.41
Debt securities	- UK	49,872	1,015	2.04	55,074	1,258	2.28
	- Overseas	40,077	834	2.08	58,027	1,271	2.19
Interest-earning assets	- UK	360,849	12,589	3.49	378,703	13,505	3.57
	- Overseas	232,111	5,941	2.56	271,681	7,531	2.77
Total interest-earning assets	- banking business (1)	592,960	18,530	3.13	650,384	21,036	3.23
	- trading business (6)	240,131			278,975		
Interest-earning assets		833,091			929,359		
Non-interest-earning assets		597,281			605,796		
Total assets		1,430,372			1,535,155		
Percentage of assets applicable to overseas operations		37.8%			40.2%		
Liabilities							
Deposits by banks	- UK	18,276	196	1.07	17,224	242	1.41
	- Overseas	20,200	404	2.00	47,371	740	1.56
Customer accounts: demand		121,252	643	0.53			
deposits	- UK				112,777	666	0.59
	- Overseas	35,087	210	0.60	43,177	483	1.12
Customer accounts: savings		84,972	1,479	1.74			
deposits	- UK				76,719	1,177	1.53
	- Overseas	26,989	133	0.49	25,257	130	0.51
Customer accounts: other time deposits	- UK	35,848	522	1.46	39,672	481	1.21
	- Overseas	23,776	504	2.12	33,971	594	1.75
Debt securities in issue	- UK	60,709	1,681	2.77	108,406	2,606	2.40
	- Overseas	22,294	342	1.53	42,769	765	1.79
Subordinated liabilities	- UK	15,609	435	2.79	16,874	470	2.79
	- Overseas	5,461	380	6.96	5,677	270	4.76
Internal funding of trading		(21,140)	264	(1.25)			
business	- UK				(40,242)	149	(0.37)
	- Overseas	11,992	(65)	(0.54)	(8,783)	(40)	0.46
Interest-bearing liabilities	- UK	315,526	5,220	1.65	331,430	5,791	1.75
	- Overseas	145,799	1,908	1.31	189,439	2,942	1.55
Total interest-bearing liabilities	- banking business	461,325	7,128	1.55	520,869	8,733	1.68
	- trading business (6)	248,647			307,564		

Interest-bearing liabilities		709,972	828,433
Non-interest-bearing liabilities:			
Demand deposits	- UK	46,420	46,495
	- Overseas	27,900	19,909
Other liabilities (2)		572,820	565,279
Owners' equity		73,260	75,039
Total liabilities and owners' equity		1,430,372	1,535,155
Percentage of liabilities applicable to overseas operations		33.9%	37.1%

For the notes to this table refer to page 14.

Business review continued

Average balance sheet and related interest continued

		2010		
		Average balance £m	Interest £m	Rate %
Assets				
Loans and advances to banks	- UK	20,334	207	1.02
	- Overseas	30,031	368	1.23
Loans and advances to customers	- UK	309,764	11,818	3.82
	- Overseas	195,822	6,894	3.52
Debt securities	- UK	60,209	1,253	2.08
	- Overseas	62,671	1,812	2.89
Interest-earning assets	- UK	390,307	13,278	3.40
	- Overseas	288,524	9,074	3.14
Total interest-earning assets	- banking business (1)	678,831	22,352	3.29
	- trading business (6)	276,330		
Interest-earning assets		955,161		
Non-interest-earning assets		717,043		
Total assets		1,672,204		
Percentage of assets applicable to overseas operations		44.1%		
Liabilities				
Deposits by banks	- UK	21,816	334	1.53
	- Overseas	59,799	999	1.67
Customer accounts: demand deposits	- UK	121,186	624	0.51
	- Overseas	39,127	607	1.55
Customer accounts: savings deposits	- UK	68,142	935	1.37
	- Overseas	25,587	213	0.83
Customer accounts: other time deposits	- UK	39,934	431	1.08
	- Overseas	43,996	914	2.08
Debt securities in issue	- UK	111,277	2,212	1.99
	- Overseas	72,175	1,065	1.48
Subordinated liabilities	- UK	19,442	398	2.05
	- Overseas	8,714	19	0.22
Internal funding of trading business	- UK	(41,451)	(140)	0.34
	- Overseas	(6,864)	(41)	0.60
Interest-bearing liabilities	- UK	340,346	4,794	1.41
	- Overseas	242,534	3,776	1.56
Total interest-bearing liabilities	- banking business	582,880	8,570	1.47
	- trading business (6)	293,993		
Interest-bearing liabilities		876,873		
Non-interest-bearing liabilities:				
Demand deposits	- UK	46,692		

	- Overseas	23,994
Other liabilities (2)		647,739
Owners' equity		76,906
Total liabilities and owners' equity		1,672,204
Percentage of liabilities applicable to overseas operations		41.3%

For the notes to this table refer to page 14.

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Business review continued

Analysis of change in net interest income - volume and rate analysis
Volume and rate variances have been calculated based on movements in average balances over the period and changes in interest rates on average interest-earning assets and average interest-bearing liabilities. Changes due to a combination of volume and rate are allocated pro rata to volume and rate movements.

	2012 over 2011 Increase/(decrease) due to changes in:		
	Average volume £m	Average rate £m	Net change £m
Interest-earning assets			
Loans and advances to banks			
UK	32	(61)	(29)
Overseas	(13)	(145)	(158)
Loans and advances to customers			
UK	(673)	29	(644)
Overseas	(664)	(331)	(995)
Debt securities			
UK	(115)	(128)	(243)
Overseas	(376)	(61)	(437)
Total interest receivable of the banking business			
UK	(756)	(160)	(916)
Overseas	(1,053)	(537)	(1,590)
	(1,809)	(697)	(2,506)
Interest-bearing liabilities			
Deposits by banks			
UK	(14)	60	46
Overseas	505	(169)	336
Customer accounts: demand deposits			
UK	(48)	71	23
Overseas	78	195	273
Customer accounts: savings deposits			
UK	(133)	(169)	(302)
Overseas	(8)	5	(3)
Customer accounts: other time deposits			
UK	50	(91)	(41)
Overseas	200	(110)	90
Debt securities in issue			
UK	1,279	(354)	925
Overseas	325	98	423
Subordinated liabilities			
UK	35	—	35
Overseas	11	(121)	(110)
Internal funding of trading business			

UK	99	(214)	(115)
Overseas	13	12	25
Total interest payable of the banking business			
UK	1,268	(697)	571
Overseas	1,124	(90)	1,034
	2,392	(787)	1,605
Movement in net interest income			
UK	512	(857)	(345)
Overseas	71	(627)	(556)
	583	(1,484)	(901)

Business review continued

Analysis of change in net interest income - volume and rate analysis continued

	2011 over 2010 Increase/(decrease) due to changes in:		
	Average volume £m	Average rate £m	Net change £m
Interest-earning assets			
Loans and advances to banks			
UK	90	(20)	70
Overseas	124	(89)	35
Loans and advances to customers			
UK	(616)	768	152
Overseas	(825)	(212)	(1,037)
Debt securities			
UK	(111)	116	5
Overseas	(127)	(414)	(541)
Total interest receivable of the banking business			
UK	(637)	864	227
Overseas	(828)	(715)	(1,543)
	(1,465)	149	(1,316)
Interest-bearing liabilities			
Deposits by banks			
UK	67	25	92
Overseas	197	62	259
Customer accounts: demand deposits			
UK	47	(89)	(42)
Overseas	(58)	182	124
Customer accounts: savings deposits			
UK	(126)	(116)	(242)
Overseas	3	80	83
Customer accounts: other time deposits			
UK	3	(53)	(50)
Overseas	189	131	320
Debt securities in issue			
UK	58	(452)	(394)
Overseas	494	(194)	300
Subordinated liabilities			
UK	58	(130)	(72)
Overseas	9	(260)	(251)
Internal funding of trading business			
UK	(4)	(285)	(289)
Overseas	10	(11)	(1)
Total interest payable of the banking business			

UK	103	(1,100)	(997)
Overseas	844	(10)	834
	947	(1,110)	(163)
Movement in net interest income			
UK	(534)	(236)	(770)
Overseas	16	(725)	(709)
	(518)	(961)	(1,479)

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Business review continued

Non-interest income
The following tables reconcile the managed basis results (a non-GAAP financial measure) to the statutory basis results.

	2012	2011	2010
	£m	£m	£m
Fees and commissions receivable			
- managed basis	5,715	6,384	8,194
- Direct Line Group discontinued operations	(6)	(5)	—
- RFS Holdings minority interest	—	—	(1)
Statutory basis	5,709	6,379	8,193
Fees and commissions payable			
- managed basis	(1,269)	(1,460)	(2,211)
- Direct Line Group discontinued operations	436	498	319
- RFS Holdings minority interest	(1)	—	—
Statutory basis	(834)	(962)	(1,892)
Income from trading activities			
- managed basis	3,531	3,313	6,070
- own credit adjustments	(1,813)	293	(7)
- Asset Protection Scheme	(44)	(906)	(1,550)
- Direct Line Group discontinued operations	2	—	—
- RFS Holdings minority interest	(1)	1	4
Statutory basis	1,675	2,701	4,517
Gain on redemption of own debt - statutory basis	454	255	553
Other operating income			
- managed basis	2,397	2,527	1,213
- own credit adjustments	(2,836)	1,621	249
- integration and restructuring costs	—	78	—
- strategic disposals	113	(104)	171
- Direct Line Group discontinued operations	(138)	(147)	(124)
- RFS Holdings minority interest	(1)	—	(154)
Statutory basis	(465)	3,975	1,355
Non-interest income (excluding insurance net premium income)	6,539	12,348	12,726

Insurance net premium income			
- managed basis	3,718	4,256	5,128
- Direct Line Group discontinued operations	(3,718)	(4,256)	(5,014)
Statutory basis	—	—	114
Total non-interest income - managed basis	14,092	15,020	18,394
Total non-interest income - statutory basis	6,539	12,348	12,840

Non-interest income continued

2012 compared with 2011

Non-interest income was down 47% at £6,539 million primarily due to the accounting charge for improved own credit of £4,649 million compared with a credit of £1,914 million in 2011, partially offset by a lower fair value charge of £44 million compared with £906 million in 2011 on the APS. On a managed basis non-interest income was down 6% at £14,092 million with higher profits on available-for-sale bond disposals in Group Treasury more than offset by a 10% decline in fees and commissions, largely due to a decline in UK Retail fees as a result of weaker consumer spending volumes, and lower insurance net premium income.

The APS, which the Group exited in October 2012, was accounted for as a credit derivative and movements in the fair value of the contract were recorded in income from trading activities. The APS fair value charge was £44 million in 2012 versus £906 million in 2011, bringing the cumulative charge for the APS to £2.5 billion.

Liability management exercises undertaken by the Group during 2012 resulted in a net gain of £454 million (2011 - £255 million).

Net fees and commissions fell by 10% largely due to a decline in UK Retail fees, as a result of weaker consumer spending volumes, and in Markets, primarily due to the run-off in the cash equity business.

Markets trading income was sustained, despite the significant reduction in trading assets following its restructuring early in 2012.

The decrease in other operating income predominantly reflected own credit adjustments and the disposal of RBS Aviation Capital in June 2012, which resulted in lower rental income in Non-Core partially offset by a lower fair value charge on the APS.

The continuing strengthening of RBS's credit profile resulted in a £4,649 million accounting charge in relation to own credit adjustment versus a gain of £1,914 million in 2011. This reflected a tightening of more than 340 basis points in the Group's cash market credit spreads over the year.

2011 compared with 2010

Non-interest income decreased by £492 million in 2011 principally driven by lower trading income in Markets and Non-Core, partially offset by a higher gain on movements in own credit adjustments. On a managed basis non-interest income decreased by £3,374 million in 2011 principally driven by lower trading income in Markets and Non-Core and a fall in insurance net premium income.

A gain on the movement in own credit adjustments of £1,914 million was recorded in 2011 as Group credit spreads widened. This compares with a smaller gain of £242 million in 2010.

The APS is accounted for as a credit derivative and movements in the fair value of the contract were recorded in income from trading activities. The APS fair value charge was £906 million in 2011. The cumulative charge for the APS was £2,456 million as at 31 December 2011.

In 2011, the Group redeemed certain mortgage backed debt securities in exchange for cash, resulting in gains totalling £255 million. This compared with a gain of £553 million in 2010 on a liability management exercise to redeem a number of Tier 1 and upper Tier 2 securities.

A charge of £850 million was booked in relation to PPI claims following the British Bankers' Association decision, in May 2011, not to appeal the findings of the Judicial Review.

Volatile market conditions led to a reduction in Markets trading income, driven by the deterioration in global credit markets as sovereign difficulties in the eurozone grew.

Non-Core trading losses increased by £690 million, reflecting costs incurred as part of the division's focus on reducing capital trading assets, with activity including the restructuring of monoline exposures, which mitigated both significant immediate and future regulatory uplifts in risk-weighted assets.

On a statutory basis insurance net premium income was reclassified to discontinued operations. On a managed basis insurance net premium income fell by 17% largely driven by Direct Line Group's exit from certain business segments, along with reduced volumes driven by the de-risking of the motor book. Insurance net premium income in Non-Core also decreased as legacy policies ran-off.

2010 results included £482 million of income recorded for GMS prior to its disposal in November 2010.

Business review continued

Operating expenses and insurance claims
The following tables reconcile the managed basis results (a non-GAAP financial measure) to the statutory basis results.

	2012	2011	2010
	£m	£m	£m
Staff costs			
- managed basis	7,639	8,163	8,956
- integration and restructuring costs	885	489	614
- bonus tax	—	27	99
- Direct Line Group discontinued operations	(447)	(322)	(292)
- RFS Holdings minority interest	(1)	(1)	2
Statutory basis	8,076	8,356	9,379
Premises and equipment			
- managed basis	2,198	2,278	2,276
- integration and restructuring costs	152	173	126
- Direct Line Group discontinued operations	(118)	(28)	(22)
- RFS Holdings minority interest	—	—	—
Statutory basis	2,232	2,423	2,380
Other administrative expenses			
- managed basis	3,248	3,395	3,716
- Payment Protection Insurance costs	1,110	850	—
- Interest Rate Hedging Products redress and related costs	700	—	—
- regulatory fines	381	—	—
- integration and restructuring costs	371	386	272
- bank levy	175	300	—
- Direct Line Group discontinued operations	(395)	(495)	(424)
- RFS Holdings minority interest	3	—	7
Statutory basis	5,593	4,436	3,571
Administrative expenses	15,901	15,215	15,330
Depreciation and amortisation			
- managed basis	1,534	1,642	1,762
- Direct Line Group discontinued operations	(52)	(36)	(25)
- amortisation of purchased intangible assets	178	222	369

- integration and restructuring costs	142	11	20
- RFS Holdings minority interest	—	—	(1)
Statutory basis	1,802	1,839	2,125
Write-down of goodwill and other intangible assets - statutory basis	124	80	1
Operating expenses	17,827	17,134	17,456
Insurance net claims			
- managed basis	2,427	2,968	4,783
- Direct Line Group discontinued operations	(2,427)	(2,968)	(4,698)
Statutory basis	—	—	85
Staff costs as a percentage of total income	45%	34%	35%

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Business review continued

2012 compared with 2011
Operating expenses increased by £693 million, or 4% primarily due to charges resulting from legacy conduct issues partially offset by Non-Core run-down and run-off of exited businesses in Markets and International Banking, following the restructuring announced in January 2012. Simplification of processes and headcount reduction in UK Retail also yielded cost benefits. On a managed basis operating expenses fell by £859 million, or 6%, with staff costs also down 6% (but broadly stable as a percentage of total income) as headcount fell by 9,600 to 137,200. The decline in expenses was largely driven by Non-Core run-down and lower variable compensation (particularly in Markets), including bonus award reductions and clawbacks following the settlements reached with UK and US authorities in relation to attempted LIBOR manipulation.

Staff expenses were cut by 3%. On a managed basis staff costs were down 6%, as headcount fell by 9,600 to 137,200.

To reflect current experience of PPI complaints received, RBS increased its PPI provision by £1,110 million in 2012, bringing the cumulative charge taken to £2.2 billion, of which £1.3 billion in redress had been paid by 31 December 2012.

On 31 January 2013, the Financial Services Authority announced the findings of its industry-wide review of the sale of Interest Rate Hedging Products to some small and medium-sized businesses that were classified as retail clients under FSA rules. As a result, RBS provided £700 million in 2012 to meet the costs of redress.

On 6 February 2013, RBS reached agreement with the Financial Services Authority, the US Department of Justice and the Commodity Futures Trading Commission in relation to the setting of LIBOR and other trading rates, including financial penalties of £381 million. The Group continues to co-operate with other bodies in this regard and expects it will incur some additional financial penalties.

2011 compared with 2010
Group expenses fell by 2% in 2011, driven by cost savings achieved as a result of the cost reduction programme and Non-Core run-off, largely reflecting the disposal of RBS Sempra and specific country exits, partially offset by PPI costs. On a managed basis Group expenses were 7% lower in 2011, driven by cost savings achieved as a result of the cost reduction programme and Non-Core run-off, largely reflecting the disposal of RBS Sempra and specific country exits.

Staff costs fell 11%, driven by lower Markets and International Banking discretionary compensation as a result of its decrease in revenues, and in Non-Core, given the impact of a 32% reduction in headcount and continued business disposals and country exits. On a managed basis staff costs fell 9%.

In May 2011, following the decision of the British Bankers' Association not to appeal the judgement of the judicial review, the Group recorded a provision of £850 million in respect of the costs of PPI redress.

The Group's cost reduction programme delivered cost savings with an underlying run rate of over £3 billion by the end of 2011.

Integration costs

	2012	2011	2010
	£m	£m	£m
Staff costs	—	38	210

Premises and equipment	(2)	6	3
Other administrative expenses	2	51	143
Depreciation and amortisation	—	11	20
	—	106	376

Note:
(1) Integration costs in 2011 excluded a £2 million charge included within net interest income and a loss of £3 million within other operating income in respect of integration activities.

2012 compared with 2011
Integration costs were nil compared with £106 million in 2011. Integration costs decreased primarily due to a reduction of RBS N.V. (formerly ABN AMRO) integration activity during the year.

2011 compared with 2010
Integration costs were £106 million compared with £376 million in 2010. Integration costs decreased primarily due to a reduction of RBS N.V. (formerly ABN AMRO) integration activity during the year.

Accruals in relation to integration costs are set out below.

	At 1 January 2012 £m	(Credit)/charge to income statement - continuing operations £m	Utilised during the year £m	At 31 December 2012 £m
Premises and equipment	11	(2)	—	9
Other administrative expenses	3	2	—	5
	14	—	—	14

Business review continued

Restructuring costs

	2012 (managed) £m	Discontinued operations £m	Continuing operations (statutory) £m	2011 (managed) £m	Discontinued operations £m	Continuing operations (statutory) £m	2010 (managed) £m	Discontinued operations £m	Continuing operations (statutory) £m
Staff costs	737	(37)	700	356	(14)	342	353	(12)	341
Premises and equipment	145	(4)	141	156	(1)	155	117	—	117
Other administrative expenses	270	(9)	261	276	(8)	268	104	(8)	96
Depreciation and amortisation	142	—	142	—	—	—	—	—	
	1,294	(50)	1,244	788	(23)	765	574	(20)	554

2012 compared with 2011
Restructuring costs were £1,244 million compared with £765 million in 2011. The increase was primarily driven by costs incurred in relation to the strategic restructuring of Markets and International Banking announced in January 2012. On a managed basis restructuring costs were £1,294 million compared with £788 million in 2011.

2011 compared with 2010
Restructuring costs were £765 million compared with £554 million in 2010. The increase is due to the number of Group restructuring projects increasing during the year. On a managed basis restructuring costs were £788 million compared with £574 million in 2010.

Accruals in relation to restructuring costs are set out below.

	At 1 January 2012 £m	Currency translation adjustments £m	Charge to income statement - continuing operations £m	Charge to income statement - discontinued operations £m	Utilised during the year £m	Transfer to disposal groups £m	At 31 December 2012 £m
Staff costs - redundancy	126	5	626	37	(336)	(24)	434
Staff costs - other	40	—	74	—	(3)	—	111
Premises and equipment	166	—	141	4	(22)	—	289
Other administrative expenses	110	(2)	261	9	(107)	(7)	264
Depreciation and amortisation	—	—	142	—	(142)	—	—
	442	3	1,244	50	(641)	(31)	1,067

Divestment costs

	2012 (managed)	Discontinued operations	Continuing operations (statutory)	2011 (managed)	Discontinued operations	Continuing operations (statutory)	2010 (managed)	Discontinued operations	Continuing operations (statutory)

	£m	£m	£m	£m	£m	£m	£m	£m	£m
Staff costs	148	(37)	111	95	(11)	84	51	—	51
Premises and equipment	9	(11)	(2)	11	—	11	6	—	6
Other administrative expenses	99	(37)	62	59	(9)	50	25	—	25
	256	(85)	171	165	(20)	145	82	—	82

2012 compared with 2011

Divestment costs were £171 million compared with £145 million in 2011 as the preparation for the European Commission mandated divestments continued throughout 2012. On a managed basis divestment costs were £256 million compared with £165 million in 2011.

2011 compared with 2010

Divestment costs of £145 million compared with £82 million in 2010 related to the European Commission mandated divestments. On a managed basis divestment costs were £165 million in 2011 compared wtih £82 million in 2010.

Accruals in relation to divestment costs are set out below.

	At 1 January 2012	Charge/(credit) to income statement - continuing operations	Charge to income statement - discontinued operations	Utilised during the year	Transfer to disposal groups	At 31 December 2012
	£m	£m	£m	£m	£m	£m
Staff costs - redundancy	45	47	37	(41)	(1)	87
Staff costs - other	1	64	—	(19)	—	46
Premises and equipment	—	(2)	11	(9)	—	—
Other administrative expenses	21	62	37	(43)	(4)	73
	67	171	85	(112)	(5)	206

Business review continued

Impairment losses

The following tables reconcile the managed basis results (a non-GAAP financial measure) to the statutory basis results.

	2012 £m	2011 £m	2010 £m
New impairment losses	5,620	9,234	9,646
Less: recoveries of amounts previously written-off	(341)	(527)	(411)
Charge to income statement	5,279	8,707	9,235
Comprising:			
Loan impairment losses	5,315	7,241	9,144
Securities			
- managed basis	(36)	198	112
- sovereign debt impairment	—	1,099	—
- interest rate hedge adjustments on impaired available-for-sale sovereign debt	—	169	—
Direct Line Group discontinued operations	—	—	(21)
Statutory basis	(36)	1,466	91
Charge to income statement	5,279	8,707	9,235

2012 compared with 2011

Total impairment losses fell by £3,428 million, or 39%, to £5,279 million. Within this, loan impairment losses declined by £1,926 million to £5,315 million, primarily driven by a £1,518 million fall in Non-Core impairments, mostly in the Ulster Bank and commercial real estate portfolios.

Core loan impairments were down £408 million, or 12%, largely due to lower default rates in UK Retail and an improved credit environment for US Retail & Commercial, which helped drive impairment reductions of £259 million and £165 million respectively. Core Ulster Bank impairments stabilised, though still at a very high level (£1,364 million in 2012 versus £1,384 million in 2011).

Loan impairments as a percentage of gross loans and advances improved by 30 basis points, principally reflecting the improved credit profile in Non-Core and the better US credit environment.

Loan impairment provisions rose to £21.3 billion, increasing coverage of risk elements in lending to 52%, compared with 49% in 2011.

2011 compared with 2010

Impairment losses decreased by 6% compared with 2010, driven largely by a £1,569 million reduction in Non-Core loan impairments, despite continuing challenges in Ulster Bank and corporate real estate portfolios. This was partially offset by impairments taken on the Group’s available-for-sale bond portfolio, as a result of the decline in the value of Greek sovereign bonds. On a managed basis impairment losses decreased by 20% compared to 2010.

Retail & Commercial impairment losses fell by £227 million, driven by improving credit metrics in UK Retail and US Retail & Commercial partially offset by increases in Ulster Bank, largely reflecting a deterioration in credit metrics on

the mortgage portfolio, and a single name provision in International Banking.

Total Core and Non-Core Ulster Bank impairment losses decreased by 4%, as the £223 million increase in Core Ulster Bank losses was more than offset by a decrease in losses recognised in Non-Core.

The Group held Greek government bonds with a notional amount of £1.45 billion. As a result of Greece's continuing fiscal difficulties, the Group recorded impairment charges on these bonds totalling £1,099 million during the year. These charges were recorded to write the bonds down to their market price as at 31 December 2011 (c.21% of notional).

Business review continued

Tax

	2012 £m	2011 £m	2010 £m
Tax charge	(469)	(1,127)	(703)
	%	%	%
UK corporation tax rate	24.5	26.5	28.0
Effective tax rate	nm	nm	nm

nm = not meaningful

The actual tax charge differs from the expected tax credit computed by applying the standard rate of UK corporation tax as follows:

	2012 £m	2011 £m	2010 £m
Expected tax credit	1,265	315	44
Sovereign debt impairment where no deferred tax asset recognised	—	(275)	—
Other losses in year where no deferred tax asset recognised	(511)	(530)	(450)
Foreign profits taxed at other rates	(383)	(417)	(517)
UK tax rate change impact	(149)	(112)	(83)
Unrecognised timing differences	59	(20)	11
Non-deductible goodwill impairment	—	(24)	(3)
Items not allowed for tax			
- losses on disposals and write-downs	(49)	(72)	(311)
- UK bank levy	(43)	(80)	—
- regulatory fines	(93)	—	—
- employee share schemes	(9)	(113)	(32)
- other disallowable items	(246)	(258)	(296)
Non-taxable items			
- gain on sale of RBS Aviation Capital	26	—	—
- gain on sale of Global Merchant Services	—	12	221
- gain on redemption of own debt	—	—	11
- other non-taxable items	104	242	341
Taxable foreign exchange movements	(1)	4	4
Losses brought forward and utilised	2	2	2
Reduction in carrying value of deferred tax asset in respect of losses in			
- Australia	(191)	—	—
- Ireland	(203)	—	—
Adjustments in respect of prior years	(47)	199	355
Actual tax charge	(469)	(1,127)	(703)

2012 compared with 2011

The high tax charge in 2012 reflects profits in high tax regimes (principally US) and losses in low tax regimes (principally Ireland), losses in overseas subsidiaries for which a deferred tax asset has not been recognised (principally

Ireland), the reduction in the carrying value of deferred tax assets in Ireland in view of continuing losses, the reduction in the carrying value of deferred tax assets in Australia following the strategic changes to the Markets and International Banking businesses announced in January 2012, and the effect of the two reductions of 1% in the rate of UK corporation tax enacted in March 2012 and July 2012 on the net deferred tax balance.

2011 compared with 2010
The high tax charge in 2011 reflects profits in high tax regimes (principally US) and losses in low tax regimes (principally Ireland), losses in overseas subsidiaries for which a deferred tax asset has not been recognised (principally Ireland and the Netherlands) and the effect of two reductions of 1% in the rate of UK corporation tax enacted in March 2011 and July 2011 on the net deferred tax balance.

Business review continued

Divisional performance

Operating profit/(loss) by division	2012 £m	2011 £m	2010 £m
UK Retail	1,891	2,021	1,348
UK Corporate	1,796	1,924	1,893
Wealth	253	248	283
International Banking	594	755	1,311
Ulster Bank	(1,040)	(984)	(683)
US Retail & Commercial	754	537	349
Retail & Commercial	4,248	4,501	4,501
Markets	1,509	899	2,724
Direct Line Group	441	454	(295)
Central items	143	191	630
Core	6,341	6,045	7,560
Non-Core	(2,879)	(4,221)	(5,715)
Managed basis	3,462	1,824	1,845
Reconciling items			
Own credit adjustments	(4,649)	1,914	242
Asset Protection Scheme	(44)	(906)	(1,550)
Payment Protection Insurance costs	(1,110)	(850)	—
Interest Rate Hedging Products redress and related costs	(700)	—	—
Regulatory fines	(381)	—	—
Sovereign debt impairment	—	(1,099)	—
Interest rate hedge adjustments on impaired available-for-sale sovereign debt	—	(169)	—
Amortisation of purchased intangible assets	(178)	(222)	(369)
Integration and restructuring costs	(1,550)	(1,064)	(1,032)
Gain on redemption of own debt	454	255	553
Strategic disposals	113	(104)	171
Bank levy	(175)	(300)	—
Bonus tax	—	(27)	(99)
Write-down of goodwill and other intangible assets	(518)	(11)	(10)
RFS Holdings minority interest	(20)	(7)	(150)
Operating loss including the results of Direct Line Group discontinued operations	(5,296)	(766)	(399)
Direct Line Group discontinued operations*	131	(424)	245
Group	(5,165)	(1,190)	(154)

* Included within Direct Line Group discontinued operations are the managed basis divisional results of Direct Line Group (DLG), certain DLG related activities in Central items and Non-Core, and related one-off and other items including write-down of goodwill, integration and restructuring costs and strategic disposals.

Business review continued

Impairment losses/(recoveries) by division	2012 £m	2011 £m	2010 £m
UK Retail	529	788	1,160
UK Corporate	838	793	767
Wealth	46	25	18
International Banking	111	168	86
Ulster Bank	1,364	1,384	1,161
US Retail & Commercial	91	326	519
Retail & Commercial	2,979	3,484	3,711
Markets	37	38	65
Central items	40	(2)	4
Core	3,056	3,520	3,780
Non-Core	2,223	3,919	5,476
Managed basis	5,279	7,439	9,256
Reconciling items			
Sovereign debt impairment	—	1,099	—
Interest rate hedge adjustments on impaired available-for-sale sovereign debt	—	169	—
Group	5,279	8,707	9,256

Net interest margin by division	2012 %	2011 %	2010 %
UK Retail	3.58	3.95	3.89
UK Corporate	3.06	3.06	2.89
Wealth	3.73	3.23	3.26
International Banking	1.64	1.73	1.92
Ulster Bank	1.88	1.87	2.03
US Retail & Commercial	3.00	3.06	2.82
Retail & Commercial	2.92	2.97	2.91
Non-Core	0.31	0.63	1.02
Group net interest margin	1.92	1.89	2.03

Risk-weighted assets by division	2012 £bn	2011 £bn	2010 £bn
UK Retail	45.7	48.4	48.8
UK Corporate	86.3	79.3	84.2
Wealth	12.3	12.9	12.5
International Banking	51.9	43.2	51.7
Ulster Bank	36.1	36.3	31.6
US Retail & Commercial	56.5	59.3	57.4
Retail & Commercial	288.8	279.4	286.2
Markets	101.3	120.3	110.3
Other	5.8	12.0	18.0
Core	395.9	411.7	414.5
Non-Core	60.4	93.3	153.7
Group before benefit of Asset Protection Scheme	456.3	505.0	568.2
Benefit of Asset Protection Scheme	—	(69.1)	(105.6)

Group before RFS Holdings minority interest	456.3	435.9	462.6
RFS Holdings minority interest	3.3	3.1	2.9
Group	459.6	439.0	465.5

Divisional performance continued
Employee numbers at 31 December
(full time equivalents rounded to the nearest hundred)

	2012	2011	2010
UK Retail	26,000	27,700	28,200
UK Corporate	13,300	13,600	13,200
Wealth	5,300	5,700	5,200
International Banking	4,400	5,400	5,300
Ulster Bank	4,500	4,200	4,200
US Retail & Commercial	14,700	15,400	15,900
Retail & Commercial	68,200	72,000	72,000
Markets	11,200	13,900	15,700
Direct Line Group	14,200	14,900	14,500
Central items	6,800	6,200	4,700
Core	100,400	107,000	106,900
Non-Core	3,100	4,700	6,900
	103,500	111,700	113,800
Business Services	33,200	34,000	34,400
Integration and restructuring	500	1,100	300
Group	137,200	146,800	148,500

Business review continued

UK Retail

	2012	2011	2010
	£m	£m	£m
Net interest income	3,990	4,302	4,054
Net fees and commissions	884	1,066	1,100
Other non-interest income	95	140	322
Non-interest income	979	1,206	1,422
Total income	4,969	5,508	5,476
Direct expenses			
- staff	(800)	(839)	(889)
- other	(372)	(437)	(480)
Indirect expenses	(1,377)	(1,423)	(1,514)
	(2,549)	(2,699)	(2,883)
Profit before impairment losses and insurance net claims	2,420	2,809	2,593
Insurance net claims	—	—	(85)
Impairment losses	(529)	(788)	(1,160)
Operating profit	1,891	2,021	1,348
Analysis of income by product			
Personal advances	916	1,089	993
Personal deposits	661	961	1,102
Mortgages	2,367	2,277	1,984
Cards	863	950	962
Other, including bancassurance in 2010	162	231	435
Total income	4,969	5,508	5,476
Analysis of impairments by sector			
Mortgages	92	182	177
Personal	307	437	682
Cards	130	169	301
Total impairment losses	529	788	1,160
Loan impairment charge as % of gross customer loans and advances (excluding reverse repurchase agreements) by sector			
Mortgages	0.1%	0.2%	0.2%
Personal	3.5%	4.3%	5.8%
Cards	2.3%	3.0%	4.9%
Total	0.5%	0.7%	1.1%
Performance ratios			
Return on equity (1)	24.4%	24.5%	16.3%
Net interest margin	3.58%	3.95%	3.89%
Cost:income ratio	51%	49%	53%

Business review continued

UK Retail continued

	2012 £bn	2011 £bn	2010 £bn
Capital and balance sheet			
Loans and advances to customers (gross) (2)			
- mortgages	99.1	95.0	90.6
- personal	8.8	10.1	11.7
- cards	5.7	5.7	6.1
	113.6	110.8	108.4
Loan impairment provisions	(2.6)	(2.7)	(2.7)
Net loans and advances to customers	111.0	108.1	105.7
Risk elements in lending (2)	4.6	4.6	4.6
Provision coverage (3)	58%	58%	59%
Customer deposits (2)	107.6	101.9	96.1
Assets under management (excluding deposits)	6.0	5.5	5.7
Loan:deposit ratio (excluding repos)	103%	106%	110%
Risk-weighted assets	45.7	48.4	48.8

Notes:
(1) Divisional return on equity is based on divisional operating profit after tax divided by average notional equity (based on 10% of the monthly average of divisional RWAs, adjusted for capital deductions).
(2) Includes businesses outlined for disposal: gross loans and advances to customers £7.6 billion (2011 - £7.3 billion; 2010 - £6.8 billion), risk elements in lending £0.5 billion (2011 and 2010 - £0.5 billion) and customer deposits £8.5 billion (2011 - £8.8 billion; 2010 - £9.0 billion).
(3) Provision coverage percentage represents loan impairment provisions as a percentage of risk elements in lending.

Over the last four years UK Retail has undertaken stretching initiatives and undergone significant change in order to meet its goal to consistently improve the service it offers to its customers. Highlights in 2012 include:

- Continued progress on the RBS and NatWest Customer Charter commitments supporting our goal of becoming Britain’s most helpful retail bank;

- Providing more than £500 million of cheaper mortgages through the Government’s Funding for Lending Scheme (FLS), launched at the end of June 2012 and opened for drawings in August 2012, which represents 14% of all completions in the last quarter of 2012;

- Seeking and responding to customer feedback to enhance the retail mobile banking app which is used by more than two million customers to manage their money and complete over one million transactions every week;

- Increasing online banking webchat functionality to allow customers real-time access to an advisor, direct from their computer, who can answer queries and action basic account services 24 hours a day; and

- Continued to invest in simplifying processes to make it easier for customers to bank with us, including introducing more than 200 cash deposit machines and ATMs to further reduce queuing times in branches.

However, the business has also had setbacks in the year. Customers suffered from disruptions to payment systems in June. Throughout this time UK Retail staff worked tirelessly to deal quickly with the issues and provide full redress and compensation to customers affected. In addition, the provision relating to historic Payment Protection Insurance (PPI) mis-selling was increased by £1.1 billion in 2012, bringing total PPI expense to date to £2.2 billion. This expense is not included in operating profit. With the new UK conduct regulator examining many products and services along with associated disclosures and sales practices, there are likely to be further impacts to business practices and potential additional costs of redress. The business is actively working to ensure its products set and sales practices are appropriate.

Ross McEwan joined UK Retail as its new Chief Executive in September 2012 and spent considerable time engaging with customers and employees around the country and reviewing business processes and performance. With his management team, he has developed a range of initiatives, building upon existing efforts, which focus on simplifying processes and providing a better experience for all customers. Ultimately, with a lot of hard work, the goal is to be the best retail bank in the UK.

Business review continued

2012 compared with 2011
Operating profit fell by 6% as a 10% decline in income was only partly offset by lower costs, down 6%, and improved impairment losses, down 33%.

Mortgage balances grew by £4.1 billion with the share of new business at 10%, ahead of our stock level of 8%. Growth as a result of FLS was starting to appear by the end of the year as mortgage applications moved through the pipeline to completion. Deposit growth of 6% was in line with the market and drove a 300 basis point improvement in the loan:deposit ratio to 103%.

Net interest income was down 7% due to weaker deposit margins and reduction in unsecured balances, partly offset by mortgage growth. Unsecured balances now represent 13% of total loans and advances to customers compared with 23% in 2008, following realignment of risk appetite and strong mortgage growth. Net interest margin declined as a result of lower rates on current account hedges and increased competition on savings rates in the early part of the year, partly offset by widening asset margins.

Non-interest income was 19% lower mainly due to:
- lower unauthorised overdraft fees as we continue to help customers manage their finances by providing mobile text alerts and further improving mobile banking functionality;
- weak consumer confidence lowering spending and associated fees on cards; and
- lower investment income as a result of weak customer demand and less advisor availability due to restructuring and retraining in preparation for regulatory changes in 2013.

Costs were down £150 million, 6%, driven by the ongoing simplification of processes across the business, lower headcount and lower FSCS levy.

Impairment losses were £259 million or 33% lower, reflecting the continued benefit of risk appetite tightening in prior years and also a smaller unsecured loan book. Impairments as a percentage of loans and advances were 50 basis points versus 70 basis points in 2011.

Risk-weighted assets continued to improve over the year as the portfolio mix adjusted, with increases in lower-risk secured mortgages, decreases in unsecured lending and further quality improvements across the book.

2011 compared with 2010
UK Retail delivered strong full year results, as operating profit increased by £673 million to £2,021 million, despite continued uncertainty in the economic climate and the low interest rate environment. Profit before impairment losses and insurance net claims was up £216 million or 8%, while impairments fell by £372 million, with further improvements in the unsecured book and continued careful mortgage underwriting. Return on equity improved to 24.5%.

The division continued to focus on growing secured lending while at the same time building customer deposits, thereby reducing the Group's reliance on wholesale funding. Loans and advances to customers grew 2%, with a change in mix from unsecured to secured as the Group actively sought to improve its risk profile. Mortgage balances grew by 5%, while unsecured lending contracted by 11%.

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Mortgage growth reflected continued strong new business levels. Gross mortgage lending market share of 10% continues above our stock position of 8%.

- Customer deposits grew 6%, outperforming the market total deposit growth of 3%. Savings balances grew by £6 billion, or 9%, with 1.5 million accounts opened, demonstrating the strength of our customer franchise and our strategy to further develop primary banking relationships.

Net interest income increased by 6% to £4,302 million, driven by strong balance sheet growth. Net interest margin increased 6 basis points recovering asset margins more than offset by more competitive savings rates and lower long term swap rate returns adversely impacting liability margins.

Non-interest income declined 15% to £1,206 million, primarily driven by lower investment and protection income as a result of the dissolution of the bancassurance joint venture. In addition, a number of changes have been made to support delivery of Helpful Banking, such as ‘Act Now’ text alerts, which have decreased fee income.

Overall expenses decreased by 6%. Cost reductions were driven by a clear management focus on process re-engineering and operational efficiency together with benefits from the dissolution of the bancassurance joint venture, partly offset by higher inflation rates in utility and mail costs.

Impairment losses decreased 32% to £788 million reflecting the impact of a strengthened risk appetite, and a more stable economic environment.

Risk-weighted assets were broadly stable, with volume growth in lower risk secured mortgages more than offset by a decrease in the unsecured portfolio.

Business review continued

UK Corporate

	2012	2011	2010
	£m	£m	£m
Net interest income	2,974	3,092	3,000
Net fees and commissions	1,365	1,375	1,353
Other non-interest income	384	396	443
Non-interest income	1,749	1,771	1,796
Total income	4,723	4,863	4,796
Direct expenses			
- staff	(928)	(922)	(912)
- other	(364)	(390)	(411)
Indirect expenses	(797)	(834)	(813)
	(2,089)	(2,146)	(2,136)
Profit before impairment losses	2,634	2,717	2,660
Impairment losses	(838)	(793)	(767)
Operating profit	1,796	1,924	1,893
Analysis of income by business			
Corporate and commercial lending	2,636	2,643	2,571
Asset and invoice finance	685	660	616
Corporate deposits	568	694	738
Other	834	866	871
Total income	4,723	4,863	4,796
Analysis of impairments by sector			
Financial institutions	15	20	20
Hotels and restaurants	52	59	52
Housebuilding and construction	143	103	131
Manufacturing	49	34	1
Private sector education, health, social work, recreational and community services	37	113	30
Property	252	170	245
Wholesale and retail trade, repairs	112	85	91
Asset and invoice finance	40	38	64
Shipping	82	22	4
Other	56	149	129
Total impairment losses	838	793	767
Loan impairment charge as % of gross customer loans and advances (excluding reverse repurchase agreements) by sector			
Financial institutions	0.3%	0.3%	0.3%
Hotels and restaurants	0.9%	1.0%	0.8%
Housebuilding and construction	4.2%	2.6%	2.9%
Manufacturing	1.0%	0.7%	—
	0.4%	1.3%	0.3%

Private sector education, health, social work, recreational and community services			
Property	1.0%	0.6%	0.8%
Wholesale and retail trade, repairs	1.3%	1.0%	0.9%
Asset and invoice finance	0.4%	0.4%	0.6%
Shipping	1.1%	0.3%	0.1%
Other	0.2%	0.6%	0.5%
Total	0.8%	0.7%	0.7%
Performance ratios			
Return on equity (1)	14.5%	15.2%	13.6%
Net interest margin	3.06%	3.06%	2.89%
Cost:income ratio	44%	44%	45%

Note:
(1) Divisional return on equity is based on divisional operating profit after tax, divided by average notional equity (based on 10% of the monthly average of divisional RWAs, adjusted for capital deductions).

Business review continued

	2012 £bn	2011 £bn	2010 £bn
Capital and balance sheet			
Loans and advances to customers (gross) (1)			
- financial institutions	5.8	5.8	6.2
- hotels and restaurants	5.6	6.1	6.8
- housebuilding and construction	3.4	3.9	4.5
- manufacturing	4.7	4.7	5.4
- private sector education, health, social work, recreational and community services	8.7	8.7	9.0
- property	24.8	28.2	29.5
- wholesale and retail trade, repairs	8.5	8.7	9.9
- asset and invoice finance	11.2	10.4	9.9
- shipping	7.6	7.8	7.5
- other	26.7	26.4	25.1
	107.0	110.7	113.8
Loan impairment provisions	(2.4)	(2.1)	(1.7)
Net loans and advances to customers	104.6	108.6	112.1
Total third party assets	110.2	114.2	117.0
Risk elements in lending (1)	5.5	5.0	4.0
Provision coverage (2)	45%	40%	44%
Customer deposits (1)	127.1	126.3	124.5
Loan:deposit ratio (excluding repos)	82%	86%	90%
Risk-weighted assets	86.3	79.3	84.2

Notes:
(1) Includes businesses outlined for disposal: loans and advances to customers £11.3 billion (2011 - £12.2 billion; 2010 - £13.9 billion), risk elements in lending £0.9 billion (2011 - £1.0 billion; 2010 - £1.2 billion) and customer deposits £13.0 billion (2011- £13.0 billion; 2010 - £15.0 billion).
(2) Provision coverage percentage represents loan impairment provisions as a percentage of risk elements in lending.

During 2012, UK Corporate continued to support its customers and the UK economy and further demonstrated a commitment to the communities it operates in.

RBS was the first bank to support the Government’s Funding for Lending Scheme (FLS). The division is using the FLS to stimulate loan demand through reduced interest rates for its customers. Since the scheme’s launch, UK Corporate has supported over 11,000 SMEs with over £1.7 billion of allocated funds through FLS initiatives. In addition, UK Corporate is providing targeted support to manufacturers through its Manufacturing Fund. This has made £1 billion available to customers, facilitating investment in technology and innovation and freeing up working capital. UK Corporate launched a Carbon Reduction Fund which provides £200 million of ring-fenced funding for businesses undertaking energy-efficiency projects. The division has also supported its clients in accessing the corporate bond markets. Corporate clients raised a total of £19 billion of bonds in 2012.

Throughout the year, UK Corporate has also continued to invest in the service it delivers to its customers through:

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The introduction of a new enhanced telephony and online offering, Business Connect. This already supports over 170,000 small business customers, offering telephony access to experienced relationship managers from 8am to 8pm, in addition to its traditional branch and relationship manager network;

- New mobile banking apps that allow customers to manage multiple accounts, make payments and transfers, and view detailed statements. In 2012 over 70,000 users were using the app twice a day, transacting more than £700 million since launch; and

- Regional 'Great place to do business' events which bring investors, local authorities and prominent members of the community together to identify opportunities for stimulating growth in the community.

UK Corporate has invested significantly to further enhance the skills of its people. As part of improvements to its specialist sector propositions, the business is tailoring its industry leading accreditation programme with industry specific modules. The bespoke modules are endorsed by key sector bodies such as the National Farmers' Union.

UK Corporate was the first high street bank to support the Evening Standard and City Gateway apprenticeship initiative, hiring an initial 16 young people onto its scheme.

UK Corporate continued
2012 compared with 2011
With economic factors continuing to suppress business confidence, 2012 saw lower income and operating profit. Nonetheless, the business delivered a return on equity of 14.5%, slightly below the prior year and comfortably ahead of the cost of capital.

Operating profit decreased by 7%, with income down 3% and increased impairments, up 6%, partially offset by a 3% decrease in costs.

Net interest income was 4% lower, reflecting a 3% fall in lending volumes as loan repayments outstripped new lending, deposit margin compression due to strong competition and the continuation of low yields on current accounts. This was partially offset by improved asset margins and a 1% increase in deposit volumes.

Non-interest income was broadly in line with 2011, with stable income from transaction services, asset finance, Markets revenue share and other lending fees.

Total costs were down 3% due to tight control over direct discretionary expenditure combined with lower indirect costs as a result of operational savings, partially offset by increased investment expenditure.

Core lending balances were up £200 million, excluding the property, housebuilding and construction sectors. The loan:deposit ratio decreased by 400 basis points, principally reflecting deposit growth and portfolio de-risking, particularly in commercial real estate. The Group took part in a number of Government initiatives, seeking responsibly to stimulate additional credit demand in the face of continued customer deleveraging and low business confidence levels.

Impairments increased by 6% with lower specific provisions, mainly in the SME business, more than offset by reduced levels of latent provision releases across the division (£44 million in 2012 versus £226 million in 2011). Impairments as a percentage of loans and advances edged up modestly to 80 basis points.

Risk-weighted assets increased by 9% as regulatory changes to capital models during H2 2012 totalling £15 billion (primarily the implementation of the market-wide slotting approach on real estate and increases to default risk weights in other models) were partly offset by a fall in funded assets.

Not reflected in operating results was UK Corporate’s £350 million share of the provision for interest rate swap redress which relates to prior periods, mainly pre-2008.

2011 compared with 2010
Operating profit increased by 2% to £1,924 million, as higher income was partially offset by higher impairments and an increase in expenses.

Net interest income increased by 3%. Net interest margin improved 17 basis points with benefits from re-pricing the lending portfolio and the revision to income deferral assumptions in Q1 2011 partially offset by increased funding costs together with continued pressure on deposit margins. A 1% increase in deposit balances supported an improvement in the loan:deposit ratio to 86%.

Non-interest income decreased by 1% as a result of lower Markets cross-sales and fee income, partially offset by increased Invoice Finance and Lombard income.

Excluding the £29 million OFT penalty in 2010, total costs increased by 2%, largely reflecting increased investment in the business and higher costs of managing the non-performing book.

Impairments of £793 million were 3% higher due to increased specific impairments and collectively assessed provisions, partially offset by lower latent loss provisions.

Wealth

	2012	2011	2010
	£m	£m	£m
Net interest income	720	645	588
Net fees and commissions	366	375	376
Other non-interest income	84	84	71
Non-interest income	450	459	447
Total income	1,170	1,104	1,035
Direct expenses			
- staff	(424)	(413)	(382)
- other	(223)	(195)	(142)
Indirect expenses	(224)	(223)	(210)
	(871)	(831)	(734)
Profit before impairment losses	299	273	301
Impairment losses	(46)	(25)	(18)
Operating profit	253	248	283
Analysis of income			
Private banking	956	902	836
Investments	214	202	199
Total income	1,170	1,104	1,035
Performance ratios			
Return on equity (1)	13.7%	13.1%	15.9%
Net interest margin	3.73%	3.23%	3.26%
Cost:income ratio	74%	75%	71%

	£bn	£bn	£bn
Capital and balance sheet			
Loans and advances to customers (gross)			
- mortgages	8.8	8.3	7.8
- personal	5.5	6.9	6.7
- other	2.8	1.7	1.6
	17.1	16.9	16.1
Loan impairment provisions	(0.1)	(0.1)	(0.1)
Net loans and advances to customers	17.0	16.8	16.0
Risk elements in lending	0.2	0.2	0.2
Provision coverage (2)	44%	38%	30%
Assets under management (excluding deposits)	28.9	30.9	33.9
Customer deposits	38.9	38.2	37.1
Loan:deposit ratio (excluding repos)	44%	44%	43%
Risk-weighted assets	12.3	12.9	12.5

Notes:

(1) Divisional return on equity is based on divisional operating profit after tax divided by average notional equity (based on 10% of the monthly average of divisional RWAs, adjusted for capital deductions).
(2) Provision coverage percentage represents loan impairment provisions as a percentage of risk elements in lending.

Wealth continued
2012 saw improved performance overall, with higher lending and deposit margins and volumes driving higher income.

In 2012 the Coutts businesses continued to focus on implementing and delivering the new divisional strategy outlined in 2011. The sale of Coutts' Latin American businesses and the completion of the rollout of Coutts global technology platform in the UK were tangible examples of this. By the end of the year the division had exited over 100 countries since the strategy was introduced and was serving clients in the remaining countries through one central operating platform, a clear demonstration of the division's commitment to its strategy.

In the UK, Q4 2012 saw the launch of Coutts' new Retail Distribution Review (RDR)-compliant advice proposition and products. Significant investment was made during 2012 to ensure clients would continue to receive the best service, advice and products based on their specific needs. One example of this was the introduction of seven new UK and global RDR-compliant multi-asset funds, allowing clients to continue to invest in a broad range of asset classes matched to their needs and risk appetites.

Clients in the UK also benefited from the launch of the Coutts Mobile service in October, offering clients greater choice and flexibility in the way they manage their banking needs electronically.

In the International business, the division further invested in Dubai, Singapore and Mumbai as it continued to embed its targeted growth strategy. Clients also benefited from enhancements to the collateralised lending programme, where higher lending limits and a greater number of currencies available has increased its relevance to clients.

2012 compared with 2011
Operating profit increased by £5 million, or 2% to £253 million driven by higher income partially offset by increased expenses and impairment losses.

Total income increased by £66 million, with net interest income up £75 million, largely driven by improvements in margins and strong divisional treasury income, particularly during H1 2012.

Non-interest income fell by 2% as the gain from the disposal of the Latin American, Caribbean and African businesses was more than offset by a decline in fee income in the UK and lower investment volumes, driven by continued economic uncertainty.

Expenses were £40 million or 5% higher at £871 million, with significant investment in change programmes, including the development of new products and services capability and the implementation of RDR in the UK.

Expenses also increased as a result of client redress following a past business review into the sale of the ALICO Enhanced Variable Rate Fund announced in November 2011 and a Financial Services Authority fine of £8.75 million relating to Anti Money Laundering control processes.

Client assets and liabilities fell by 1% with a £2 billion decrease in assets under management, primarily reflecting low margin client outflows of £1.4 billion and the impact of client transfers following the disposal of the Latin American, Caribbean and African businesses. This fall was partially offset by increases in lending and deposit volumes.

Impairment losses were £46 million, up £21 million, largely reflecting a small number of large specific impairments.

2011 compared with 2010
Operating profit decreased by 12% on 2010 to £248 million, driven by increases in expenses (13%) and impairments (39%) partially offset by a 7% growth in income.

Income increased by £69 million with a strong treasury income and increases in lending and deposit volumes. Non-interest income rose 3%, with investment income growing 2% despite turbulent market conditions.

Expenses increased by £97 million, largely driven by adverse foreign exchange movements and headcount growth to service the increased revenue base. Additional strategic investment in technology enhancement, rebranding and programmes to support regulatory change also contributed to the increase.

Client assets and liabilities managed by the division decreased by 1%. Customer deposits grew 3% in a competitive environment and lending volumes grew 5%. Assets under management declined 9%, with fund outflows contributing 3% of the decrease and market conditions making up the balance.

Business review continued

International Banking

	2012 £m	2011 £m	2010 £m
Net interest income from banking activities	922	1,199	1,353
Funding costs of rental assets	(9)	(42)	(37)
Net interest income	913	1,157	1,316
Non-interest income	1,209	1,398	1,961
Total income	2,122	2,555	3,277
Direct expenses			
- staff	(577)	(706)	(871)
- other	(162)	(226)	(274)
Indirect expenses	(678)	(700)	(735)
	(1,417)	(1,632)	(1,880)
Profit before impairment losses	705	923	1,397
Impairment losses	(111)	(168)	(86)
Operating profit	594	755	1,311
Of which:			
Ongoing businesses	602	773	1,348
Run-off businesses	(8)	(18)	(37)
Analysis of income by product			
Cash management	943	940	1,368
Trade finance	291	275	243
Loan portfolio	865	1,265	1,578
Ongoing businesses	2,099	2,480	3,189
Run-off businesses	23	75	88
Total income	2,122	2,555	3,277
Analysis of impairments by sector			
Manufacturing and infrastructure	42	254	(17)
Property and construction	7	17	102
Transport and storage	(3)	11	—
Telecommunications, media and technology	12	—	7
Banks and financial institutions	43	(42)	49
Other	10	(72)	(55)
Total impairment losses	111	168	86
Loan impairment charge as % of gross customer loans and advances (excluding reverse repurchase agreements)	0.3%	0.3%	0.2%
Performance ratios (ongoing businesses)			
Return on equity (1)	9.2%	11.5%	15.4%
Net interest margin	1.64%	1.73%	1.92%
Cost:income ratio	66%	62%	55%

Note:

(1) Divisional return on equity is based on divisional operating profit after tax divided by average notional equity (based on 10% of the monthly average of divisional RWAs, adjusted for capital deductions), for the ongoing businesses.

International Banking continued

	2012	2011	2010
	£bn	£bn	£bn
Capital and balance sheet			
Loans and advances to customers (gross) (1)	42.2	57.7	62.9
Loan impairment provisions	(0.4)	(0.8)	(0.8)
Net loans and advances to customers	41.8	56.9	62.1
Loans and advances to banks	4.7	3.4	3.9
Securities	2.6	6.0	6.8
Cash and eligible bills	0.5	0.3	0.7
Other	3.4	3.3	4.4
Total third party assets (excluding derivatives mark-to-market)	53.0	69.9	77.9
Risk elements in lending	0.4	1.6	1.5
Provision coverage (2)	93%	52%	58%
Customer deposits (excluding repos)	46.2	45.1	43.7
Bank deposits (excluding repos)	5.6	11.4	7.3
Loan:deposit ratio (excluding repos and conduits)	85%	103%	112%
Risk-weighted assets	51.9	43.2	51.7
	£m	£m	£m
Run-off businesses (1)			
Total income	23	75	88
Direct expenses	(31)	(93)	(125)
Operating loss	(8)	(18)	(37)

Notes:

(1) Excludes disposal groups.

(2) Provision coverage percentage represents loan impairment provisions as a percentage of risk elements in lending.

(3) Run-off businesses consist of the exited corporate finance businesses.

International Banking was formed in January 2012 to create an integrated, client-focused business which serves RBS's large global customers' financing, risk management, trade finance, payments and cash management needs internationally.

Since its formation, the division has made significant progress in strengthening its balance sheet and making efficient use of resources. The loan portfolio decreased significantly due to strategic reduction initiatives and disciplined capital allocation. The division's liability composition also improved, with additional customer deposits raised in the final quarter and the strategic run-off of commercial paper and short-term bank deposits.

Performance in 2012 was restricted by macroeconomic pressures and additional regulatory requirements across the industry. Given these constraints, International Banking kept its focus on cost control throughout the year.

Despite these headwinds, the division was recognised externally for its efforts in serving its customers' needs, helping RBS Group gain awards such as:

- Top European investment grade corporate bond bookrunner (Dealogic).

- Number one cash management manager in the UK and number two in Europe (Euromoney Cash Management Survey).
- Quality Leader in Large Corporate Trade Finance in the UK, and number one for Large Corporate Trade Finance Penetration in the UK (Greenwich).

Business review continued

2012 compared with 2011
Operating profit decreased by £161 million as a decline in income was only partially mitigated by lower expenses and impairment losses.

Income was 17% lower:
- Loan portfolio decreased by 32%, mainly due to a strategic reduction in assets, in order to allocate capital more efficiently, and the effect of portfolio credit hedging and lower corporate appetite for risk management activities.

- Cash management was broadly in line with the previous year. Deposit margins declined following reductions in both three month LIBOR and five year fixed rates across Europe; however, this was offset by lower liquidity costs due to the strategic initiative to reduce short-term bank deposits.

- Trade finance increased by 6% as a result of increased activity, particularly in Asia.

- The restructuring in 2012 led to a reduction in activities undertaken in the division, which contributed to a decline in income.

Expenses declined by £215 million, reflecting planned restructuring initiatives following the formation of the International Banking division. Savings were achieved through headcount reduction, run-off of discontinued businesses and a resulting decrease in infrastructure support costs. Revenue-linked expenses also fell in line with the decrease in income.

Impairment losses decreased by £57 million with the non-repeat of a single name impairment.

Third party assets declined by 24%, with targeted reductions in the lending portfolio following a strategic reduction in assets.

Customer deposits increased by 2%. Successful efforts to rebuild customer confidence following the Moody's credit rating downgrade and the Group technology incident in June 2012 outweighed economic pressures. This, coupled with the managed reduction in loans and advances to customers, improved the loan:deposit ratio to 85%.

Bank deposits were down 51%, mainly as a result of lower short-term balances, reflecting a strategic initiative to reduce liquidity outflow risk.

Risk-weighted assets increased by 20%, reflecting the impact of regulatory uplifts partially offset by successful mitigation through balance sheet reduction. Risk-weighted asset intensity in the loan book has increased significantly given the uplifts, which will result in strategic adjustments going forward.

2011 compared with 2010
Operating profit was down 42%, partly reflecting the sale of Global Merchant Services (GMS) which completed on 30 November 2010. Adjusting for the disposal, operating profit decreased 32%, driven by a decrease in income and an impairment provision on a single name in 2011.

Excluding GMS income of £451, income was 10% lower despite the success of deposit-gathering initiatives, as customer deposits increased £1 billion in a competitive environment.

Excluding GMS expenses of £244 million, expenses decreased by £4 million, reflecting business improvement initiatives and investment in technology and support infrastructure.

Impairment losses increased to £168 million compared with £86 million in 2010 reflecting a single name impairment.

Ulster Bank

	2012	2011	2010
	£m	£m	£m
Net interest income	649	736	839
Net fees and commissions	145	142	156
Other non-interest income	51	69	58
Non-interest income	196	211	214
Total income	845	947	1,053
Direct expenses			
- staff	(211)	(221)	(237)
- other	(49)	(67)	(74)
Indirect expenses	(261)	(259)	(264)
	(521)	(547)	(575)
Profit before impairment losses	324	400	478
Impairment losses	(1,364)	(1,384)	(1,161)
Operating loss	(1,040)	(984)	(683)
Analysis of income by business			
Corporate	360	435	521
Retail	360	428	465
Other	125	84	67
Total income	845	947	1,053
Analysis of impairments by sector			
Mortgages	646	570	294
Corporate			
- property	276	324	375
- other corporate	389	434	444
Other lending	53	56	48
Total impairment losses	1,364	1,384	1,161
Loan impairment charge as % of gross customer loans and advances (excluding reverse repurchase agreements) by sector			
Mortgages	3.4%	2.9%	1.4%
Corporate			
- property	6.4%	6.8%	6.9%
- other corporate	5.0%	5.6%	4.9%
Other lending	3.8%	3.5%	3.7%
Total	4.2%	4.1%	3.1%
Performance ratios			
Return on equity (1)	(21.8%)	(22.8%)	(16.8%)
Net interest margin	1.88%	1.87%	2.03%
Cost:income ratio	62%	58%	55%

Note:

(1) Divisional return on equity is based on divisional operating loss after tax divided by average notional equity (based on 10% of the monthly average of divisional RWAs, adjusted for capital deductions).

Business review continued

	2012 £bn	2011 £bn	2010 £bn
Capital and balance sheet			
Loans and advances to customers (gross)			
- mortgages	19.2	20.0	21.2
- corporate			
- property	4.3	4.8	5.4
- other corporate	7.8	7.7	9.0
- other lending	1.3	1.6	1.3
	32.6	34.1	36.9
Loan impairment provisions	(3.9)	(2.7)	(1.6)
Net loans and advances to customers	28.7	31.4	35.3
Risk elements in lending			
- mortgages	3.1	2.2	1.5
- corporate			
- property	1.9	1.3	0.7
- other corporate	2.3	1.8	1.2
- other lending	0.2	0.2	0.2
Total risk elements in lending	7.5	5.5	3.6
Provision coverage (1)	52%	50%	45%
Customer deposits	22.1	21.8	23.1
Loan:deposit ratio (excluding repos)	130%	143%	152%
Risk-weighted assets	36.1	36.3	31.6
Spot exchange rate - €/£	1.227	1.196	1.160

Note:
(1) Provision coverage percentage represents loan impairment provisions as a percentage of risk elements in lending.

The challenging macroeconomic environment across the island of Ireland had a significant impact on Ulster Bank's financial performance for 2012. There were some emerging signs of improvement in the Republic of Ireland economy during Q4 2012, most notably in the availability of institutional funding, some stabilisation of residential property prices and continued economic growth, albeit modest.

While impairment levels remained elevated during 2012, net interest margin and expense management improved. Further progress was made on Ulster Bank's deposit gathering strategy with customer deposit balances increasing by 9% in Q4 2012, driving a significant reduction in the loan to deposit ratio.

Following the Group technology incident in June 2012, Ulster Bank made significant efforts to help customers who were affected, extending branch hours, tripling call centre staff and providing full redress.

Ulster Bank continued
2012 compared with 2011
Operating loss increased by £56 million primarily reflecting a reduction in income driven by lower interest earning asset volumes.

Total expenses fell by £26 million, reflecting the benefits of cost saving initiatives.

Impairment losses remained elevated, as weak underlying credit metrics prevailed. Falling asset values throughout most of 2012 and high levels of unemployment coupled with weak domestic demand continued to depress the property market. The impairment charge for 2012 was driven by a combination of new defaulting customers and deteriorating security values. Risk elements in lending increased by £2 billion during the year reflecting continued difficult conditions in both the commercial and residential property sectors.

The loan to deposit ratio improved from 143% to 130%, driven by a combination of deposit growth and a decrease in the loan book. The loan book increased by 1% as a result of movements in foreign exchange rates offset by natural amortisation and limited new lending due to low levels of market demand. Retail and SME deposits increased by 8%; however, this was partly offset by outflows of wholesale balances driven by market volatility and the impact of a rating downgrade in the second half of 2011.

2011 compared with 2010
Profit before impairment losses decreased by £78 million in 2011 with lower income partially mitigated by cost savings. Impairment losses of £1,384 million increased by 19% from 2010 resulting in an operating loss of £984 million, 44% higher than 2010.

Income fell by 10% driven by a contracting performing loan book coupled with higher funding costs. Loans and advances to customers decreased by 8% during 2011.

Expenses fell by 5% reflecting tight management of the cost base across the business.

Impairment losses increased by 19% largely reflecting the deterioration in credit metrics on the mortgage portfolio driven by a combination of higher debt flow and further fall in asset prices.

Despite intense competition, retail and small business deposit balances have grown strongly throughout 2011, driven by the benefits of a focused deposit gathering strategy. However, total customer deposit balances fell by 6% largely driven by the outflow of wholesale customer balances due to rating downgrades.

Risk-weighted assets increased by 15% in 2011 reflecting the deterioration in credit risk metrics.

Business review continued

US Retail & Commercial

	2012 US$m	2011 US$m	2010 US$m	2012 £m	2011 £m	2010 £m
Net interest income	3,087	3,048	2,940	1,948	1,900	1,902
Net fees and commissions	1,233	1,350	1,328	778	841	859
Other non-interest income	579	473	464	365	296	301
Non-interest income	1,812	1,823	1,792	1,143	1,137	1,160
Total income	4,899	4,871	4,732	3,091	3,037	3,062
Direct expenses						
- staff	(1,313)	(1,344)	(1,238)	(828)	(838)	(801)
- other	(833)	(893)	(897)	(526)	(557)	(580)
- litigation settlement	(138)	—	—	(88)	—	—
Indirect expenses	(1,274)	(1,250)	(1,255)	(804)	(779)	(813)
	(3,558)	(3,487)	(3,390)	(2,246)	(2,174)	(2,194)
Profit before impairment losses	1,341	1,384	1,342	845	863	868
Impairment losses	(145)	(524)	(802)	(91)	(326)	(519)
Operating profit	1,196	860	540	754	537	349
Average exchange rate - US$/£				1.585	1.604	1.546
Analysis of income by product						
Mortgages and home equity	856	744	786	541	463	509
Personal lending and cards	643	709	761	405	442	492
Retail deposits	1,364	1,487	1,465	860	927	948
Commercial lending	965	936	901	609	584	583
Commercial deposits	698	667	627	441	416	406
Other	373	328	192	235	205	124
Total income	4,899	4,871	4,732	3,091	3,037	3,062
Analysis of impairments by sector						
Residential mortgages	(2)	44	85	(1)	28	55
Home equity	150	165	164	95	103	106
Corporate and commercial	(120)	88	354	(77)	55	228
Other consumer	104	101	146	65	61	96
Securities	13	126	53	9	79	34
Total impairment losses	145	524	802	91	326	519
Loan impairment charge as % of gross customer loans and advances (excluding reverse repurchase agreements) by sector						
Residential mortgages	—	0.5%	0.9%	—	0.5%	0.9%
Home equity	0.7%	0.7%	0.7%	0.7%	0.7%	0.7%
Corporate and commercial	(0.3%)	0.2%	1.1%	(0.3%)	0.2%	1.1%
Other consumer	0.8%	0.8%	1.4%	0.8%	0.8%	1.4%
Total	0.2%	0.5%	1.0%	0.2%	0.5%	1.0%

Performance ratios						
Return on equity (1)	8.3%	6.3%	3.7%	8.3%	6.3%	3.7%
Adjusted return on equity (non-GAAP) (2)	8.9%	6.3%	3.7%	8.9%	6.3%	3.7%
Net interest margin	3.00%	3.06%	2.82%	3.00%	3.06%	2.82%
Cost:income ratio	73%	72%	72%	73%	72%	72%
Adjusted cost:income ratio (2)	71%	72%	72%	71%	72%	72%

Notes:

(1) Divisional return on equity is based on divisional operating profit after tax divided by average notional equity (based on 10% of the monthly average of divisional RWAs, adjusted for capital deductions).

(2) Excludes litigation settlement and net gain on sale of Visa B shares in 2012 of £88 million (US$138 million) and £39 million (US$62 million) .

Business review continued

US Retail & Commercial continued

	2012 US$bn	2011 US$bn	2010 US$bn	2012 £bn	2011 £bn	2010 £bn
Capital and balance sheet						
Loans and advances to customers (gross)						
- residential mortgages	9.4	9.4	9.4	5.8	6.1	6.1
- home equity	21.5	23.1	23.6	13.3	14.9	15.2
- corporate and commercial	38.5	35.3	31.7	23.8	22.9	20.5
- other consumer	13.5	12.0	10.7	8.4	7.7	6.9
	82.9	79.8	75.4	51.3	51.6	48.7
Loan impairment provisions	(0.9)	(1.1)	(1.2)	(0.5)	(0.7)	(0.8)
Net loans and advances to customers	82.0	78.7	74.2	50.8	50.9	47.9
Total third party assets	117.3	117.3	112.4	72.5	75.8	72.4
Investment securities	19.5	23.5	21.4	12.0	15.2	13.8
Risk elements in lending						
- retail	1.3	1.0	0.7	0.8	0.6	0.4
- commercial	0.6	0.6	0.7	0.3	0.4	0.5
Total risk elements in lending	1.9	1.6	1.4	1.1	1.0	0.9
Provision coverage (1)	48%	72%	85%	48%	72%	85%
Customer deposits (excluding repos)	95.6	92.8	92.1	59.2	60.0	59.3
Bank deposits (excluding repos)	2.9	8.0	9.5	1.8	5.2	6.1
Loan:deposit ratio (excluding repos)	86%	85%	81%	86%	85%	81%
Risk-weighted assets	91.3	91.8	89.1	56.5	59.3	57.4
Spot exchange rate - US$/£				1.616	1.548	1.552

Note:
(1) Provision coverage percentage represents loan impairment provisions as a percentage of risk elements in lending.

In the first quarter of 2012, RBS Citizens implemented five strategic priorities to sharpen the division’s back-to-basics strategy. The strategy is founded on the belief that building an engaged workforce which is focused on the customer experience and on being their primary banking partner, with an embedded culture of risk management, will position the franchise to deliver financial results consistent with a top performing regional bank.

Efforts in both the Consumer and Commercial businesses throughout 2012 were aligned with those priorities and our customers have acknowledged our efforts. According to a 2012 survey conducted by American Banker, RBS Citizens was ranked in the top ten of US banks for corporate reputation, an improvement of eight places from 2011.

Core Customer Commitments were implemented in Consumer Banking’s branch network at the end of last year. Early indications show progress towards the Commitments’ aim to enhance customer experience:

- At the end of 2012, 77% of customers surveyed externally were ‘completely satisfied’ or ‘very satisfied’, compared with the peer average of 71%.

- RBS Citizens' net promoter score, a measure of how likely customers are to recommend the bank, increased to 20% over the course of 2012 and was over ten percentage points above the peer average.

Consumer Banking further improved and expanded its distribution channels and product capabilities including the roll-out of intelligent deposit machines and the on-going build out of its mortgage capabilities, reaching the top 20 nationally for mortgage originations in 2012. The business made enhancements to its mobile banking services and subsequently its apps for both iPhone and Android were rated the 'best integrated apps' in the industry based on an analysis of consumer ratings conducted by Javelin Strategy & Research.

In 2012, Commercial Banking responded to client feedback, introducing its own core Client Commitments and developing a new Commercial Client on-boarding process to improve the way clients are welcomed to RBS Citizens.

Commercial Banking took further significant steps towards strengthening its customer proposition with a more streamlined, efficient and integrated service and product offering by integrating the Treasury Solutions, Foreign Exchange and Interest Rate Derivatives functions into Commercial Banking.

The business made good progress towards expanding its capital markets capabilities. At the end of 2012, RBS Citizens ranked #4 in the new capital markets business for middle market customers within the footprint, and ranked in the top ten nationally.

2012 compared with 2011
US Retail & Commercial posted an operating profit of £754 million ($1,196 million), up £217 million ($336 million), or 40%, from 2011. Excluding the £88 million ($138 million) litigation settlement in Q1 2012 and the £39 million ($62 million) net gain on the sale of Visa B shares in Q2 2012, operating profit was up £266 million ($412 million), or 50%, largely reflecting lower impairment losses due to an improved credit environment.

Net interest income was up £48 million ($39 million), or 3%, driven by targeted commercial loan growth, deposit pricing discipline and lower funding costs. This was partially offset by consumer loan run-off and lower asset yields reflecting prevailing economic conditions.

Non-interest income was up £6 million. In US dollar terms non-interest income was down $11 million, or 1%, reflecting a decline in debit card fees as a result of the Durbin Amendment legislation and lower securities gains and deposit fees. This was largely offset by strong mortgage banking fees of £69 million ($109 million), up 71%, and the £47 million ($75 million) gross gain on the sale of Visa B shares.

Gross loans and advances to customers were down £0.3 billion. In US dollar terms loans and advances to customers were up $3.1 billion, or 4%, due to strong growth in commercial loan volumes.

Customer deposits decreased by 1% as a result of movements in foreign exchange rates partially offset by strong growth achieved in checking balances. Consumer checking balances fell by 1% while small business checking balances grew by 4% over the year.

Excluding the £88 million ($138 million) litigation settlement, relating to a class action lawsuit regarding the way overdraft fees were assessed on customer accounts prior to 2010, and the £8 million ($13 million) litigation reserve associated with the sale of Visa B shares, and a one-off £21 million ($33 million) pension gain in Q4 2012, total expenses were down 1%, reflecting lower loan collection costs and the elimination of the Everyday Points rewards programme for consumer debit card customers, partially offset by higher operational losses.

During the year, RBS Citizens offered former employees a one-time opportunity to receive the value of future pension benefits as a single lump sum payment. The transaction allowed RBS Citizens to partially de-risk its pension plan and future liability under the plan. A strong participant take-up rate of 60% enabled RBS Citizens to reduce its pension liability by 17% and recognise a £21 million ($33 million) accounting gain.

Impairment losses were down £235 million ($379 million), or 72%, reflecting an improved credit environment and lower impairments on securities. Loan impairments improved by £168 million ($266 million) driven primarily by commercial loan impairments. Impairments as a percentage of loans and advances fell to 20 basis points.

2011 compared with 2010
Operating profit increased to £537 million ($860 million) from £349 million ($540 million), an increase of £188 million ($320 million), or 54%. Excluding a credit of £73 million ($113 million) related to changes to the defined benefit plan in Q2 2010, operating profit increased £261 million ($433 million), or 95%, substantially driven by lower impairments and improved income.

The macroeconomic operating environment remained challenging, with low rates, high unemployment, a soft housing market, sluggish consumer activity and the continuing impact of legislative changes including the Durbin Amendment in the Dodd-Frank Act which became effective on 1 October 2011.

The Durbin Amendment lowers the allowable interchange on debit transactions to $0.23-$0.24 per transaction. The current annualised impact of the Durbin Amendment is estimated at £94 million ($150 million).

Net interest income was down £2 million. In US dollar terms, net interest income increased by $108 million, or 4%. Net interest margin improved by 24 basis points to 3.06% reflecting changes in deposit mix, continued discipline around deposit pricing and the positive impact from the balance sheet restructuring programme carried out during Q3 2010 combined with strong commercial loan growth, partially offset by run-off of consumer loans.

Non-interest income was down £23 million. In US dollar terms, non interest income increase by $31 million, or 2%. The increase was primarily driven by higher account and transaction fees, partially offset by the impact of legislative changes on debit card and deposit fees.

Excluding the defined benefit plan credit of £73 million ($113 million) in Q2 2010, total expenses were down £93 million ($16 million), 4%, due to a number of factors including lower Federal Deposit Insurance Corporation (FDIC) deposit insurance levies, and lower litigation and marketing costs, partially offset by higher regulatory costs.

Impairment losses declined by £193 million ($278 million), or 37%, largely reflecting an improved credit environment slightly offset by higher impairments related to securities. Loan impairments as a percentage of loans and advances improved to 0.5% from 1.0%.

Customer deposits were up 1% with particularly strong growth achieved in checking balances. Consumer checking balances grew by 6%, while small business checking balances grew by 5% over the year.

Business review continued

Markets

	2012 £m	2011 £m	2010 £m
Net interest income	111	67	581
Net fees and commissions receivable	128	371	520
Income from trading activities	4,105	3,846	5,020
Other operating income	139	131	112
Non-interest income	4,372	4,348	5,652
Total income	4,483	4,415	6,233
Direct expenses			
- staff	(1,453)	(1,963)	(2,082)
- other	(721)	(746)	(663)
Indirect expenses	(763)	(769)	(699)
	(2,937)	(3,478)	(3,444)
Profit before impairment losses	1,546	937	2,789
Impairment losses	(37)	(38)	(65)
Operating profit	1,509	899	2,724
Of which:			
Ongoing businesses	1,564	943	2,743
Run-off businesses	(55)	(44)	(19)
Analysis of income by product			
Rates	2,006	1,474	2,312
Currencies	757	1,060	1,047
Asset backed products (ABP)	1,318	1,254	1,479
Credit markets	862	616	1,350
Investor products and equity derivatives	224	593	672
Total income ongoing businesses	5,167	4,997	6,860
Inter-divisional revenue share	(691)	(767)	(883)
Run-off businesses	7	185	256
Total income	4,483	4,415	6,233
Memo - fixed income and currencies			
Rate/currencies/ABP/credit markets	4,943	4,404	6,188
Less: primary credit markets	(568)	(688)	(863)
Total fixed income and currencies	4,375	3,716	5,325
Performance ratios (ongoing businesses)			
Return on equity (1)	10.0%	6.1%	19.1%
Cost:income ratio	64%	77%	53%
Compensation ratio (2)	32%	42%	31%

Notes:

(1) Divisional return on equity is based on divisional operating profit after tax divided by average notional equity (based on 10% of the monthly average of divisional RWAs, adjusted for capital deductions), for the ongoing

businesses.

(2) Compensation ratio is based on staff costs as a percentage of total income.

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Business review continued

	2012	2011	2010
	£bn	£bn	£bn
Capital and balance sheet (ongoing businesses)			
Loans and advances to customers (gross)	29.8	31.5	24.4
Loan impairment provisions	(0.2)	(0.2)	(0.2)
Net loans and advances to customers	29.6	31.3	24.2
Loans and advances to banks	16.6	29.9	44.4
Reverse repos	103.8	100.4	94.7
Securities	92.4	108.1	115.8
Cash and eligible bills	30.2	28.1	38.8
Other	11.8	14.8	20.1
Total third party assets (excluding derivatives mark-to-market)	284.4	312.6	338.0
Net derivative assets (after netting)	21.9	37.0	37.4
Provision coverage (1)	77%	75%	86%
Customer deposits (excluding repos)	26.3	36.8	37.4
Bank deposits (excluding repos)	45.4	48.2	50.6
Risk-weighted assets	101.3	120.3	110.3
Run-off businesses (2)	£m	£m	£m
Total income	7	185	256
Direct expenses	(62)	(229)	(275)
Operating loss	(55)	(44)	(19)
Balance sheet - run-off businesses (2)	£bn	£bn	£bn
Total third party assets (excluding derivatives mark-to-market)	0.1	1.3	2.4

Notes:
(1) Provision coverage percentage represents loan impairment provisions as a percentage of risk elements in lending.
(2) Run-off businesses consist of the exited cash equities, corporate banking and equity capital market operations.

During 2012, the economic environment was dominated by weak prospects for global growth and the uncertain outlook for Eurozone sovereign debt. However, positive central bank activity and a more stable credit environment resulted in marginally improved trading opportunities.

Against this backdrop, the division continued to focus on its strengths and client offering. In January 2012 RBS announced the creation of the Markets division and, at the same time, the exit of the cash equities and mergers & acquisitions businesses. Following further review in Q4 2012, the remaining Investor Products and Equity Derivatives (IPED) operation was moved into Rates to form a Derivative Product Solutions (DPS) business. In addition, Markets has also developed a range of measures to enhance its culture and control environment, focusing on improving both supervision and behaviours. Taken together, these actions reinforce Markets' commitment to put the client at the centre of everything we do and to focus resources on meeting client needs.

Markets continued
2012 compared with 2011
Operating profit increased by 68% reflecting 2% growth in income and 20% decrease in direct expenses, most notably through a reduction in staff costs.

Rates benefited from a strong trading performance, while losses incurred in managing counterparty exposures during the third quarter of 2011 were not repeated during 2012. Revenues for the year were up 36% to £2.0 billion.

Currencies volumes were weak across the industry, although the Spot FX business minimised the impact on revenue. Options income was limited by further Eurozone uncertainty.

Asset Backed Products continued to perform strongly as markets were sustained throughout the year by investors' search for yield. Revenues for the year were £1.3 billion, up 5% from a strong performance of £1.25 billion in 2011.

A 40% increase in Credit Markets revenue to £862 million was driven by Flow Credit which, as a result of improved risk management and more benign market conditions, recorded good profitability compared with a loss in 2011. This was partially offset by weaker earnings from credit origination.

The 62% decrease in IPED followed significantly weaker client volumes in key markets. The business has been restructured and rationalised. It will be reported within Rates going forward.

The division focused on controlling costs throughout 2012, driving total expenses down by 16%. Lower staff expenses, down 26%, reflect lower headcount and lower levels of variable compensation, including reductions and clawbacks following the Group's LIBOR settlements reached on 6 February 2013, with the compensation ratio falling from 42% to 32%. Headcount reductions totalled 2,700 in the year, including that resulting from the exit of businesses announced in January. Other expenses fell by 3% as rigorous controls on discretionary expenditure and the exiting of product areas continued to take effect, partially offset by higher legal expenses.

The reduction in third party assets reflected management action to optimise and de-risk the balance sheet, consistent with previously disclosed medium-term objectives.

The division reduced risk-weighted assets, successfully focusing on lowering risk and enhancing models whilst managing the requirement for greater prudence in the regulatory environment.

Not reflected in Markets operating results in 2012 were the following items: £381 million for regulatory fines; £350 million for its share of the provision for interest rate swap redress; and approximately £700 million in restructuring costs associated with the strategic changes that took place during 2012.

2011 compared with 2010
Operating profit fell by 67%, from £2,724 million for 2010 to £899 million for 2011, driven by a 29% decrease in revenue. The year was characterised by volatile and deteriorating credit markets, especially during the second half of the year when the European sovereign debt crisis drove a sharp widening in credit spreads.

Due to this deterioration in the markets both the Rates and Credit businesses suffered significantly, and income from trading activities fell from £5,234 million in 2010 to £4,601 million in 2011. The heightened volatility increased risk aversion amongst clients and limited opportunities for revenue generation in the secondary markets.

Total costs increased by 1% due to increased investment costs in 2011, which included a programme to meet new regulatory requirements. The compensation ratio in Markets was 42%, driven by fixed salary costs and prior year deferred awards.

Variable compensation accrued in the first half of the year were reduced in the second half of the year, leaving the former GBM 2011 variable compensation awards 58% lower than 2010.

Third party assets fell from £338.0 billion in 2010 to £312.6 billion in 2011 as a result of lower levels of activity and careful management of balance sheet exposures.

A 9% increase in risk-weighted assets reflected the impact of significant regulatory changes, with a £21 billion uplift as a result of CRD III, largely offset by the impact of the division's focus on risk management.

Business review continued

Direct Line Group

	2012	2011	2010
	£m	£m	£m
Earned premiums	4,044	4,221	4,459
Reinsurers' share	(326)	(252)	(148)
Net premium income	3,718	3,969	4,311
Fees and commissions	(430)	(400)	(410)
Instalment income	126	138	159
Investment income	243	265	277
Other income	60	100	179
Total income	3,717	4,072	4,516
Direct expenses			
- staff expenses	(338)	(288)	(287)
- other expenses	(387)	(333)	(325)
Total direct expenses	(725)	(621)	(612)
Indirect expenses	(124)	(225)	(267)
	(849)	(846)	(879)
Net claims	(2,427)	(2,772)	(3,932)
Operating profit/(loss)	441	454	(295)
Analysis of income by product			
Personal lines motor excluding broker			
- own brands	1,733	1,874	1,962
- partnerships	138	228	373
Personal lines home excluding broker			
- own brands	475	490	488
- partnerships	377	378	408
Personal lines rescue and other excluding broker			
- own brands	182	185	197
- partnerships	184	132	168
Commercial	347	346	333
International	337	365	341
Other (1)	(56)	74	246
Total income	3,717	4,072	4,516
In-force policies (000s)			
Personal lines motor excluding broker			
- own brands	3,714	3,787	4,162
- partnerships	336	320	645
Personal lines home excluding broker			
- own brands	1,754	1,811	1,797
- partnerships	2,485	2,497	2,530
Personal lines rescue and other excluding broker			
- own brands	1,803	1,844	1,966
- partnerships	7,628	7,307	7,497
Commercial	466	422	352

International	1,462	1,387	1,082
Other (1)	50	1	644
Total in-force policies (2)	19,698	19,376	20,675

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Direct Line Group continued

	2012 £m	2011 £m	2010 £m
Gross written premium			
Personal lines motor excluding broker			
- own brand	1,494	1,584	1,647
- partnerships	136	137	257
Personal lines home excluding broker			
- own brand	455	474	478
- partnerships	534	549	556
Personal lines rescue and other excluding broker			
- own brand	177	174	178
- partnerships	176	174	159
Commercial	436	435	397
International	557	570	425
Other (1)	1	1	201
Total gross written premium	3,966	4,098	4,298
Performance ratios			
Return on tangible equity (3)	11.7%	10.3%	(6.8%)
Loss ratio (4)	65%	70%	91%
Commission ratio (5)	12%	10%	10%
Expense ratio (6)	23%	21%	20%
Combined operating ratio (7)	100%	101%	121%
Balance sheet			
Total insurance reserves (£m) (8)	8,066	7,284	7,643

Notes:

(1) 'Other' predominately consists of the personal lines broker business and from 2012 businesses previously reported in Non-Core.

(2) Total in-force policies include travel and creditor policies sold through RBS Group. These comprise travel policies included in bank accounts e.g. Royalties Gold Account, and creditor policies sold with bank products including mortgage, loan and card payment protection.

(3) Return on tangible equity is based on annualised operating profit after tax divided by average tangible equity adjusted for dividend payments.

(4) Loss ratio is based on net claims divided by net premium income.

(5) Commission ratio is based on fees and commissions divided by net premium income.

(6) Expense ratio is based on expenses divided by net premium income.

(7) Combined operating ratio is the sum of the loss, commission and expense ratios.

(8) Consists of general and life insurance liabilities, unearned premium reserves and liability adequacy reserve.

In October 2012, the Group completed the successful initial public offering of Direct Line Group, selling 520.8 million of its existing ordinary shares. This represented 34.7% of the issued share capital, generating gross proceeds of £911 million.

During 2012, Direct Line Group made good progress despite competitive market conditions. The operating profit of £441 million was down £13 million compared with the previous year driven by lower total income, partially offset by lower net claims.

A combined operating ratio (COR) of 100% represented an improvement of 100 basis points compared with 2011 driven predominantly by an improved loss ratio. The full year 2012 result included Home weather event claims of approximately £105 million versus £20 million in 2011, which was more than offset by £390 million of releases from reserves held against prior year claims across the portfolio. Of these releases, £68 million related to the run-off business where the impact on the income statement is broadly neutral. For Direct Line Group's ongoing operations, the current year attritional loss ratio improved by 1.6 percentage points which reflects actions taken to improve risk selection and the implementation of the claims transformation programme. In 2012 all categories within Direct Line Group made an operating profit.

Direct Line Group made further progress in executing its strategic plan with developments made in its pricing capability through the implementation of a new pricing model and rating engine across the Motor and Home divisions. The new claims management system introduced during 2011 is now operational for the majority of new Motor and Home claims. Benefits, including shorter settlement times for customers and improved legal case management, are being realised as a result of the improved claims process.

During 2012, a number of partnership agreements, including Nationwide Building Society and Sainsbury's Bank, were either renewed or extended. In addition, Direct Line Group signed an arm's length, five year distribution agreement with RBS Group for the continued provision, post divestment, of general insurance products to UK Retail customers.

Following launch on comparethemarket.com, Churchill and Privilege motor and home products are now available on all four major price comparison websites in the UK. This reinforces Direct Line Group's multi-channel distribution strategy.

Direct Line Group continues to focus on reducing operational costs, targeting the delivery of gross annual cost savings of £100 million in 2014 through overall improvements in operational efficiency including claims handling, continued efforts to simplify internal structures and better managing customer acquisition costs. Steps announced during the second half of the year included measures to reduce costs in central functions as well as the reduction of around 70 senior leadership roles across the organisation.

Roll-out of a new e-trading platform in Commercial began in Q3 2012 and was launched in January 2013. This new platform has been developed to aid with internal cost efficiency and provide new routes to market as well as to significantly improve the interface with brokers and customers.

International consolidated its direct market position in Italy and Germany with a total of 1.5 million in-force policies at the end of 2012. Gross written premium for 2012 was up 4% in local currency on 2011 and followed a period of strong growth in 2010 and 2011.

Direct Line Group further improved its capital efficiency following a number of initiatives including the consolidation of four underwriting entities into one. The combined entity, U K Insurance Limited, received inaugural credit ratings of ‘A’ from Standard and Poor’s and ‘A2’ from Moody’s. Direct Line Group also issued £500 million of Tier 2 debt and paid £1 billion of dividends to RBS Group.

Direct Line Group operates in an industry that is under a significant amount of scrutiny and is preparing for substantial regulatory change. Direct Line Group is actively engaging with major stakeholders throughout the ongoing debates surrounding referral and legal fees, the increase in whiplash claims and the implementation of the gender directive in order to help deliver the best possible outcome for its customers and shareholders.

Separation and divestment update
From 1 July 2012, Direct Line Group has operated on a substantially standalone basis with independent corporate functions and governance following the successful implementation of a comprehensive programme of separation initiatives. During 2012, these included launching a new corporate identity and the Direct Line Group Board became fully compliant with the UK Corporate Governance Code following further non-executive director appointments. New contracts of employment have been agreed and issued to staff, independent HR systems have been implemented and an arm’s length transitional services agreement has been reached with RBS Group for residual services. In January 2013, it was announced that Capgemini would design, deliver and operate Direct Line Group’s IT infrastructure.

The Group sold the first tranche of ordinary shares representing 34.7% of the share capital of Direct Line Group in October 2012 via an Initial Public Offering. This is consistent with the Group’s plan to cede control of Direct Line Group by the end of 2013 and a step toward complete disposal by the end of 2014, as required by the European Commission.

In accordance with IFRS 5, Direct Line Group has been recognised as a discontinued operation with consequent changes to the presentation of comparative information. The assets and liabilities relating to Direct Line Group are included in Disposal groups as of 31 December 2012. The Group has written down its investment in Direct Line Group at 31 December 2012 to 216 pence per share, the market value on that date, which resulted in a £394 million goodwill write-down.

2012 compared with 2011
Operating profit of £441 million was £13 million, or 3% lower than 2011 as lower total income was partially offset by lower net claims.

Gross written premium of £3,966 million was 3% lower, driven by the impact of de-risking in previous years and changes in the mix of the portfolio in Motor together with competitive market conditions in Home. International was also down reflecting adverse exchange rate movements.

Total income of £3,717 million was £355 million, or 9% lower than prior year due to flow through of lower written premiums, increased commissions payable relating to business previously reported within Non-Core, the cessation of Tesco Personal Finance tariff income and lower supply chain income and lower investment income.

Investment income of £243 million was £22 million lower, primarily as a result of £27 million financing costs relating to the Tier 2 debt issued in April 2012 and lower reinvestment rates during 2012. This was mostly offset by higher realised gains arising from portfolio management initiatives, including those arising from business previously reported in Non-Core.

Net claims of £2,427 million were £345 million, or 12% lower than 2011 reflecting lower exposure, higher releases of reserves from prior years and improved claims experience. The 2012 result includes approximately £105 million of Home weather event claims, significantly more than £20 million in 2011 under benign weather conditions.

Expenses of £849 million were broadly flat. Staff expenses were £50 million, or 17% higher partly reflecting the transfer of some head office functions costs to Direct Line Group ahead of separation from RBS Group, together with additional staff recruited to provide services previously provided by RBS Group.

Direct Line Group's reported Return on Tangible Equity was 11.7% in 2012.

Direct Line Group continued
2011 compared with 2010
Operating profit rose by £749 million in 2011, principally due to the non repeat of the bodily injury reserve strengthening in 2010, de-risking of the motor book, exit of certain business segments and more benign weather in 2011.

Gross written premium fell £200 million, 5%, as the business continued to drive improved profitability through reduced volumes in unattractive segments. This was partially offset by growth in Commercial and International.

Total income fell £444 million, 10%, following the exit of personal lines broker, a decline in premiums reflecting reduced motor volumes and higher reinsurance costs to reduce the risk profile of the book.

Net claims fell £1,160 million, 30%, due to the non recurrence of bodily injury reserve strengthening in 2010, actions taken to de-risk the book, the exit of certain business segments and more benign weather in 2011.
Total direct expenses rose by £9 million principally driven by project activity to support the transformation plan.

Investment income fell £12 million, 4%, reflecting decreased yields on the portfolio in 2011, partially offset by higher realised gains.

At the end of 2011, Direct Line Group's investment portfolios comprised primarily cash, gilts and investment grade bonds. Within the UK portfolio, £8.9 billion, and the International portfolio, £827 million, there was no exposure to sovereign debt issued by Portugal, Ireland, Italy, Greece or Spain.

Total in-force policies fell 6% in the year due to planned de-risking of the motor book and the exiting of certain other segments and partnerships, including personal lines broker.

Central items

	2012	2011	2010
	£m	£m	£m
Central items not allocated	143	191	630

Funding and operating costs have been allocated to operating divisions, based on direct service usage, requirement for market funding and other appropriate drivers where services span more than one division.

Residual unallocated items relate to volatile corporate items that do not naturally reside within a division.

2012 compared with 2011
Central items not allocated represented a credit of £143 million compared with £191 million in 2011.

Significant central costs included the Group technology incident cost of £175 million, a £160 million provision for various litigation and legacy conduct issues, as well as unallocated Treasury costs of circa £390 million. VAT recoveries of £85 million and Group Pension fund adjustment of circa £50 million in 2011 were not repeated.

Offsetting these costs, profits on Group Treasury available-for-sale bond disposals totalled £880 million compared with £516 million in 2011, as active management of the liquid assets portfolio as well as favourable market conditions enabled the Group to crystallise gains on some holdings.

2011 compared with 2010
Central items not allocated represented a credit of £191 million in 2011, a decline of £439 million compared with 2010.

2010 benefited from c.£300 million of accounting gains on hybrid securities, c.£150 million of which was amortised during 2011.

A VAT recovery of £176 million in 2010 compared with £85 million recovered in 2011.

Business review continued

Non-Core

	2012	2011	2010
	£m	£m	£m
Net interest income	346	863	1,756
Funding costs of rental assets	(102)	(215)	(283)
Net interest income	244	648	1,473
Net fees and commissions	105	(38)	471
Loss from trading activities	(654)	(721)	(31)
Insurance net premium income	—	286	702
Other operating income			
- rental income	523	958	1,035
- other (1)	70	55	(896)
Non-interest income	44	540	1,281
Total income	288	1,188	2,754
Direct expenses			
- staff	(272)	(375)	(731)
- operating lease depreciation	(246)	(347)	(452)
- other	(163)	(256)	(573)
Indirect expenses	(263)	(317)	(500)
	(944)	(1,295)	(2,256)
(Loss)/profit before insurance net claims and impairment losses	(656)	(107)	498
Insurance net claims	—	(195)	(737)
Impairment losses	(2,223)	(3,919)	(5,476)
Operating loss	(2,879)	(4,221)	(5,715)
Analysis of income/(loss) by business			
Banking & portfolios	40	1,465	1,463
International businesses	250	411	778
Markets	(2)	(688)	513
Total income	288	1,188	2,754
Loss from trading activities			
Monoline exposures	(205)	(670)	(5)
Credit derivative product companies	(205)	(85)	(139)
Asset-backed products (2)	101	29	235
Other credit exotics	(28)	(175)	77
Equities	(2)	(11)	(17)
Banking book hedges	(38)	(1)	(82)
Other	(277)	192	(100)
	(654)	(721)	(31)
Impairment losses			
Banking & portfolios	2,346	3,833	5,328
International businesses	56	82	200
Markets	(179)	4	(52)
Total impairment losses	2,223	3,919	5,476

Loan impairment charge as % of gross customer loans and advances (excluding reverse repurchase agreements) (3)			
Banking & portfolios	4.2%	4.9%	5.0%
International businesses	5.1%	3.7%	4.4%
Markets	—	(3.0%)	0.2%
Total	4.2%	4.8%	4.9%

Notes:

(1) Includes losses on disposals of £14 million for 2012 (2011 - £127 million; 2010 - £504 million).

(2) Asset-backed products include super asset backed structures and other asset-backed products.

(3) Includes disposal groups.

Business review continued

	2012	2011	2010
Performance ratios			
Net interest margin	0.31%	0.63%	1.02%
Cost:income ratio	nm	109%	82%
Adjusted cost:income ratio (1)	nm	130%	112%
nm = not meaningful			
	£bn	£bn	£bn
Capital and balance sheet			
Loans and advances to customers (gross) (2)	55.4	79.4	108.4
Loan impairment provisions	(11.2)	(11.5)	(10.3)
Net loans and advances to customers	44.2	67.9	98.1
Total third party assets (excluding derivatives)	57.4	93.7	137.9
Total third party assets (including derivatives)	63.4	104.7	153.9
Risk elements in lending (2)	21.4	24.0	23.4
Provision coverage (3)	52%	48%	44%
Customer deposits (2)	2.7	3.5	6.7
Risk-weighted assets	60.4	93.3	153.7
Gross customer loans and advances			
Banking & portfolios	54.5	77.3	104.9
International businesses	0.9	2.0	3.5
Markets	—	0.1	—
	55.4	79.4	108.4
Risk-weighted assets			
Banking & portfolios	53.3	64.8	83.5
International businesses	2.4	4.1	5.6
Markets	4.7	24.4	64.6
	60.4	93.3	153.7
Third party assets (excluding derivatives)			
Banking & portfolios	51.1	81.3	113.9
International businesses	1.2	2.9	4.4
Markets	5.1	9.5	19.6
	57.4	93.7	137.9

Third party assets (excluding derivatives)	31 December 2011	Run-off	Disposals/ restructuring	Drawings/ roll overs	Impairments	Foreign exchange	31 December 2012
	£bn	£bn	£bn	£bn	£bn	£bn	£bn
Commercial real estate	31.5	(5.0)	(2.2)	0.1	(1.7)	(0.6)	22.1
Corporate	42.2	(7.3)	(9.8)	1.6	(0.4)	(0.8)	25.5
SME	2.1	(1.0)	(0.3)	0.2	—	—	1.0
Retail	6.1	(0.8)	(1.9)	0.1	(0.2)	(0.1)	3.2

Other	1.9	(1.3)	—	—	—	(0.1)	0.5
Markets	9.8	(1.0)	(3.9)	0.3	0.1	(0.2)	5.1
Total (excluding derivatives)	93.6	(16.4)	(18.1)	2.3	(2.2)	(1.8)	57.4
Markets - RBS Sempra Commodities JV	0.1	(0.1)	—	—	—	—	—
Total (4)	93.7	(16.5)	(18.1)	2.3	(2.2)	(1.8)	57.4

Notes:

(1) Adjusted cost:income ratio represents operating expenses expressed as a percentage of total income after netting insurance claims against income.

(2) Excludes disposal groups.

(3) Provision coverage percentage represents loan impairment provisions as a percentage of risk elements in lending.

(4) Disposals of £0.2 billion have been signed as at 31 December 2012 but are pending completion (2011 - £0.2 billion; 2010 - £12 billion).

Non-Core continued

Commercial real estate third party assets	2012 £bn	2011 £bn	2010 £bn
UK (excluding NI)	8.9	11.4	16.7
Ireland (ROI and NI)	5.8	7.7	10.2
Spain	1.4	1.8	1.3
Rest of Europe	4.9	7.9	9.4
USA	0.9	2.2	3.6
RoW	0.2	0.5	1.4
Total (excluding derivatives)	22.1	31.5	42.6

Impairment losses by donating division and sector	2012 £m	2011 £m	2010 £m
UK Retail			
Mortgages	—	5	5
Personal	4	(27)	8
Total UK Retail	4	(22)	13
UK Corporate			
Manufacturing and infrastructure	19	76	26
Property and construction	88	224	437
Transport	16	52	3
Financial institutions	(38)	5	69
Lombard	48	75	129
Other	107	96	166
Total UK Corporate	240	528	830
Ulster Bank			
Mortgages	—	—	42
Commercial real estate			
- investment	288	609	630
- development	611	1,552	1,759
Other corporate	77	173	251
Other EMEA	7	15	52
Total Ulster Bank	983	2,349	2,734
US Retail & Commercial			
Auto and consumer	49	58	82
Cards	1	(9)	23
SBO/home equity	130	201	277
Residential mortgages	21	16	4
Commercial real estate	(12)	40	185
Commercial and other	(12)	(3)	17
Total US Retail & Commercial	177	303	588
Markets			
Manufacturing and infrastructure	3	57	(290)

Property and construction	623	752	1,296
Transport	199	(3)	33
Telecoms, media and technology	32	68	9
Banking and financial institutions	(58)	(98)	196
Other	18	(19)	14
Total Markets	817	757	1,258
Other			
Wealth	1	1	51
Central items	1	3	2
Total Other	2	4	53
Total impairment losses	2,223	3,919	5,476

Business review continued

Gross loans and advances to customers (excluding reverse repurchase agreements) by donating division and sector	2012 £m	2011 £m	2010 £m
UK Retail			
Mortgages	—	1.4	1.6
Personal	—	0.1	0.4
Total UK Retail	—	1.5	2.0
UK Corporate			
Manufacturing and infrastructure	0.1	0.1	0.3
Property and construction	3.6	5.9	11.4
Transport	3.8	4.5	5.4
Financial institutions	0.2	0.6	0.8
Lombard	0.4	1.0	1.7
Other	4.2	7.5	7.4
Total UK Corporate	12.3	19.6	27.0
Ulster Bank			
Commercial real estate			
- investment	3.4	3.9	4.0
- development	7.6	8.5	8.4
Other corporate	1.6	1.6	2.2
Other EMEA	0.3	0.4	0.4
Total Ulster Bank	12.9	14.4	15.0
US Retail & Commercial			
Auto and consumer	0.6	0.8	2.6
Cards	—	0.1	0.1
SBO/home equity	2.0	2.5	3.2
Residential mortgages	0.4	0.6	0.7
Commercial real estate	0.4	1.0	1.5
Commercial and other	0.1	0.4	0.5
Total US Retail & Commercial	3.5	5.4	8.6
Markets			
Manufacturing and infrastructure	3.9	6.6	8.7
Property and construction	12.3	15.3	19.6
Transport	1.7	3.2	5.5
Telecoms, media and technology	0.4	0.7	0.9
Banking and financial institutions	4.7	5.6	12.0
Other	3.7	7.0	9.3
Total Markets	26.7	38.4	56.0
Other			
Wealth	—	0.2	0.4
Direct Line Group	—	—	0.2
Central items	—	(0.2)	(1.0)

Total Other	—	—	(0.4)
Gross loans and advances to customers (excluding reverse repurchase agreements)	55.4	79.3	108.2

Non-Core continued

Non-Core third party assets fell to £57 billion, a reduction of £36 billion, or 39%, during the year and an overall reduction of £200 billion, or 78%, since the division was set up. This was achieved through a mixture of disposals, run-off and impairments. By the end of 2012, the Non-Core funded balance sheet was under 7% of the Group's funded balance sheet compared with 21% when the division was created. Non-Core remains on target to reach its third party asset target of c.£40 billion, a reduction of approximately 85% of its original portfolio, by the end of 2013.

2012 compared with 2011

Third party assets declined by £36 billion, or 39%, largely reflecting disposals of £18 billion and run-off of £16 billion. The disposal of RBS Aviation Capital in Q2 2012 contributed c.£5 billion of this reduction.

Risk-weighted assets were £33 billion lower, principally driven by disposals, run-off and restructuring of existing positions.

An operating loss of £2,879 million was £1,342 million lower than 2011, principally due to lower impairments and expenses, partially offset by lower net interest income following run-off and disposals.

Impairment losses fell by £1,696 million to £2,223 million, with £1,366 million of this reduction from the Ulster Bank portfolio and £269 million from the real estate portfolio.

Income declined by £900 million as continued divestment and run-off reduced net interest income. Rental income was lower following the disposal of RBS Aviation Capital in Q2 2012.

Expenses were £351 million lower, driven by reduced headcount and lower operating lease depreciation, principally following the disposal of RBS Aviation Capital.

Headcount declined by 34% to 3,100 reflecting the divestment activity and run-off across the business.

2011 compared with 2010

Operating loss of £4,221 million in 2011 was £1,494 million lower than the loss recorded in 2010. The continued divestment of Non-Core businesses and portfolios has reduced revenue streams as well as the cost base.

Losses from trading activities increased by £690 million compared with 2010, principally as a result of the disposal of RBS Sempra Commodities in 2010 and costs incurred as part of the division's focus on reducing capital intensive trading assets and mitigating future regulatory uplifts in risk-weighted assets.

Impairment losses fell by £1,557 million despite ongoing challenges in the real estate and Ulster Bank portfolios, reflecting improvements in other asset classes.

Third party assets declined by £44 billion (32%) reflecting disposals of £22 billion and run-off of £22 billion.

Risk-weighted assets were £60 billion lower than 2010, principally driven by significant disposal activity on trading book assets combined with run-off.

Headcount declined by 2,200 (32%) to 4,700 in 2011, largely reflecting the divestment activity in relation to Asia, Non-Core Insurance and RBS Sempra Commodities.

Consolidated balance sheet at 31 December 2012

	2012 £m	2011 £m	2010 £m
Assets			
Cash and balances at central banks	79,290	79,269	57,014
Net loans and advances to banks	29,168	43,870	57,911
Reverse repurchase agreements and stock borrowing	34,783	39,440	42,607
Loans and advances to banks	63,951	83,310	100,518
Net loans and advances to customers	430,088	454,112	502,748
Reverse repurchase agreements and stock borrowing	70,047	61,494	52,512
Loans and advances to customers	500,135	515,606	555,260
Debt securities	157,438	209,080	217,480
Equity shares	15,232	15,183	22,198
Settlement balances	5,741	7,771	11,605
Derivatives	441,903	529,618	427,077
Intangible assets	13,545	14,858	14,448
Property, plant and equipment	9,784	11,868	16,543
Deferred tax	3,443	3,878	6,373
Prepayments, accrued income and other assets	7,820	10,976	12,576
Assets of disposal groups	14,013	25,450	12,484
Total assets	1,312,295	1,506,867	1,453,576
Liabilities			
Bank deposits	57,073	69,113	66,051
Repurchase agreements and stock lending	44,332	39,691	32,739
Deposits by banks	101,405	108,804	98,790
Customers deposits	433,239	414,143	428,599
Repurchase agreements and stock lending	88,040	88,812	82,094
Customer accounts	521,279	502,955	510,693
Debt securities in issue	94,592	162,621	218,372
Settlement balances	5,878	7,477	10,991
Short positions	27,591	41,039	43,118
Derivatives	434,333	523,983	423,967
Accruals, deferred income and other liabilities	14,801	23,125	23,089
Retirement benefit liabilities	3,884	2,239	2,288
Deferred tax	1,141	1,945	2,142
Insurance liabilities	—	6,312	6,794
Subordinated liabilities	26,773	26,319	27,053
Liabilities of disposal groups	10,170	23,995	9,428
Total liabilities	1,241,847	1,430,814	1,376,725
Non-controlling interests	2,318	1,234	1,719
Owners' equity	68,130	74,819	75,132
Total equity	70,448	76,053	76,851
Total liabilities and equity	1,312,295	1,506,867	1,453,576

Commentary on consolidated balance sheet
2012 compared with 2011
Total assets of £1,312.3 billion at 31 December 2012 were down £194.6 billion, 13%, compared with 31 December 2011. This was principally driven by a decrease in loans and advances to banks and customers led by Non-Core disposals and run off, decreases in debt securities and the continuing reduction in the mark-to-market value of derivatives.

Loans and advances to banks decreased by £19.4 billion, 23%, to £64.0 billion. Excluding reverse repurchase agreements and stock borrowing ('reverse repos'), down £4.7 billion, 12%, to £34.8 billion, bank placings declined £14.7 billion, 34%, to £29.2 billion.

Loans and advances to customers declined £15.5 billion, 3%, to £500.1 billion. Within this, reverse repurchase agreements were up £8.6 billion, 14%, to £70.0 billion. Customer lending decreased by £24.0 billion, 5%, to £430.1 billion, or £22.6 billion to £451.2 billion before impairments. This reflected reductions in Non-Core of £22.6 billion, along with declines in International Banking, £14.3 billion, UK Corporate, £2.9 billion, Markets, £1.0 billion and Ulster Bank, £0.7 billion, together with the effect of exchange rate and other movements, £4.7 billion. These were partially offset by the transfer from disposal groups of £18.9 billion of customer balances relating to the UK branch-based businesses, together with underlying growth in UK Retail, £2.6 billion, US Retail & Commercial, £1.9 billion and Wealth, £0.2 billion.

Debt securities were down £51.6 billion, 25%, to £157.4 billion, driven mainly by reductions within Markets and Group Treasury in holdings of UK and Eurozone government securities and financial institution bonds.

Settlement balance assets and liabilities decreased £2.0 billion to £5.7 billion and £1.6 billion to £5.9 billion respectively reflecting the overall reduction in the size of the balance sheet.

Movements in the value of derivative assets, down £87.7 billion, 17%, to £441.9 billion, and liabilities, down £89.7 billion, 17%, to £434.3 billion, primarily reflect decreases in interest rate and credit derivative contracts, together with the effect of currency movements, with Sterling strengthening against both the US dollar and the Euro.

Intangible assets decreased £1.3 billion, 9%, to £13.5 billion, primarily as a result of write-down of the Direct Line Group goodwill, £0.4 billion, and the transfer of the remaining £0.5 billion of goodwill together with £0.2 billion of other intangible assets to assets of disposal groups at 31 December 2012.

Property, plant and equipment decreased by £2.1 billion, 18%, to £9.8 billion driven largely by the disposal of investment property in Non-Core.

The decrease in assets and liabilities of disposal groups, down £11.4 billion, 45%, to £14.0 billion, and £13.8 billion, 58%, to £10.2 billion respectively, primarily reflects the removal of the UK branch-based businesses from disposal groups following Santander's withdrawal from the purchase, together with the disposal of RBS Aviation Capital in the second quarter. These were partly offset by the transfer to disposal groups of Direct Line Group at 31 December 2012.

Deposits by banks decreased £7.4 billion, 7%, to £101.4 billion, with a decrease in inter-bank deposits, down £12.0 billion, 17%, to £57.1 billion. This was partly offset by an increase in repurchase agreements and stock lending ('repos'), up £4.6 billion, 12%, to £44.3 billion, improving the Group's mix of secured and unsecured funding.

Customer accounts increased £18.3 billion, 4%, to £521.3 billion. Within this, repos decreased £0.8 billion, 1%, to £88.0 billion. Excluding repos, customer deposits were up £19.1 billion, 5%, at £433.2 billion, primarily reflecting the transfer from disposal groups of £21.5 billion of customer accounts relating to the UK branch-based businesses together with underlying increases in UK Retail, £6.0 billion, International Banking, £2.0 million, US Retail & Commercial, £1.8 billion, UK Corporate, £0.8 billion, Ulster Bank, £0.7 billion and Wealth, £0.7 billion. This was partially offset by decreases in Markets, £9.7 billion, and Non-Core, £0.9 billion, together with exchange and other movements £3.8 billion.

Debt securities in issue decreased £68.0 billion, 42%, to £94.6 billion reflecting the maturity of the remaining notes issued under the UK Government's Credit Guarantee Scheme, £21.3 billion, the repurchase of bonds and medium term notes as a result of the liability management exercise completed in September 2012, £4.4 billion, and the continuing reduction of commercial paper and medium term notes in issue in line with the Group's strategy.

Short positions were down £13.4 billion, 33%, to £27.6 billion mirroring decreases in debt securities.

Retirement benefit liabilities increased by £1.6 billion, 73%, to £3.9 billion with net actuarial losses of £2.3 billion on the Group's defined benefit pension schemes, primarily arising from significant reductions in the real discount rates in the Sterling, Euro and US dollar currency zones. These were partially offset by the £0.6 billion excess of employer contributions paid over the current year pension charge.

Insurance liabilities of £6.2 billion relating to Direct Line Group were transferred to liabilities of disposal groups at 31 December 2012.

Subordinated liabilities increased by £0.5 billion, 2% to £26.8 billion, primarily as a result of the net increase in dated loan capital. Issuances of £1.4 billion and redemptions of £0.3 billion were partly offset by a net decrease of £0.6 billion arising from the liability management exercise completed in March 2012, which consisted of redemptions of £3.4 billion offset by the issuance of £2.8 billion new loan capital.

Non-controlling interests increased by £1.1 billion, 88%, to £2.3 billion, predominantly due to the sale of 34.7% of the Group's investment in Direct Line Group during the fourth quarter.

Owner's equity decreased by £6.7 billion, 9%, to £68.1 billion, driven by the £6.0 billion attributable loss for the period together with movements in foreign exchange reserves, £0.9 billion, the recognition of actuarial losses in respect of the Group's defined benefit pension schemes, net of tax, £1.9 billion, and other reserve movements of £0.2 billion. Partially offsetting these reductions were gains in available-for-sale reserves, £0.6 billion, and cash flow hedging reserves, £0.8 billion, share capital and reserve movements in respect of employee share schemes, £0.8 billion and other share issuances of £1.0 billion.

Commentary on consolidated balance sheet
2011 compared with 2010
Total assets of £1,506.9 billion at 31 December 2011 were up £53.3 billion, 4%, compared with 31 December 2010. This principally reflects an increase in cash and balances at central banks and the mark-to-market value of derivatives in Markets, partly offset by decreases in debt securities and equity shares and the continuing disposal and run-off of Non-Core assets.

Cash and balances at central banks were up £22.3 billion, 39%, to £79.3 billion due to improvements in the Group's structured liquidity position during 2011.

Loans and advances to banks decreased by £17.2 billion, 17%, to £83.3 billion. Reverse repurchase agreements and stock borrowing ('reverse repos') were down £3.2 billion, 7%, to £39.4 billion and bank placings declined £14.0 billion, 24%, to £43.9 billion, primarily as a result of the reduction in exposure to eurozone banks and lower cash collateral requirements.

Loans and advances to customers were down £39.7 billion, 7%, to £515.6 billion. Within this, reverse repurchase agreements were up £9.0 billion, 17%, to £61.5 billion. Customer lending decreased by £48.7 billion, 10%, to £454.1 billion or £46.9 billion, 9%, to £473.9 billion before impairment provisions. This reflected the transfer to disposal groups of £19.5 billion of customer balances relating to the UK branch-based businesses. There were also planned reductions in Non-Core of £28.1 billion, together with declines in International Banking, £4.7 billion, UK Corporate, £3.0 billion and Ulster Bank, £2.0 billion, together with the effect of exchange rate and other movements, £1.9 billion. These were partially offset by growth in Markets, £6.4 billion, Wealth, £0.8 billion, UK Retail, £2.3 billion and US Retail & Commercial, £2.8 billion.

Debt securities were down £8.4 billion, 4%, to £209.1 billion driven mainly by a reduction in holdings of government and financial institution bonds in Markets and Group Treasury.

Equity shares decreased £7.0 billion, 32%, to £15.2 billion which largely reflects the closure of positions to reduce the Group's level of unsecured funding requirements to mitigate the potential impact of unfavourable market conditions.

Settlement balances declined £3.8 billion, 33% to £7.8 billion as a result of decreased customer activity.

Movements in the value of derivative assets up £102.5 billion, 24%, to £529.6 billion, and liabilities, up £100.0 billion, 24%, to £524.0 billion, primarily reflect increases in interest rate contracts as a result of a significant downward shift in interest rates across all major currencies, together with increases in the mark-to-market value of credit derivatives as a result of widening credit spreads and rising credit default swap prices.

Property, plant and equipment declined £4.7 billion, 28%, to £11.9 billion, primarily as a result of the transfer of RBS Aviation Capital's operating lease assets to disposal groups.

Deferred taxation was down £2.5 billion, 39%, to £3.9 billion, largely as a result of the utilisation of brought forward tax losses in the UK.

The increase in assets and liabilities of disposal groups reflects the reclassification of the UK branch-based businesses and RBS Aviation Capital pending their disposal, partly offset by the completion of disposals, primarily RBS Sempra Commodities JV and certain Non-Core project finance assets.

Deposits by banks increased £10.0 billion, 10%, to £108.8 billion, with higher repurchase agreements and stock lending (‘repos’), up £6.9 billion, 21%, to £39.7 billion and higher inter-bank deposits, up £3.1 billion, 5%, to £69.1 billion.

Customer accounts fell £7.7 billion, 2%, to £503.0 billion. Within this, repos increased £6.7 billion, 8%, to £88.8 billion. Excluding repos, customer deposits were down £14.4 billion, 3%, to £414.1 billion, reflecting the transfer to disposal groups of £21.8 billion of customer accounts relating to the UK branch-based businesses. This was partly offset by the net effect of growth in International Banking, £1.7 billion, UK Corporate, £1.8 billion, UK Retail, £5.8 billion, US Retail & Commercial, £0.5 billion and Wealth, £1.8 billion, together with exchange rate and other movements of £0.5 billion and declines in Markets, £1.1 billion, Ulster Bank, £0.8 billion and Non-Core, £2.9 billion.

Debt securities in issue were down £55.8billion, 26% to £162.6 billion driven by reductions in the level of certificates of deposit and commercial paper in Markets and Group Treasury.

Settlement balances declined £3.5 billion, 32%, to £7.5 billion and short positions were down £2.1 billion, 5%, to £41.0 billion due to decreased customer activity.

Subordinated liabilities were down £0.7 billion, 3%, to £26.3 billion, primarily reflecting the redemption of £0.2 billion US dollar and £0.4 billion Euro denominated dated loan capital.

The Group’s non-controlling interests decreased by £0.5 billion, 28%, to £1.2 billion, primarily due to the disposal of the majority of the RBS Sempra Commodities JV business, £0.4 billion.

Owners’ equity decreased by £0.3 billion to £74.8 billion. This was driven by the attributable loss for the year, £2.0 billion, together with the recognition of actuarial losses in respect of the Group’s defined benefit pension schemes, net of tax, £0.5 billion and exchange rate and other movements of £0.3 billion. Offsetting these reductions were gains in available-for-sale reserves, £1.1 billion and cashflow hedging reserves, £1.0 billion and the issue of shares under employee share schemes, £0.4 billion.

Business review continued

Cash flow

	2012	2011	2010
	£m	£m	£m
Net cash flows from operating activities	(45,113)	3,325	19,291
Net cash flows from investing activities	27,175	14	3,351
Net cash flows from financing activities	2,017	(1,741)	(14,380)
Effects of exchange rate changes on cash and cash equivalents	(3,893)	(1,473)	82
Net (decrease)/increase in cash and cash equivalents	(19,814)	125	8,344

2012

The major factors contributing to the net cash outflow from operating activities of £45,113 million were the decrease of £48,736 million in operating assets and liabilities, the net operating loss before tax of £5,276 million from continuing and discontinued operations, loans and advances written off net of recoveries of £3,925 million and other non-cash items of £1,491 million. These were partially offset by the elimination of foreign exchange differences of £7,140 million, provisions for impairment losses of £5,283 million and depreciation and amortisation of £1,854 million.

Net cash inflows from investing activities of £27,175 million related to the net inflows from sales of securities of £26,092 million, the sale of property, plant and equipment of £2,215 million and investments in business interests and intangible assets of £352 million offset by net cash outflows from the purchase of property, plant and equipment of £1,484 million.

Net cash inflows from financing activities of £2,017 million relate primarily to the issue of subordinated liabilities of £2,093 million and proceeds of non-controlling interests issued of £889 million partly offset by interest paid on subordinated liabilities of £746 million and dividends paid of £301 million.

2011

The major factors contributing to the net cash inflow from operating activities of £3,325 million were the elimination of foreign exchange differences of £2,702 million, depreciation and amortisation of £1,875 million and inflow from other items of £2,900 million, partially offset by the net operating loss before tax of £708 million from continuing and discontinued operations and the decrease of £3,444 million in operating assets and liabilities.

Net cash inflows from investing activities of £14 million related to the net inflows from sales of securities of £3,074 million, and sale of property, plant and equipment of £1,840 million offset by net cash outflows from investments in business interests and intangible assets of £1,428 million and from the purchase of property, plant and equipment of £3,472 million.

Net cash outflows from financing activities of £1,741 million relate primarily to interest on subordinated liabilities of £714 million, repayment of subordinated liabilities of £627 million and redemption of non-controlling interests of £382 million.

2010

The major factors contributing to the net cash inflow from operating activities of £19,291 million were the increase of £17,095 million in operating assets less operating liabilities, depreciation and amortisation of £2,220 million and income taxes received of £565 million, partly offset by the net operating loss before tax of £940 million from continuing and discontinued operations.

Net cash flows from investing activities of £3,351 million relate to the net inflows from sales of securities of £4,119 million and investments in business interests and intangibles of £3,446 million. This was partially offset by the outflow of £4,112 million from investing activities of discontinued operations.

Net cash outflow from financing activities of £14,380 million primarily arose from the redemption of non-controlling interests of £5,282 million, dividends paid of £4,240 million, repayment of subordinated liabilities of £1,588 million and the redemption of preference shares of £2,359 million.

Capital resources

The following table analyses the Group's regulatory capital resources on a fully consolidated basis at 31 December as monitored by the FSA for regulatory purposes.

	2012	2011	2010	2009	2008
	£m	£m	£m	£m	£m
Capital base					
Tier 1 capital	57,135	56,990	60,124	76,421	69,847
Tier 2 capital	12,152	8,546	9,897	15,389	32,223
Tier 3 capital	—	—	—	—	260
	69,287	65,536	70,021	91,810	102,330
Less: Supervisory deductions	(2,487)	(4,828)	(4,732)	(4,565)	(4,155)
Total regulatory capital	66,800	60,708	65,289	87,245	98,175
Risk-weighted assets					
Credit risk	323,200	344,300	385,900	513,200	551,300
Counterparty risk	48,000	61,900	68,100	56,500	61,100
Market risk	42,600	64,000	80,000	65,000	46,500
Operational risk	45,800	37,900	37,100	33,900	36,900
	459,600	508,100	571,100	668,600	695,800
Asset Protection Scheme relief	—	(69,100)	(105,600)	(127,600)	n/a
	459,600	439,000	465,500	541,000	695,800
Risk asset ratios	%	%	%	%	%
Core Tier 1	10.3	10.6	10.7	11.0	6.6
Tier 1	12.4	13.0	12.9	14.1	10.0
Total	14.5	13.8	14.0	16.1	14.1

It is the Group's policy to maintain a strong capital base, to expand it as appropriate and to utilise it efficiently throughout its activities to optimise the return to shareholders while maintaining a prudent relationship between the capital base and the underlying risks of the business. In carrying out this policy, the Group has regard to the supervisory requirements of the Financial Services Authority (FSA). The FSA uses Risk Asset Ratio (RAR) as a measure of capital adequacy in the UK banking sector, comparing a bank's capital resources with its risk-weighted assets (the assets and off-balance sheet exposures are 'weighted' to reflect the inherent credit and other risks); by international agreement, the RAR should be not less than 8% with a Tier 1 component of not less than 4%. At 31 December 2012, the Group's total RAR was 14.5% (2011 - 13.8%) and the Tier 1 RAR was 12.4% (2011 -13.0%). For further information refer to Balance sheet management: Capital management on pages 86 to 95.

Business review continued

Analysis of balance sheet pre and post disposal groups

In accordance with IFRS 5 assets and liabilities of disposal groups are presented as a single line on the face of the balance sheet. As allowed by IFRS, disposal groups are included within risk measures in the Risk and balance sheet management section.

	2012			2011			2010		
	Balance sheet £m	Disposal groups (1) £m	Gross of disposal groups £m	Balance sheet £m	Disposal groups (2) £m	Gross of disposal groups £m	Balance sheet £m	Disposal groups (3) £m	Gross of disposal groups £m
Assets									
Cash and balances at central banks	79,290	18	79,308	79,269	127	79,396	57,014	184	57,198
Net loans and advances to banks	29,168	2,112	31,280	43,870	87	43,957	57,911	651	58,562
Reverse repurchase agreements and stock borrowing	34,783	—	34,783	39,440	—	39,440	42,607	—	42,607
Loans and advances to banks	63,951	2,112	66,063	83,310	87	83,397	100,518	651	101,169
Net loans and advances to customers	430,088	1,863	431,951	454,112	19,405	473,517	502,748	5,013	507,761
Reverse repurchase agreements and stock borrowing	70,047	—	70,047	61,494	—	61,494	52,512	—	52,512
Loans and advances to customers	500,135	1,863	501,998	515,606	19,405	535,011	555,260	5,013	560,273
Debt securities	157,438	7,186	164,624	209,080	—	209,080	217,480	—	217,480
Equity shares	15,232	5	15,237	15,183	5	15,188	22,198	20	22,218
Settlement balances	5,741	—	5,741	7,771	14	7,785	11,605	555	12,160
Derivatives	441,903	15	441,918	529,618	439	530,057	427,077	5,148	432,225
Intangible assets	13,545	750	14,295	14,858	15	14,873	14,448	—	14,448
Property, plant and equipment	9,784	223	10,007	11,868	4,749	16,617	16,543	18	16,561
Deferred tax	3,443	—	3,443	3,878	—	3,878	6,373	—	6,373
Other financial assets	—	924	924	1,309	—	1,309	1,306	—	1,306
Prepayments, accrued income and other assets	7,820	742	8,562	9,667	456	10,123	11,270	704	11,974
Assets of disposal groups	14,013	(13,838)	175	25,450	(25,297)	153	12,484	(12,293)	191
Total assets	1,312,295	—	1,312,295	1,506,867	—	1,506,867	1,453,576	—	1,453,576
Liabilities									
Bank deposits	57,073	1	57,074	69,113	1	69,114	66,051	266	66,317
	44,332	—	44,332	39,691	—	39,691	32,739	—	32,739

Repurchase agreements and stock lending									
Deposits by banks	101,405	1	101,406	108,804	1	108,805	98,790	266	99,056
Customer deposits	433,239	753	433,992	414,143	22,610	436,753	428,599	2,267	430,866
Repurchase agreements and stock lending	88,040	—	88,040	88,812	—	88,812	82,094	—	82,094
Customer accounts	521,279	753	522,032	502,955	22,610	525,565	510,693	2,267	512,960
Debt securities in issue	94,592	—	94,592	162,621	—	162,621	218,372	—	218,372
Settlement balances	5,878	—	5,878	7,477	8	7,485	10,991	907	11,898
Short positions	27,591	—	27,591	41,039	—	41,039	43,118	—	43,118
Derivatives	434,333	7	434,340	523,983	126	524,109	423,967	5,042	429,009
Accruals, deferred income and other liabilities	14,801	2,679	17,480	23,125	1,233	24,358	23,089	925	24,014
Retirement benefit liabilities	3,884	—	3,884	2,239	—	2,239	2,288	—	2,288
Deferred tax	1,141	—	1,141	1,945	—	1,945	2,142	—	2,142
Insurance liabilities	—	6,193	6,193	6,312	—	6,312	6,794	—	6,794
Subordinated liabilities	26,773	529	27,302	26,319	—	26,319	27,053	—	27,053
Liabilities of disposal groups	10,170	(10,162)	8	23,995	(23,978)	17	9,428	(9,407)	21
Total liabilities	1,241,847	—	1,241,847	1,430,814	—	1,430,814	1,376,725	—	1,376,725

For the notes to this table refer to the following page.

Business review continued

Analysis of balance sheet pre and post disposal groups continued

	2012			2011			2010		
	Balance sheet £m	Disposal groups (1) £m	Gross of disposal groups £m	Balance sheet £m	Disposal groups (2) £m	Gross of disposal groups £m	Balance sheet £m	Disposal groups (3) £m	Gross of disposal groups £m
Selected financial data									
Gross loans and advances to customers	451,224	1,875	453,099	473,872	20,196	494,068	520,803	5,049	525,852
Customer loan impairment provisions	(21,136)	(12)	(21,148)	(19,760)	(791)	(20,551)	(18,055)	(36)	(18,091)
Net loans and advances to customers	430,088	1,863	431,951	454,112	19,405	473,517	502,748	5,013	507,761
Gross loans and advances to banks	29,282	2,112	31,394	43,993	87	44,080	58,038	651	58,689
Bank loan impairment provisions	(114)	—	(114)	(123)	—	(123)	(127)	—	(127)
Net loans and advances to banks	29,168	2,112	31,280	43,870	87	43,957	57,911	651	58,562
Total loan impairment provisions	(21,250)	(12)	(21,262)	(19,883)	(791)	(20,674)	(18,182)	(36)	(18,218)
Customer REIL	40,993	13	41,006	40,708	1,549	42,257	38,453	53	38,506
Bank REIL	134	—	134	137	—	137	145	—	145
REIL	41,127	13	41,140	40,845	1,549	42,394	38,598	53	38,651
Gross unrealised gains on debt securities	3,946	230	4,176	4,978	—	4,978	2,595	—	2,595
Gross unrealised losses on debt securities	(1,832)	(15)	(1,847)	(3,408)	—	(3,408)	(4,097)	—	(4,097)

Notes:

(1) Primarily Direct Line Group.

(2) Primarily UK branch-based businesses, RBS Aviation Capital, sold in 2012, and remainder of RBS Sempra Commodities JV.

(3) Primarily RBS Sempra Commodities JV, Non-Core project finance assets and certain interests in Latin America, Europe and the Middle East.

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Strategic risk objectives

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Our business and our strategy

Our approach to risk management

Except as otherwise indicated by an asterisk (*), the information in the Risk and balance sheet management section (pages 66 to 252) is within the scope of the Independent auditor's report.

In the balance sheet, all assets and liabilities of disposal groups are presented as a single line. In the risk and balance sheet management section, balances and exposures relating to disposal groups are included within risk measures for all periods presented. Refer to pages 64 and 65 for analysis of balance sheet pre and post disposal groups.

Strategic risk objectives*

Risk management plays an integral role in the delivery of the Group's strategic goal to be a safe and secure banking group. The implementation of a stronger and more effective culture of risk management and control provides the platform necessary to address historical vulnerabilities, rebuild upon the Group's core strengths and position it on a sustainable and profitable path for future growth.

Financial strength and resilience are at the heart of the Group's Strategic Plan. The Group has defined this level of robustness as that which is capable of achieving and sustaining a standalone credit rating (i.e. without government support) that is in line with those of its strongest international peers.

Given this central aim, in 2009 the Group Board set out four key strategic objectives, aligned to the Group's Strategic Plan. These are to:

- Maintain capital adequacy: to ensure that the Group has sufficient capital resources to meet regulatory requirements and to cover the potential for unexpected losses in its asset portfolio;

- Deliver stable earnings growth: to ensure that strategic growth is based around a longer-term risk versus reward consideration, with significantly lower volatility in underlying profitability than was seen over the previous five years;

- Ensure stable and efficient access to funding and liquidity: such that the Group has sufficient funding to meet its obligations, taking account of the constraint that some forms of funding may not be available when they are most needed; and

- Maintain stakeholder confidence: to ensure that stakeholders have confidence in the Group's recovery plan, its ability to deliver its strategic objectives and the effectiveness of its business culture and operational controls.

Each objective is essential in its own right, but also mutually supportive of the others.

These strategic risk objectives are the bridge between the Group-level business strategy and the frameworks, limits and tolerances that are used to set risk appetite and manage risk in the business divisions on a day-to-day basis.

We set risk appetite at Group level. This establishes the level and type of risks that we are able and willing to take to meet our strategic objectives and our wider obligations to stakeholders. We cascade and embed this risk appetite across the Group, allowing:

- each business to understand its acceptable levels of risk; and

- commercial strategies to be aligned with the use of available financial resources.

By setting a clear risk appetite and embedding a strong risk culture throughout our businesses, we can identify, measure and control risk exposures and respond effectively to shocks.

Key developments
In 2012, the Group continued to strengthen its approach to risk management amidst a challenging and ever-changing external environment. Areas of progress included:

- reducing exposures in line with the objective of being safe and sustainable;
- improving the quality of data, including forward-looking measures;
- developing a framework for the effective management of conduct risk;
- strengthening the credit risk and country risk appetite and management frameworks and ensuring consistent application across the Group; and
- further realigning the Group Policy Framework to the business model and continuing assurance.

This is how the Group brings the Strategic Plan to life in the management of risk.

More detailed discussions on how the Group strengthened its approach to risk management in 2012 and the areas of focus going forward is contained within the relevant sub-sections on the following pages.

*unaudited

Business review Risk and balance sheet management continued

Strategic risk objectives* continued
Top and emerging risk scenarios*
As part of its risk management process, the Group identifies and monitors its top and emerging risk scenarios. Such risk scenarios are those the materialisation of which would lead to a significant unexpected negative outcome, thereby causing the Group as a whole or a particular division to fail to meet one or more strategic risk objectives. In assessing the potential impact of risk materialisation, the Group takes into account both financial and reputational considerations.

Although management is concerned with a range of risk scenarios, a relatively small number attracted particular attention from senior management during the past year. These can be grouped into three broad categories:

- Macro-economic risks.
- Regulatory and legal risks.
- Risks related to the Group's operations.

In addition, further information on these and other risks facing the Group appears in the discussion of Risk Factors on pages 459 to 471.

Descriptions of top and emerging risks are provided below:

Macro-economics risks

(i) Increased defaults in sectors to which the Group has concentrated exposure, particularly commercial real estate
The Group has concentrated lending exposure to several sectors, most notably commercial real estate, giving rise to the risk of losses and reputational damage from unexpectedly high defaults. Another sector to which the Group has concentrated lending exposure is shipping. Several of the Group's businesses are exposed to these sectors, principally Non-Core, Ulster Bank and UK Corporate.

Impact on the Group
- If borrowers are unable to refinance existing debt, they may default. Further, if the value of collateral they have provided continues to decline, the resulting impairments may be larger than expected. In addition, as other lenders seek to sell assets, the Group may find it more difficult to meet its own targets for a reduction in its exposure to certain sectors.

Mitigants
- The Group is mitigating its risks by monitoring exposures carefully and achieving reductions through a combination of repayments, roll-offs and asset sales whenever possible. In addition, it has placed limits on the origination of new business of this type.

(ii) The risk of a eurozone event
Europe was of concern throughout the year owing to a combination of slow growth in major economies and negative growth in peripheral countries labouring under high public debt burdens. As a result, several risks might materialise, including the default of one or more eurozone sovereigns, the exit from the eurozone of one or more member countries or the redenomination of the currency of a eurozone country followed by the devaluation of that country's currency. Although the Group's direct exposure to most peripheral eurozone countries is modest, it has material exposure to

Ireland through its ownership of Ulster Bank. In addition, it has material exposure to core eurozone countries such as Germany, the Netherlands, France and, to a lesser extent, Italy. Details of the Group's eurozone exposures appear on pages 215 to 239. All divisions are affected by this risk.

Impact on the Group

- If a peripheral eurozone sovereign defaults on its debt, the Group could experience unexpected impairments, either as a result of its exposure to the sovereign or as a result of its exposure to financial institutions or corporations located in that country.

- If one or more sovereigns exit the eurozone, credit ratings for eurozone borrowers more broadly may be downgraded, resulting in increases in credit spreads and decreases in security values, giving rise to market value losses.

- If one or more peripheral eurozone sovereigns redenominates its currency, resulting in a devaluation, the Group could experience losses to the extent that its exposures to these sovereigns are not funded by liabilities that similarly redenominate.

Mitigants

The Group has taken a number of steps to mitigate the impact of these risks.

- To mitigate the impact of a eurozone sovereign default, the Group has reduced its exposures to peripheral eurozone countries. To mitigate the impact of the exit from the eurozone of one or more countries, and the sovereign ratings downgrade that would likely result, the Group has extended its limit control framework to include all eurozone countries.

- Finally, to mitigate the impact of redenomination, the Group has reduced exposures and sought where possible to reduce mismatches between the currencies in which assets and liabilities are denominated.

(iii) The risk of a more severe or protracted economic downturn

Following the financial crisis of 2007, economies in the UK, Europe and the US have struggled to recover and return to growth. An unexpectedly severe downturn could result from economic weakness in the emerging markets of Asia, spreading to the US, the UK and Europe. A slowdown in or reversal of economic growth could undermine the austerity plans of the UK and other countries in Europe. The risk to the UK is of particular concern. While all divisions are potentially affected, those most at risk include UK Corporate, UK Retail, Markets, Non-Core and Ulster Bank.

*unaudited

Impact on the Group

- If the UK experiences an unexpectedly severe economic downturn, the Group is exposed to the risk of losses largely as a result of increased impairments in its retail and commercial businesses in the UK. Its investment banking activities in the UK could also be adversely affected.

- A worsening of the already difficult economic environment in Ireland could result in increased impairments in Ulster Bank. In addition, it could make the sale or refinancing of related exposures in Non-Core more difficult, slowing progress towards the elimination of these exposures.

Mitigants

- To mitigate the risk, the Group actively monitors its risk positions with respect to country, sector, counterparty and product relative to risk appetite, placing exposures on Watch and subjecting them to greater scrutiny. In addition, the Group reduces exposures when appropriate and practicable.

(iv) An increase in the Group's obligations to support pension schemes
The Group has established various pension schemes, thereby incurring certain obligations as sponsor of these schemes. All of the Group's businesses are exposed to this risk.

- If the value of the pension scheme assets is not adequate to fund pension scheme liabilities, the Group may be required to set aside additional capital in support of the schemes. The amount of additional capital that may be required depends on the size of the shortfall when the assets are valued. However, as asset values are lower and liabilities higher than they were when the fund was last valued, an increase in capital required is a possibility.

- In addition, the Group may be required to increase its cash contributions to the schemes. Similarly, the amount of additional cash contributions that may be required depends on the size of the shortfall when the assets are valued. If interest rates fall further, the value of the schemes' assets may decline as the value of their liabilities increases, leading to the need to increase cash contributions still further.

Mitigants

- In order to mitigate the risk, the Group has taken a number of steps, including changing the terms of its pension schemes to reduce the rate at which liabilities are increasing. These include: capping the growth rate of pensionable salary at two percent, and changing the retirement age to 65 with same contributions, with the option for individuals to retire at age 60 and pay an extra five percent of their salary to fund it.

Regulatory and legal risks

(i) A failure to demonstrate compliance with existing regulatory requirements related to conduct
The Group is subject to regulation governing the conduct of its business activities. For example, it must ensure that it sells its products and services only to informed and suitable customers and handles complaints efficiently and effectively. This risk affects all divisions.

Impact on the Group

- If the Group sells unsuitable products and services to customers or if the sales process is flawed, it may incur regulatory censure, including fines. In addition, it may suffer serious reputational damage.

- If the Group fails to handle customer complaints appropriately, it may incur regulatory censure, including fines. In addition, it may incur increased costs as it investigates these complaints and compensates customers. Further, it may

suffer serious reputational damage.

Mitigants

In order to mitigate these risks, the Group has taken a number of steps:

- In order to mitigate the risk of mis-selling, affected divisions are exiting some businesses and improving staff training and controls in others.

- In order to improve the handling of customer complaints, divisions have detailed action plans in place to meet or exceed customer and regulatory requirements and address known shortcomings.

(ii) A failure to demonstrate compliance with other existing regulatory requirements

The Group is also subject to regulation governing its business activities more broadly. For example, it is required to take the steps necessary to ensure that it complies with rules in place to prevent money laundering, bribery and other forms of unlawful activity. It is also required to comply with certain regulations regarding the timely provision of banking services to customers. This risk affects all divisions.

Impact on the Group

- If the Group sells products and services to sanctioned individuals or groups, it may expose itself to the risk of litigation as well as regulatory censure. Its reputation would also suffer materially.

- If the Group, as a result of a systems failure, is unable to provide banking services to customers, it may incur regulatory fines and censure as well as suffer significant reputational damage.

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Strategic risk objectives*: Top and emerging risk scenarios continued
Mitigants

- The Group is in the process of installing a new global client screening program, the objective of which is to prevent the inadvertent provision of products and services to sanctioned individuals or groups.

- The Group has also established and is implementing a plan to enhance the resilience of information technology and payment processing systems.

(iii) Losses or reputational damage arising from litigation
Given its diverse operations, the Group is exposed to the risk of litigation. For example, during the course of 2012, it was the subject of investigations into its activities in respect of LIBOR as well as securitisation. This risk affects all of the Group's divisions.

Impact on the Group

- As a result of litigation, the Group may incur fines, suffer reputational damage, or face limitations on its ability to operate. In the case of LIBOR, the Group reached settlements with the Financial Services Authority, the Commodity Futures Trading Association and the US Department of Justice. It continues to cooperate with other governmental and regulatory authorities in relation to LIBOR investigations; the probable outcome is that the Group will incur additional financial penalties at the conclusion of these investigations.

Mitigants

- The Group defends claims against it to the best of its ability.

(iv) A failure to demonstrate compliance with new requirements arising from structural reform
In addition to existing regulation, the Group will be subject to new regulation arising from structural reform. For example, legislation creating the Single European Payment Area (SEPA) will require the Group to develop and implement the infrastructure necessary to effect domestic and cross border payments. This risk affects Markets, International Banking and Ulster Bank in particular.

Impact on the Group

- Compliance with the regulation will require substantial changes in the Group's systems. As a result, the Group may not be able to meet the deadline for implementation, giving rise to the risk of regulatory fines and censure. In addition, as such a failure would affect customers, it could also have a material negative impact on the Group's reputation.

Mitigants

- The Group has a project in train to design, develop and deliver the required systems changes.

Risks related to the Group's operations

(i) A failure of information technology systems
The Group relies on information technology systems to service its customers, giving rise to the risk of losses and significant reputational damage should one or more of these systems fail. The risks of an information technology system failure affects all of the Group's businesses.

Impact on the Group

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A failure could prevent the Group from making or receiving payments, processing vouchers or providing other types of services to its customers.

- A failure could also prevent the Group from managing its liquidity position, giving rise to the risk of illiquidity.

- A lack of management information could lead to an inadvertent breach of regulations governing capital or liquidity.

- A failure could also leave the Group vulnerable to cyber crime. The Group is also exposed to this risk indirectly, through outsourcing arrangements with third parties.

Mitigants

- The Group has developed a risk appetite framework to manage these risks and is implementing a plan to bring its risk position within risk appetite by improving batch processing through process redesign and simplification. The Group expects these investments to result in improvements over the course of 2013 and 2014.

(ii) A failure of operational controls

The Group is exposed to the risk of losses arising from a failure of supervisory controls to prevent a deviation from procedures. An example of such a deviation is an unauthorised trading event. Should existing controls prove inadequate, one or more individuals may expose the Group to risks far in excess of its approved risk appetite. While all divisions are exposed to this risk to some degree, Markets is particularly at risk.

Impact on the Group

- If one or more individuals deviate from procedures, the Group may take excessively large positions. If market prices change adversely, the Group may incur losses. Such losses may be substantial if the positions themselves are very large relative to the relevant market.

Mitigants

- Markets has developed a plan for addressing identified weaknesses, has benchmarked it against those of its peers and is implementing it.

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Risk appetite and risk governance

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Risk appetite and risk governance

Risk appetite*

Risk appetite is both a key business tool and an integral part of RBS's enterprise-wide approach to risk management. It is aligned with the Group's strategic objectives, helping to strike an optimal balance between building a sustainable risk profile and creating long-term value for the Group's customers, investors and wider stakeholders. The risk appetite framework is designed to ensure that each business can withstand significant deteriorations in economic and market conditions.

The Group's risk appetite is set and owned by the Group Board. It identifies and establishes the level and type of risks that RBS is able and willing to take in order to:

- meet its strategic objectives - the Group's Strategic Plan is built on the core foundations of serving its customers well, building a sustainable risk profile and creating long-term value for its shareholders; and

- meet its wider obligations to stakeholders - a bank that is safe and sound and puts serving customers at the heart of its thinking should also perform well for its owners, employees, regulators and communities.

Risk appetite is cascaded and embedded across the Group. It provides a greater understanding of the acceptable levels of risk for each business, aligning commercial strategies with the use of scarce financial resources, such as capital and funding. It provides a solid platform from which RBS can focus on its key business strengths and competitive advantages over the long term.

Delivering a sustainable and conservative risk profile

Risk appetite starts with the tone from the top (i.e. the strategic goals and risk philosophy set by the Group Board) and is cascaded through key targets, limits and risk tolerances that influence decision making from enterprise-wide to transactional level.

A strong risk culture is a key part of ensuring risk appetite is effectively embedded across the Group. The link between risk appetite and strategic objectives encourages people at all levels of the business to think about risk, how they apply it and how they manage it. It incorporates the quantitative and qualitative aspects of risk, and uses both absolute and relative risk measures.

The risk appetite framework is based upon four main pillars:

- Risk envelope metrics - RBS has set sustainable business goals over a medium-term horizon (including a target for the capital ratio, leverage ratio, loan:deposit ratio, liquidity portfolio and use of wholesale funding. These effectively set the broad boundaries within which the Group operates. The Non-Core division also acts as a primary driver for reducing risk and the size of the balance sheet.

- Quantitative risk appetite targets - Risk appetite is also aligned to potential risk exposures and vulnerabilities under severe but plausible stress conditions. Quantitative targets, under stress conditions, are set around the Group's strategic risk objectives (refer to page 68).

- Qualitative risk appetite targets - The third strategic risk objective of maintaining stakeholder confidence covers qualitative aspects relating to the culture of risk management and controls and meeting stakeholder expectations. Risk appetite is based around identified expectations across a range of stakeholders (e.g. customers, employees, investors and the general public) and is closely aligned with key risk policies and controls (e.g. the Group Policy

Framework, conduct risk, reputational risk).

- Risk control frameworks and limits - Risk control frameworks set granular tolerances and limits for material risk types (e.g. credit risk, market risk, conduct risk and operational risk) that are used to manage risk on a day-to-day basis. These limits support and are required to be consistent with the high-level risk appetite targets.

The framework is supported by a programme of communication, engagement and training rolled out across the Group to engender a wide understanding of the purpose and value of an effective risk appetite.

The Group Policy Framework (see following section) directly supports the qualitative aspects of risk appetite, helping to rebuild and maintain stakeholder confidence in the Group's risk control and governance. This integrated approach ensures that an appropriate standard of control is set for each of the material risks the Group faces, with an effective assurance process put in place to monitor and report on performance.

Risk appetite has its own policy standard within the Group Policy Framework that sets out clear roles and responsibilities to measure, cascade and report performance against risk appetite, and to provide assurances that business is being conducted within approved risk limits and tolerances.

The Board Risk Committee reviews the framework and its targets on a regular basis to ensure they remain aligned to strategic objectives, business performance, emerging risks and changes in the external environment.

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Creating sustainable value within risk appetite
Risk appetite supports value creation delivered in a safe and sustainable way. It is embedded within the annual planning and budgeting process. Business strategies are designed on the basis of key value drivers (e.g. regulatory framework, customer franchises, internal control framework, incentives) and whether they fit within agreed risk appetite boundaries.

A range of different but complementary tools have been developed to measure whether strategic plans are consistent with risk appetite, to test broader 'what if' questions and to assess the impact of changes in key assumptions:

- Integrated stress testing - (refer to page 80) assesses how earnings, capital and funding positions change under an unfavourable, yet plausible, scenario. Stress scenarios can differ by theme, geographical location or severity.

- Economic capital - provides complementary insights, with a breadth of understanding of risk profile changes and 'tail risks' across millions of different modelled scenarios.

- Sensitivity analysis - provides 'ready reckoners' around changes in key variables. It offers a high-level view on questions such as 'what if GDP worsened by a further 1%?', identifying certain tipping points where the Group's risk profile moves outside its risk appetite.

Effective processes for reporting the results have also been developed, presenting the Board and senior management with a holistic and dynamic view of key risk exposures.

Group Policy Framework*
Achieving and sustaining a robust control framework comparable to those of the Group's strongest international peers is critical to achieving the successful delivery of the Group's risk objectives.

The Group Policy Framework (GPF), introduced in 2009, supports this goal by providing a consistent and structured overarching framework for conduct, control and governance. It provides clear guidance and controls on how the Group does business, linked to its risk appetite, its business conduct and compliance responsibilities, and its focus on delivering a control environment consistent with best practice against relevant external benchmarks.

The GPF and related initiatives aim to ensure that:

- The Group has ethical principals and clear control standards to identify the risks it faces to support effective risk management and meet regulatory and legal requirements;

- Policies are followed across the Group and compliance can be clearly evidenced, assessed and reported by line management;

- The control environment is monitored and overseen through good governance.

Communication and training programmes ensure staff are aware of their own responsibilities. Policy standard owners and sponsors review their policies on a regular basis, documenting identified shortfalls and addressing them within an agreed time frame.

In 2011, a number of key enhancements were delivered including the following:

-

The Group's policy standards were rewritten to ensure they clearly express the existing mandatory controls required to mitigate the key risks the Group faces;

- All of the Group's policy standards were externally benchmarked; and

- For each policy standard, appropriate risk-based assurance activity was introduced to ensure each division is appropriately controlled and compliance with policy can be demonstrated.

During 2012, the scope of the GPF was refined further. Key developments included:

- Following external benchmarking exercises, additional policy standards were introduced setting out new mandatory controls required to mitigate key risks to the Group.

- A conduct risk framework was agreed and is being progressively established. Grouped under four policy standards - employee conduct, corporate conduct, market conduct; and conduct towards our customers - each is designed to provide high level direction to the Group and is supported by the Group's Code of Conduct (refer to page 307 for more detail).

- The Group's key credit risk policies and mandatory controls were restructured and realigned to reflect the two distinct portfolios of credit risk: wholesale and retail. These changes are aimed at simplifying the policy structure and making it clearer to divisions which standards are applicable to their respective businesses.

- Certain procedural-related policy standards were removed from the framework to reduce bureaucracy and simplify the structure.

The GPF continues to be improved. The results of assurance activity, monitoring and analysis of the internal and external environment are used to reassess the policy standards on a regular basis.

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Risk appetite and risk governance continued

Risk organisation*

The Group has an independent risk management function ('RBS Risk Management') which manages risk through independent challenge and oversight of the customer-facing businesses and support functions. It provides an overarching risk control framework linked to the risk appetite of the Group.

The Head of Restructuring and Risk is the Group Chief Risk Officer, who leads this function through the strategic setting and execution of its responsibilities. The Head of Restructuring and Risk reports to the Group Chief Executive and the Board Risk Committee, with a right of access to the Chairman.

RBS Risk Management is designed to align as closely as possible with the customer-facing businesses and support functions while maintaining an appropriate level of independence, which underpins the Group's approach to risk management and is reinforced through the Group by appropriate reporting lines.

Within RBS Risk Management, Group functional heads (e.g. the Group Chief Credit Officer for the credit risk discipline, the Group Head of Operational Risk for the operational risk discipline) report directly into the Head of Restructuring and Risk and are responsible for firm-wide risk appetite and standards under their respective disciplines. For example, Group Compliance is responsible for conduct risk policy ownership, change management, assurance and training frameworks at Group level, including anti-money laundering, sanctions, terrorist financing, anti-bribery and corruption.

Risk management within divisions focuses on all material risks including credit, market, operational, regulatory and country risk, and business activities. Liquidity risk and the day-to-day management of liquidity and funding of the book is Group Treasury's responsibility.

Oversight of risk within divisions is the responsibility of the relevant divisional Chief Risk Officer (CRO), with input from the relevant Group heads of function. This involves ensuring that:

- All activities undertaken by the individual divisions are consistent with the Group's risk appetite targets;
- Group policies and resulting operating frameworks, including delegated authorities and limits, are complied with through effective monitoring and exception reporting; and
- There is the effective operation of Group-wide risk processes such as the Group Policy Framework and the New Product Risk Assessment Process.

Divisional CROs have a direct functional reporting line to the Deputy Group CRO.

The Head of Restructuring and Risk and the Deputy Group CRO have a direct involvement in the selection, appointment or removal of divisional CROs and Group functional heads and also have responsibility for their ongoing performance assessment and management.

Divisions mirror the Group set-up for risk management, i.e. the Divisional Executive Committees are responsible for setting and owning their risk appetite within Group constraints. The Divisional Risk Committees oversee the businesses relative to divisional and Group risk appetite and focus on ensuring that risks are adequately monitored and controlled.

The Divisional CROs provide independent oversight to this process, with support from the Group Chief Risk Officer, the Deputy Group CRO and Group functional heads as appropriate. Additional challenge and oversight is provided by Group functional heads on an ongoing basis and by Divisional Risk and Audit Committees on a periodic review basis.

For more information on risk governance and a presentation of the Group's risk committees, refer to pages 76 to 79. For a summary of the main risk types faced by the Group and how it manages each of them, refer to pages 81 to 85

Three lines of defence

Having a strong three lines of defence model is important in a strong control environment. The Executive Committee approved a refreshed model in February 2012 and work is underway to embed this across the Group. The model's main purpose is to define accountabilities and responsibilities for managing risk across the Group.

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Risk governance*

The Group is committed to achieving the highest standards of corporate governance in every aspect of the business, including risk management.
A key aspect of the Group Board's responsibility as the main decision-making body at Group level is the setting of Group risk appetite to ensure that the levels of risk that the Group is willing to accept in the attainment of its strategic business and financial objectives are clearly understood.

To enable the Group Board to carry out its objectives, it has delegated authority to senior Board and executive committees, as required and appropriate. A number of key committees specifically consider risk across the Group, as set out in the diagram below.

Notes:
(1) The following sub-committees report directly to the Group Asset and Liability Management Committee: Capital and Stress Testing Committee, Pension Risk Committee, Balance Sheet Management Committee.
(2) The following sub-committees report directly to the Group Risk Committee: Global Market Risk Committee, Group Country Risk Committee, Group Models Committee, Group Credit Risk Committee and Operational Risk Executive Committee. In addition, Divisional Risk Committees report to the Group Risk Committee. The Capital and Stress Testing Committee also provides monthly updates to the Group Risk Committee, escalating issues as necessary.

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Risk appetite and risk governance: Risk governance* continued
The key risk responsibilities of each of these committees as well as their membership are set out in the table below. Further information on the Group Board and Board Committees is available on page 256.

These committees are supported at a divisional level by a risk governance structure embedded in the business. These committees play a key role in ensuring that the Group's risk appetite is supported by effective risk management frameworks, limits and policies, together with clear accountabilities for approval, monitoring, oversight, reporting and escalation.

During 2012, the Conduct Risk Committee was created as a sub-committee of the Executive Risk Forum. Effective conduct risk management is not only a commercial imperative for the Group; customers, clients and counterparties demand it as a precursor to building trust. For more information on conduct risk and the Group's management of this risk type, refer to page 249.

Board/Committee	Risk focus	Membership
Group Board	The Group Board ensures that the Group manages risk effectively by approving and monitoring the Group's risk appetite, considering Group stress scenarios and agreed mitigants and identifying longer-term strategic threats to the Group's business operations.	The Board of directors
Executive Committee	The Executive Committee considers recommendations on risk management matters referred by the Executive Risk Forum and/or Group Risk Committee, including recommendations on risk appetite, risk policies and risk management strategies. It operates under delegated authority from the Group Board.	Group Chief Executive Group Finance Director Chief Administration Officer Chief Executive Officers of divisions Head of Restructuring and Risk
Board Risk Committee	The Board Risk Committee provides oversight and advice to the Group Board on current and potential future risk exposure of the Group and risk strategy. It reviews the Group's performance on risk appetite, oversees the operation of the Group Policy Framework and provides a risk review of remuneration arrangements. It operates under delegated authority from the Group Board.	At least three independent non-executive directors, one of whom is the Chairman of the Group Audit Committee.
Group Audit Committee	The Group Audit Committee reviews accounting policies, financial reporting and regulatory compliance practices of the Group, as well as its systems and standards of internal controls and monitors the Group's processes for internal audit and external audit. It has responsibility for	At least three independent non-executive directors, at least one of whom is a financial expert as defined in the SEC rules under the US Exchange Act.

	monitoring relationships with regulatory authorities. It operates under delegated authority from the Group Board.	
Group Performance and Remuneration Committee	The Group Performance and Remuneration Committee has oversight of the Group's policy on remuneration and receives advice from RBS Risk Management and the Board Risk Committee to ensure that there is thorough risk input into incentive plan design and target setting, as well as risk review of performance bonus pools and clawback. It operates under delegated authority from the Group Board.	At least three independent non-executive directors
Group Sustainability Committee	The Group Sustainability Committee is responsible for overseeing and challenging how management is addressing sustainability and reputation issues related to all stakeholder groups. This includes customer and related citizenship activities, oversight of the delivery of the Purpose, Vision and Values cultural and behavioural change, and oversight of the sustainability aspects of the people agenda. It operates under delegated authority from the Group Board.	Independent non-executive directors

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Business review Risk and balance sheet management continued

Board/Committee	Risk focus	Membership
Executive Risk Forum	The Executive Risk Forum has full authority to act on all material and/or enterprise-wide risk and control matters across the Group. It approves the most material limits and decisions above defined thresholds and delegates decisions below these thresholds to sub-committees and appropriate individuals. It operates under delegated authority from the Executive Committee.	Group Chief Executive Group Finance Director Chief Administration Officer Chief Executive Officers of divisions Head of Restructuring and Risk Deputy Group Chief Risk Officer
Group Asset and Liability Management Committee	The Group Asset and Liability Management Committee is responsible for identifying, managing and controlling Group balance sheet risks in executing its business strategy. It operates under delegated authority from the Executive Risk Forum.	Group Finance Director Group Treasurer Chief Executive Officers of divisions Head of Restructuring and Risk Key Group Finance function heads Chief Executive Officer, Markets, M&IB
Group Risk Committee	The Group Risk Committee acts on material and/or enterprise-wide risk and control matters across the Group. It is an oversight committee which reviews and challenges risks and limits across the functional areas and plays a key role exercising and demonstrating effective risk oversight across the Group. It reviews risks and issues on both a thematic and specific basis and focuses on forward-looking, emerging risks. It considers the overall risk profile across the Group and identifies any key issues for escalation to the Executive Risk Forum. It operates under delegated authority from the Executive Risk Forum.	Deputy Group Chief Risk Officer Divisional Chief Risk Officers Key Group Risk function heads
Conduct Risk Committee	The Conduct Risk Committee is responsible for the governance, leadership and strategic oversight of the Group's conduct risk agenda, as well as escalating and reporting any material or strategically significant issues or matters to the Executive Risk Forum. It operates under delegated authority from the Executive Risk Forum.	Head of Restructuring and Risk Group General Counsel Deputy Group Chief Risk Officer Global Head of Compliance Director, Group Regulatory Affairs Chief Executive Officer, Wealth Management Managing Director, Products and Marketing, UK Retail Chief Executive Officer, Corporate Banking Vice Chairman, RBS Citizens Financial Group Co-Head, M&IB Americas Director, Group Operations, Business Services Chief Operating Officer, Ulster Bank Group

		Chief Executive Officer, RBS England & Wales and NatWest Scotland Head of Group Internal Audit
Pension Risk Committee	The Pension Risk Committee considers the Group-wide view of pension risk appetite, mechanisms that could potentially be used for managing risk within the funds, and implications of the pension schemes' financial strategy. It also reviews actuarial funding assumptions from a Group perspective as appropriate. The Pension Risk Committee consults with the Trustee's Investment Executive where necessary. The Pension Risk Committee operates under delegated authority from the Group Asset and Liability Management Committee.	Group Finance Director Head of Restructuring and Risk Group Treasurer Global Head of Market and Insurance Risk Group Chief Accountant Chief Executive Officer, Markets, M&IB Global Head of Markets, M&IB Group Head of Pension Risk Deputy Group Chief Risk Officer Head of Group Pensions

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Business review Risk and balance sheet management continued

Risk appetite and risk governance: Risk governance* continued

Board/Committee	Risk focus	Membership
Capital and Stress Testing Committee	The Capital and Stress Testing Committee leads the integrated development and maintenance of risk capital approaches, frameworks and standards. It reviews positions and plans, agrees approaches and standards and provides cross-functional challenge on the topics outlined in its terms of reference. It is responsible to the Group Finance Director and the Head of Restructuring and Risk for many of these activities. It provides updates to the Group Asset and Liability Management Committee and Group Risk Committee and seeks approvals where necessary. It operates under delegated authority from the Group Asset and Liability Management Committee.	Group Finance Director Key Group Finance function heads Key Group Risk function heads
Executive Credit Group	The Executive Credit Group decides on requests for the extension of existing or new credit limits on behalf of the Group Board where the proposed aggregate facility limits are in excess of the credit approval authorities granted to individuals in divisions or in RBS Risk Management, or where an appeal against a decline decision of the Group Chief Credit Officer (or delegates) or Group Chief Risk Officer is referred for final decision.	Group A members (1) Head of Restructuring and Risk Deputy Chief Risk Officer Group Chief Credit Officer/Chief Credit Officer N.V. Head of Global Restructuring Group Chief Risk Officer, Corporate Banking Group B members (1) Group Chief Executive Group Finance Director Deputy Chief Executive Officers, M&IB (1)Decisions require input from at least one member from each of Group A and Group B.
Divisional Risk and Audit Committees	Divisional Risk and Audit Committees report to the Board Risk Committee and the Group Audit Committee on a quarterly basis. Their main responsibilities are to: · monitor the performance of the divisions relative to divisional and Group risk appetite; and · review accounting policies, internal control, financial reporting functions,	Members: at least three non-executive members who are executives of the Group who do not have executive responsibility in the relevant division. Attendees: at least two executives of the division, as appropriate. Representatives from finance, risk, internal audit and external audit.

internal audit, external audit and regulatory compliance.	Members of the Board Risk Committee and Group Audit Committee also have the right to attend.

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Stress testing*

Stress testing describes the evaluation of a bank's financial position under severe but plausible stress scenarios. Stress testing also refers to the broader framework under which these tests are developed, evaluated and used within the Group's decision-making process in the context of the wider economic environment.

Internal stress tests

The Group's stress testing framework is designed to embed stress testing as a key risk management technique into mainstream risk reporting, capital planning and business processes at divisional, legal entity and Group levels.

The Executive Risk Forum (see Risk governance on page 78) is the main body overseeing the Group's stress testing approach, processes and results. The forum is primarily responsible for reviewing and challenging the results of any Group-wide stress test and ensuring that, where necessary, appropriate management actions are undertaken. The Board Risk Committee receives reports detailing stress tests undertaken as part of the financial planning process. It reviews and challenges the stress scenarios and considers their impact on the Group's financial position. These reports outline relevant management actions as well as the extent to which such actions mitigate the effects of the stress scenario on the Group's capital adequacy. The Board Risk Committee may also request additional stress tests as it deems necessary.

Stress testing forms part of the Group's risk and capital management framework and is a major component of the Basel III requirements. It highlights to senior management potential unexpected adverse outcomes related to a mixture of risks and provides an indication of how much capital might be required to absorb losses should adverse scenarios materialise. Stress tests, part of the financial planning process are conducted and presented to senior management semi-annually. Stress tests are also conducted to meet regulatory requirements as well as to assess the impact of business decisions on the Group's capital position. Examples of the former include the European Banking Authority's EU-wide stress tests, the International Monetary Fund's Financial Sector Assessment Program and the UK Financial Services Authority's anchor stress tests while examples of the latter include stress tests conducted in connection with the transfer of assets from The Royal Bank of Scotland N.V. to The Royal Bank of Scotland plc.
Scenario stress testing is conducted throughout the Group as detailed below:

- As part of the financial planning and strategy cycle, stress tests are conducted by divisions and aggregated to produce firm-wide results. These stress tests are also used for monitoring divisional and Group risk appetite.

- Stress testing is performed centrally by Group functions both to meet regulatory requirements and for ad-hoc business analysis and decision-making. These stress tests also include reverse stress tests, which identify scenarios and circumstances that could render RBS's business model unviable.

- Division-specific stress testing is undertaken to support risk identification and risk management decision-making.

- Risk-type specific stress testing is also conducted. For example, within the market risk management framework, a comprehensive programme of stress tests covers a variety of historical and hypothetical scenarios, including reverse stress tests.

Stress test scenarios specifically target both firm-wide vulnerabilities and negative global impacts. They consider a five-year horizon and include stress projections for macroeconomic variables such as GDP, unemployment rates, property prices, stock price indices, interest rates and inflation.

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Business review Risk and balance sheet management continued

Risk appetite and risk governance continued
Risk coverage*
The main risk types faced by the Group are presented below, together with a summary of the key areas of focus and how the Group managed these risks in 2012.

Risk type	Definition	Features	How the Group managed risk and the focus in 2012
Capital adequacy risk	The risk that the Group has insufficient capital.	Potential to disrupt the business model and stop normal functions of the Group. Potential to cause the Group to fail to meet the supervisory requirements of regulators. Significantly driven by credit risk losses.	Core Tier 1 ratio was 10.3%, a sixty basis point improvement on 2011 (excluding the effect of APS). This largely reflected reduction in risk profile with risk-weighted assets (RWAs) down by nearly 10%, principally in Non-Core due to disposals and run-off and in Markets. Refer to pages 86 to 95.
Liquidity and funding	The risk that the Group is unable to meet its financial liabilities as they fall due.		The Group's performance in 2012 represented a new benchmark in the management of liquidity risk as the Group began operating under normalised market practices for the management of liquidity and funding risk despite a backdrop of continued market uncertainty and certain Group-specific factors such as a downgrade of the Group's external credit rating. The Group met or exceeded its medium term strategic funding and liquidity targets by 2012 year end. This included a loan:deposit ratio of 100%, short-term wholesale funding (STWF) of £42 billion, representing 5% of funded assets (target: less than 10%) and £147 billion liquidity portfolio which covered STWF 3.5 times (target: greater than 1.5 times STWF). Refer to pages 96 to 115.
Credit risk	The risk that the Group will incur losses owing to the failure of a customer or counterparty to meet its obligation to settle outstanding	Loss characteristics vary materially across portfolios. Significant link between losses and the macroeconomic	The Group manages credit risk based on a suite of credit approval, risk concentration, early warning and problem management frameworks and associated risk management systems and tools.

amounts.	environment. Can include concentration risk - the risk of loss due to the concentration of credit risk to a specific product, asset class, sector or counterparty.	With a view to strengthening its credit risk management framework and ensuring consistent application across the Group, during 2012 the Group Credit Risk function launched a set of credit control standards with which divisions must comply, to supplement the existing policy suite. These standards comprise not only governance and policy but also behavioural, organisational and management norms that determine how the Group manages credit from origination to repayment. During 2012, loan impairment charges were 27% lower than in 2011 despite continuing challenges in Ulster Bank Group (Core and Non-Core) and commercial real estate portfolios. Credit risk associated with legacy exposures continued to be reduced, with a further 34% decline in Non-Core credit RWAs during the year. The Group also continued to make progress in reducing key credit concentration risks, with exposure to commercial real estate declining 16% during 2012. Refer to pages 116 to 200.

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Business review Risk and balance sheet management continued

Risk type	Definition	Features	How the Group managed risk and the focus in 2012
Country risk	The risk of material losses arising from significant country-specific events.	Can arise from sovereign events, economic events, political events, natural disasters or conflicts. Potential to affect parts of the Group's credit portfolio that are directly or indirectly linked to the country in question. Primarily present in credit portfolios of Markets, International Banking, Ulster Bank (Ireland), Group Centre (mainly Treasury) and Non-Core.	Under the Group's country risk framework, all countries except the UK and the US are currently under limit control. All countries with material exposures are monitored continually using the Group's country risk watchlist process to identify emerging issues and facilitate the development of mitigation strategies. Detailed portfolio reviews are undertaken on a regular basis to ensure that country portfolio compositions remain aligned to the Group's country risk appetite in light of evolving economic and political developments. In the context of several sovereign downgrades, the Group has made continued progress in managing down its sovereign exposures. Having recognised an impairment on its holding of Greek government bonds in 2011, the Group participated in the restructuring of Greek sovereign debt in the first quarter of 2012 and no longer holds Greek government bonds. During 2012, the Group brought nearly all advanced countries under country limit control and further restricted its country risk appetite. Balance sheet exposures to periphery eurozone countries decreased by 13% or £9 billion to £59 billion with £20 billion outside of Ireland. Funding mismatches in Ireland and Spain reduced to approximately £9 billion and £4 billion respectively. Mismatches in other periphery eurozone countries were modest. Refer to pages 211 to 239.
Insurance risk	The risk of financial loss through fluctuations in the timing, frequency and/or severity of insured events, relative to the expectations at the time of underwriting.	Frequent small losses which are material in aggregate. Infrequent large material losses.	The Group's insurance risk resides principally in its majority owned subsidiary, Direct Line Insurance Group plc (DLG), which is listed on the London Stock Exchange. DLG ensures that it prices its policies and invests its resources appropriately to minimise the risk of potential loss. The risks are mitigated by agreeing policies and minimum standards that are regularly reviewed. The controls are

supplemented by reviews by external experts.

*unaudited

Business review Risk and balance sheet management continued

Risk appetite and risk governance: Risk coverage* continued

Risk type	Definition	Features	How the Group managed risk and the focus in 2012
Market risk	The risk arising from fluctuations in interest rates, foreign currency, credit spreads, equity prices, commodity prices and risk-related factors such as market volatilities.	Frequent small losses which are material in aggregate. Infrequent large material losses due to stress events. The majority of the Group's market risk exposure is in the Markets, International Banking and Non-Core divisions and Group Treasury. The Group is also exposed to market risk through interest rate risk and foreign exchange risk on its non-trading activities in the retail and commercial businesses.	A comprehensive structure is in place aimed at ensuring the Group does not exceed its qualitative and quantitative tolerance for market risk. The Group's market risk policy statements set out its qualitative tolerance for market risk. They define the governance, responsibilities and requirements for the identification, measurement, analysis, management and communication of market risk arising from the Group's trading and non-trading investment activities. The Group market risk limit framework expresses the Group's quantitative tolerance for market risk. The Group limit metrics capture, in broad terms, the full range of market risk exposures, ensuring the risk is appropriately defined and communicated. During 2012, the Group continued to reduce its risk exposures; market risk limits were lowered accordingly. Average trading VaR was £97 million, 8% lower than 2011, largely reflecting asset sales in Non-Core and decreases in ABS trading inventory in Markets. Refer to pages 201 to 210.
Operational risk	The risk of loss resulting from inadequate or failed processes, people, systems or from external events.	Frequent small losses. Infrequent significant losses.	The Group aims to manage operational risk to an acceptable level by taking into account the cost of minimising the risk against the resultant reduction in exposure. During 2012, the Group continued to make good progress in enhancing its operational risk framework and risk management capabilities. Key areas of focus have included: embedding risk assessments, increasing the coverage of the scenario analysis portfolio, and improving statistical capital modelling capabilities.

Operational risk data have been enriched by the outputs from these enhancements, resulting in a more complete view of the Group's operational risk profile and more informed risk appetite decisions.

The level of operational risk remains high due to the scale of change occurring across the Group (both structural and regulatory), macroeconomic stresses (e.g. eurozone distress) and other external threats such as e-crime. In June 2012 the Group was affected by a technology incident as a result of which the processing of certain customers accounts and payments were subject to considerable delay.

Refer to pages 241 to 243.

*unaudited

Business review Risk and balance sheet management continued

Risk type	Definition	Features	How the Group managed risk and the focus in 2012
Regulatory risk	The risk arising from non-compliance with regulatory requirements, regulatory change or regulator expectations.	Adverse impacts on strategy, capital structure, business models and operational effectiveness. Financial cost of adapting to changes in laws, rules or regulations or of penalties for non-compliance. Financial cost and reputational damage in respect of penalties for non-compliance/breach of regulations.	Management of regulatory risk entails early identification and effective management of changes in legislative and regulatory requirements that may affect the Group. Within the Group Policy Framework, specific policies define the minimum standards for regulatory engagement, upstream risk management and registration and licensing of individuals. These set minimum standards within their respective areas, applicable across the Group. During 2012, the Group, along with the rest of the banking industry, continued to experience unprecedented levels of prospective changes to laws and regulations from national and supranational regulators. Particular areas of focus were: conduct regulation; prudential regulation (capital, liquidity, governance and risk management); treatment of systemically important entities (systemic capital surcharges and recovery and resolution planning); and structural reforms, with the UK's Independent Commission on Banking proposals, the European Union's Liikanen Group recommendations and the Dodd-Frank/Volcker Rule agenda in the US. Refer to pages 244 to 248.
Conduct risk	The risk that the conduct of the Group and its staff towards its customers, or within the markets in which it operates, leads to reputational damage and/or financial loss.	Arises from breaches of regulatory rules or laws by individual employees, or as a result of the Group's retail or wholesale market conduct. It may also arise from the failure to meet customers' or regulators' expectations of the Group.	A defined and measurable appetite for conduct risk has been established to ensure commercial decisions take account of conduct risk implications. A management framework has been developed to enable the consistent identification, assessment and mitigation of conduct risks. Embedding of this framework started during 2012 and is continuing in 2013. Grouped under four pillars (employee conduct, corporate conduct, market conduct and conduct towards the Group's customers),

Non-compliance may result in regulator enforcement, adverse publicity and financial penalties.	each conduct risk policy is designed to ensure the Group meets its obligations and expectations. Awareness initiatives and targeted conduct risk training for each policy, aligned to the phased policy roll-out, have been developed and are being delivered to help embed understanding and provide the necessary clarity. These actions are designed to facilitate effective conduct risk management, and address shortcomings identified through recent instances of inappropriate conduct. Refer to page 249.

*unaudited

Risk appetite and risk governance: Risk coverage* continued

Risk type	Definition	Features	How the Group managed risk and the focus in 2012
Reputational risk	The risk of brand damage and/or financial loss due to the failure to meet stakeholders' expectations of the Group.	Can arise from a range of actions taken (or, in some cases, not taken) by the Group, as well as its wider policies and practices. Can be detrimental to the business in a number of ways, including an inability to build or sustain customer relationships, low staff morale, regulatory censure, or reduced access to funding sources.	The Group Board has ultimate responsibility for managing the Group's reputation, although all parts of the Group have responsibility for any reputational impact arising from their operations. The Board's oversight is supported by executive risk committees (including a new Conduct Risk Committee) and by the Group Sustainability Committee. In 2012, the Group strengthened the alignment of reputational risk management with its strategic objective of serving customers well and with the management of a range of risk types that have a reputational sensitivity. There are still legacy reputational issues to work through, but dealing with them in an open and direct manner is a necessary prerequisite to rebuilding a strong reputation for the Group. Refer to page 250.
Business risk	The risk of losses as a result of adverse variance in the Group's revenues and/or costs relative to its business plan and strategy.	May be caused by internal factors such as volatility in pricing, sales volumes and input costs, and/or by external factors such as exposure to macroeconomic, regulatory and industry risks. Influenced by other risks the Group faces that may contribute to adverse changes in revenues and/or costs, were these risks to crystallise.	The Group seeks to minimise its exposure to business risk, subject to its wider strategic objectives. Business risk is identified, measured and managed through the Group's planning cycles and performance management processes. The Group operates a rolling forecast process which identifies projected changes in, or risks to, operating profit and ensures appropriate action is taken. The management of business risk lies primarily with divisions, with oversight at the Group level led by Finance. During 2012, the Group continued to de-risk its balance sheet and to shrink its more volatile Markets business. The Group has further enhanced its scenario modelling to better understand potential threats to

			earnings, and to develop appropriate contingency plans. Refer to page 250.
Pension risk	The risk arising from the Group's contractual liabilities to or with respect to its defined benefit pension schemes, as well as the risk that it will have to make additional contributions to such schemes.	Funding position can be volatile due to the uncertainty of future investment returns and the projected value of schemes' liabilities.	The Group manages the risk it faces as a sponsor of its defined benefit pension schemes using a framework that encompasses risk reporting and monitoring, stress testing, modelling and an associated governance structure. This helps ensure the Group is able to fulfil its obligation to support the defined benefit pension schemes to which it has exposure. In 2012, the Group focused on enhancing its pension risk management and modelling systems and implementing a Group pension risk policy standard. Refer to pages 251 and 252.

Each risk type maps into the Group's risk appetite framework and contributes to the overall achievement of its strategic objectives with underlying frameworks and limits. The key frameworks and developments over the past year are described in the relevant sections of the following pages.

*unaudited

Capital management

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Capital management

Introduction*

The Group aims to maintain an appropriate level of capital to meet its business needs and regulatory requirements, and the Group operates within an agreed risk appetite.

The appropriate level of capital is determined based on the dual aims of: (i) meeting minimum regulatory capital requirements; and (ii) ensuring the Group maintains sufficient capital to uphold investor and rating agency confidence in the organisation, thereby supporting the business franchise and funding capacity.

2012 achievements*

The Group's Core Tier 1 ratio of 10.3% is higher than at the end of 2011 (after adjusting for Asset Protection Scheme effects) despite absorbing regulatory changes equivalent to 109 basis points and in the face of challenging economic headwinds and continuing costs of de-risking. This has been achieved through a continued focus on reshaping the Group's use of capital.

The Group has developed its stress testing capability to identify the impact of a wider set of potential scenarios. The stress outcomes show that the de-risking in the Group has been effective in reducing the impacts of stress scenarios and at the same time the capital ratios have been improving, resulting in increased capital buffers. The changes to the risk profiles as a result of de-risking include run-down of Non-Core, reduction in concentrations, and revising the strategic footprint of the Markets division.

The capital allocation approaches used in the Group will be developed to become increasingly risk sensitive and align risk management and resource allocation more fully.

Governance and approach

The Group Asset and Liability Management Committee (GALCO) is responsible for ensuring the Group maintains adequate capital at all times. The Capital and Stress Testing Committee (CAST) is a cross-functional body driving and directing integrated risk capital activities including determination of the amount of capital the Group should hold, how and where capital is allocated and planning for actions that would ensure that an adequate capital position would be maintained in a stressed environment. These activities have linkages to capital planning, risk appetite and regulatory change. CAST reports through GALCO and comprises senior representatives from Risk Management, Group Finance and Group Treasury.

Determining appropriate capital*

The minimum regulatory capital requirements are identified by the Group through the Internal Capital Adequacy Assessment Process and then agreed between the Group Board and the appropriate supervisory authority.

The Group's own determination of how much capital is sufficient is derived from the desired credit rating level, risk appetite and reflects the current and emerging regulatory requirements of the Group. It is evaluated through the application of both internally and externally defined stress tests that identify potential changes in capital ratios to a range of scenarios.

The Group identifies the management and recovery actions that could be applied to stress environments. These form an important part of the capital management approach and the contingency planning arrangements, complementing the established buffers.

Monitoring and maintenance*

Based on these determinations, which are continually reassessed, the Group aims to maintain capital adequacy, both at Group level and in each regulated entity.

The Group operates a rigorous capital planning process aimed at ensuring the capital position is controlled within the agreed parameters. This incorporates regular re-forecasts of the capital positions of the regulated entities and the overall Group. In the event that the projected position might deteriorate beyond acceptable levels, the Group would issue further capital and/or revise business plans accordingly.

Stress testing approaches are used to determine the level of capital required to ensure the Group expects to remain adequately capitalised.

Capital allocation*

Capital resources are allocated to the Group's businesses based on key performance parameters agreed by the Group Board in the annual strategic planning process. Principal among these is a profitability metric, which assesses the effective use of the capital allocated to the business. Projected and actual return on equity is assessed against target returns set by the Group Board. The allocations also reflect strategic priorities, the intensity of regulatory capital use and the usage of other key Group resources such as balance sheet funding and liquidity.

Economic profit is also planned and measured for each division during the annual planning process. It is calculated by deducting the cost of equity utilised in the particular business from its operating profit and measures the value added over and above the cost of equity.

The Group aims to deliver sustainable returns across the portfolio of businesses with projected business returns stressed to test key vulnerabilities.

The divisions use return on capital metrics when making pricing decisions on products and transactions to ensure customer activity is appropriately aligned with Group and divisional targets and allocations.

The Financial Services Authority (FSA) uses the risk asset ratio as a measure of capital adequacy in the UK banking sector, comparing a bank's capital resources with its RWAs (the assets and off-balance sheet exposures are weighted to reflect the inherent credit and other risks). By international agreement, the risk asset ratios should not be less than 8% with a Tier 1 component of not less than 4%.

Capital ratios*

The Group's capital, RWAs and risk asset ratios, calculated in accordance with FSA definitions, are set out below.

Capital	2012 £bn	2011 £bn	2010 £bn
Core Tier 1	47.3	46.3	49.6
Core Tier 1 (excluding Asset Protection Scheme (APS))	47.3	49.1	53.8
Tier 1	57.1	57.0	60.1
Total	66.8	60.7	65.3

Risk-weighted assets by risk	2012 £bn	2011 £bn	2010 £bn
Credit risk			
- non-counterparty	323.2	344.3	385.9
- counterparty	48.0	61.9	68.1
Market risk	42.6	64.0	80.0
Operational risk	45.8	37.9	37.1
	459.6	508.1	571.1
APS relief	—	(69.1)	(105.6)
	459.6	439.0	465.5

Risk asset ratios	%	%	%
Core Tier 1	10.3	10.6	10.7
Core Tier 1 (excluding APS)	10.3	9.7	9.5
Tier 1	12.4	13.0	12.9
Total	14.5	13.8	14.0

Key point

- The Core Tier 1 ratio, excluding relief provided by APS, has improved to 10.3% at 31 December 2012 driven by continued run-down and disposal of Non-Core assets and the reshaping of the balance sheet and capital usage in Markets.

Refer to page 94 for details on regulatory changes due to Basel III and Capital Requirement Directive IV and commentary on related projections for the Group.

Pillar 3*

The Group publishes its Pillar 3 disclosures on its website, providing a range of additional information relating to Basel II and risk and capital management across the Group. The disclosures focus on capital resources and adequacy and discuss a range of credit risk measures and management methods (such as credit risk mitigation, counterparty credit risk and provisions) and their associated RWAs under the various Basel II approaches. Detailed disclosures are also made on equity exposures, securitisations, operational risk, market risk and interest rate risk in the banking book.

*unaudited

Capital management continued

Capital resources*

Flow statement (Basel 2.5)

The table below analyses the movement in Core Tier 1, Other Tier 1 and Tier 2 capital during the year.

Core Tier 1 capital	£m
At 1 January 2012	46,341
Attributable loss net of movements in fair value of own credit	(2,647)
Ordinary shares issued	120
Share capital and reserve movements in respect of employee share schemes	821
Foreign exchange reserve movements	(867)
Decrease in non-controlling interests	(24)
Decrease in capital deductions including APS first loss	4,307
Decrease in goodwill and intangibles	1,313
Defined pension fund movement (net of prudential filter adjustment)	(977)
Other movements	(1,067)
At 31 December 2012	47,320
Other Tier 1 capital	
At 1 January 2012	10,649
Foreign currency reserve movements	(189)
Decrease in Tier 1 deductions	(252)
Other movements	(393)
At 31 December 2012	9,815
Tier 2 capital	
At 1 January 2012	8,546
Dated subordinated debt issued	4,167
Dated subordinated debt redeemed/matured	(3,582)
Foreign exchange movements	(643)
Decrease in capital deductions including APS first loss	4,649
Other movements	(985)
At 31 December 2012	12,152
Supervisory deductions	
At 1 January 2012	(4,828)
Decrease in deductions	2,341
At 31 December 2012	(2,487)
Total regulatory capital at 31 December 2012	66,800

*unaudited

Business review Risk and balance sheet management continued

Reconciliation between accounting and regulatory consolidation*
The table below provides a reconciliation between accounting and regulatory consolidation.

2012	Accounting balance sheet £m	Deconsolidation of insurance and other entities (1) £m	Consolidation of banking associates/ other entities (2) £m	Regulatory consolidation £m
Assets				
Cash and balances at central banks	79,290	—	544	79,834
Loans and advances to banks	63,951	(30)	48	63,969
Loans and advances to customers	500,135	1,438	2,883	504,456
Debt securities	157,438	(12)	743	158,169
Equity shares	15,232	(194)	—	15,038
Settlement balances	5,741	—	—	5,741
Derivatives	441,903	—	—	441,903
Intangible assets	13,545	—	—	13,545
Property, plant and equipment	9,784	(1,320)	32	8,496
Deferred tax	3,443	—	—	3,443
Prepayments, accrued income and other assets	7,820	(77)	(320)	7,423
Assets of disposal groups	14,013	(10,544)	—	3,469
	1,312,295	(10,739)	3,930	1,305,486
Liabilities				
Deposits by banks	101,405	—	92	101,497
Customer accounts	521,279	—	3,486	524,765
Debt securities in issue	94,592	—	—	94,592
Settlement balances	5,878	—	—	5,878
Short positions	27,591	—	—	27,591
Derivatives	434,333	—	—	434,333
Accruals, deferred income and other liabilities	14,801	(100)	253	14,954
Retirement benefit liabilities	3,884	—	—	3,884
Deferred tax	1,141	(5)	—	1,136
Subordinated liabilities	26,773	—	99	26,872
Liabilities of disposal groups	10,170	(9,267)	—	903
	1,241,847	(9,372)	3,930	1,236,405
Non-controlling interests	2,318	(1,367)	—	951
Owners' equity	68,130	—	—	68,130
Total equity	70,448	(1,367)	—	69,081
	1,312,295	(10,739)	3,930	1,305,486

Notes:
(1) The Group must only include particular types of subsidiary undertaking in the regulatory consolidation. Insurance undertakings and non-financial undertakings are excluded from the regulatory consolidation, although they are

included in the consolidation for financial reporting.

(2) The Group must proportionally consolidate its associated undertakings where they are classified as credit institutions or financial institutions for regulatory purposes. These will generally have been equity accounted for financial reporting purposes.

*unaudited

Capital management: Capital resources continued

Reconciliation between accounting equity and regulatory capital*

The table below provides a reconciliation of shareholders' equity per accounting balance sheet to the regulatory capital.

	2012 £m	2011 £m	2010 £m
Shareholders' equity (excluding non-controlling interests)			
Called-up share capital	6,582	15,318	15,125
Paid-in equity	431	431	431
Share premium	24,361	24,001	23,922
Retained earnings	10,596	18,929	21,239
AFS reserve - debt securities	(409)	(1,065)	(2,061)
AFS reserve - equity shares	63	108	25
Cash flow hedging reserve	1,666	879	(140)
Other reserves	24,840	16,218	16,591
	68,130	74,819	75,132
Less: innovative securities transferred to other Tier 1 capital	(431)	(431)	(431)
Less: preference shares transferred to other Tier 1 capital	(4,313)	(4,313)	(4,313)
Non-controlling interests	2,318	1,234	1,719
Less: innovative securities transferred to other Tier 1 capital	(548)	(548)	(548)
Less: minority interest deconsolidated	(1,367)	(259)	(259)
Regulatory adjustments and deductions			
Own credit	691	(2,634)	(1,182)
Defined benefit pension adjustment	913	—	—
Unrealised losses on AFS debt securities	409	1,065	2,061
Unrealised gains on AFS equity shares	(63)	(108)	(25)
Cash flow hedging reserve	(1,666)	(879)	140
Other adjustments for regulatory purposes	(197)	571	204
Goodwill and other intangible assets	(13,545)	(14,858)	(14,448)
50% of expected loss	(13,954)	(15,316)	(12,827)
Less: 50% of internal rating based impairment allowances	11,432	11,865	10,169
Less: tax on 50% of expected loss over impairment provisions	618	915	758
50% securitisation positions	(1,107)	(2,019)	(2,321)
50% of APS first loss	—	(2,763)	(4,225)
	(16,469)	(24,161)	(21,696)
Core Tier 1 capital	47,320	46,341	49,604
Other Tier 1 capital			
Preference shares - equity transferred from shareholders' equity	4,313	4,313	4,313
Preference shares - debt transferred from subordinated liabilities	1,054	1,094	1,097
Innovative securities transferred from shareholders' equity	431	431	431
Innovative securities transferred from non-controlling interests	548	548	548
Innovative/hybrid securities transferred from subordinated liabilities	3,146	3,688	3,683

	9,492	10,074	10,072
Tier 1 deductions			
50% material holdings	(295)	(340)	(310)
Tax on excess of expected losses over impairment provisions	618	915	758
	323	575	448
Total Tier 1 capital	57,135	56,990	60,124

*unaudited

	2012 £m	2011 £m	2010 £m
Qualifying Tier 2 capital			
Subordinated debt	26,773	26,319	27,053
Less: transferred to other Tier 1 capital	(4,200)	(4,782)	(4,780)
Less: amortisation	(5,049)	(4,275)	(2,915)
Less: other adjustments	(1,910)	(897)	(761)
	15,614	16,365	18,597
Unrealised gains on AFS equity shares	63	108	25
Collectively assessed impairment provisions	399	635	778
Non-controlling Tier 2 capital	—	11	11
	16,076	17,119	19,411
Tier 2 deductions			
50% of securitisation positions	(1,107)	(2,019)	(2,321)
50% excess of expected losses over impairment provisions	(2,522)	(3,451)	(2,658)
50% of material holdings	(295)	(340)	(310)
50% of APS first loss	—	(2,763)	(4,225)
	(3,924)	(8,573)	(9,514)
Total Tier 2 capital	12,152	8,546	9,897
Supervisory deductions			
Unconsolidated Investments			
- Direct Line Group	(2,081)	(4,354)	(3,962)
- Other investments	(162)	(239)	(318)
Other deductions	(244)	(235)	(452)
	(2,487)	(4,828)	(4,732)
Total regulatory capital	66,800	60,708	65,289

Key points

- Core Tier 1 capital increased by £1 billion during 2012. Excluding APS however, Core Tier 1 capital decreased by £1.8 billion.

- Attributable loss, net of fair value of own credit, of £2.6 billion was partially offset by lower Core Tier 1 deduction for securitisation positions of £1.1 billion, primarily relating to restructuring of monolines within Non-Core.

*unaudited

Business review Risk and balance sheet management continued

Capital management continued

Risk-weighted assets*

Divisional analysis

Risk-weighted assets by risk category and division were as follows:

	Credit risk		Market	Operational	Gross
	Non-counterparty	Counterparty	risk	risk	RWAs
2012	£bn	£bn	£bn	£bn	£bn
UK Retail	37.9	—	—	7.8	45.7
UK Corporate	77.7	—	—	8.6	86.3
Wealth	10.3	—	0.1	1.9	12.3
International Banking	46.7	—	—	5.2	51.9
Ulster Bank	33.6	0.6	0.2	1.7	36.1
US Retail & Commercial	50.8	0.8	—	4.9	56.5
Retail & Commercial	257.0	1.4	0.3	30.1	288.8
Markets	14.0	34.7	36.9	15.7	101.3
Other	4.0	0.4	—	1.4	5.8
Core	275.0	36.5	37.2	47.2	395.9
Non-Core	45.1	11.5	5.4	(1.6)	60.4
Group before RFS Holdings MI	320.1	48.0	42.6	45.6	456.3
RFS Holdings MI	3.1	—	—	0.2	3.3
Group	323.2	48.0	42.6	45.8	459.6
2011					
UK Retail	41.1	—	—	7.3	48.4
UK Corporate	71.2	—	—	8.1	79.3
Wealth	10.9	—	0.1	1.9	12.9
International Banking	38.9	—	—	4.3	43.2
Ulster Bank	33.6	0.6	0.3	1.8	36.3
US Retail & Commercial	53.6	1.0	—	4.7	59.3
Retail & Commercial	249.3	1.6	0.4	28.1	279.4
Markets	16.7	39.9	50.6	13.1	120.3
Other	9.8	0.2	—	2.0	12.0
Core	275.8	41.7	51.0	43.2	411.7
Non-Core	65.6	20.2	13.0	(5.5)	93.3
Group before RFS Holdings MI	341.4	61.9	64.0	37.7	505.0
RFS Holdings MI	2.9	—	—	0.2	3.1
Group	344.3	61.9	64.0	37.9	508.1
APS relief	(59.6)	(9.5)	—	—	(69.1)
Net RWAs	284.7	52.4	64.0	37.9	439.0
2010					
UK Retail	41.7	—	—	7.1	48.8
UK Corporate	76.4	—	—	7.8	84.2
Wealth	10.4	—	0.1	2.0	12.5
International Banking	44.0	—	—	7.7	51.7
Ulster Bank	29.2	0.5	0.1	1.8	31.6

US Retail & Commercial	52.1	0.9	—	4.4	57.4
Retail & Commercial	253.8	1.4	0.2	30.8	286.2
Markets	21.5	34.5	44.7	9.6	110.3
Other	16.4	0.4	0.2	1.0	18.0
Core	291.7	36.3	45.1	41.4	414.5
Non-Core	91.3	31.8	34.9	(4.3)	153.7
Group before RFS Holdings MI	383.0	68.1	80.0	37.1	568.2
RFS Holdings MI	2.9	—	—	—	2.9
Group	385.9	68.1	80.0	37.1	571.1
APS relief	(88.2)	(17.4)	—	—	(105.6)
Net RWAs	297.7	50.7	80.0	37.1	465.5

*unaudited

Flow statement

The table below analyses the movement in credit risk, market risk and operational risk RWAs by key drivers during the year.

	Credit risk		Market	Operational	Gross
	Non-counterparty	Counterparty	risk	risk	RWAs
	£bn	£bn	£bn	£bn	£bn
At 1 January 2012	344.3	61.9	64.0	37.9	508.1
Business and market movements (1)	(46.0)	(20.4)	(16.3)	7.9	(74.8)
Disposals	(7.3)	(3.8)	(6.5)	—	(17.6)
Model changes (2)	32.2	10.3	1.4	—	43.9
At 31 December 2012	323.2	48.0	42.6	45.8	459.6

Notes:

(1) Represents changes in book size, composition, position changes and market movements.

(2) Refers to implementation of a new model or modification of an existing model after approval from the FSA.

Key Points

- The £75 billion decrease due to business and market movements is driven by:
  - Market risk and counterparty risk decreased by £16 billion and £20 billion due to reshaping the business risk profile;
  - Run-off of balances in Non-Core;
  - Declines in Retail and Commercial due to loans migrating into default and customer deleveraging; and
  - Reduction in credit risk in the Group liquidity portfolio as European peripheral exposures were sold.

- The increase in operational risk follows the recalibration based on the average of the previous three years financial results. The substantial losses recorded in 2008 no longer feature in the calculation.

- Disposals of £18 billion relate to Non-Core disposals, including RBS Aviation Capital and exposures relating to credit derivative product companies, monolines and other counterparties.

- Model changes of £44 billion reflect:
  - Changes to credit metrics applying to corporate, bank and sovereign exposures as models were updated to reflect more recent experience, £30 billion; and
  - Application, of slotting approach to UK commercial real estate exposures, £12 billion.

Looking forward

Basel III*

The rules issued by the Basel Committee on Banking Supervision (BCBS), commonly referred to as Basel III, are a comprehensive set of reforms designed to strengthen the regulation, supervision, risk and liquidity management of the banking sector.

In December 2010, the BCBS issued the final text of the Basel III rules, providing details of the global standards agreed by the Group of Governors and Heads of Supervision, the oversight body of the BCBS and endorsed by the G20 leaders at their November 2010 Seoul summit.

The new capital requirements regulation and capital requirements directive that implement Basel III proposals within the European Union (EU) (collectively known as CRD IV) are in two parts, Capital Requirements Directive (CRD) and the Capital Requirements Regulation. Further technical detail will be provided by the European Banking Authority through its Implementing Technical Standards and Regulatory Technical Standards.

The CRD IV has not yet been finalised and consequently the Basel III implementation date of 1 January 2013 has been missed. While it is anticipated that agreement of the CRD IV will be achieved during 2013, the implementation date remains uncertain.

CRD IV and Basel III will impose a minimum common equity Tier 1 (CET1) ratio of 4.5% of RWAs. There are three buffers which will affect the Group: the capital conservation buffer(1); the counter-cyclical capital buffer(2) (up to 2.5% of RWAs), to be applied when macro-economic conditions indicate areas of the economy are over-heating; and the Global-Systemically Important Bank (G-SIB) buffer(3), leading to an additional common equity Tier 1 requirement of 4% and a total common equity Tier 1 ratio of 8.5%. The regulatory target capital requirements will be phased in and are expected to apply in full from 1 January 2019.

Notes:
(1) The capital conservation buffer is set at 2.5% of RWAs and is intended to be available in periods of stress. Drawing on the buffer would lead to a corresponding reduction in the ability to make discretionary payments such as dividends and variable compensation.
(2) The counter-cyclical buffer is institution specific and depends on the Group's geographical footprint and the macroeconomic conditions pertaining in the individual countries in which the Group operates. As there is a time lag involved in determining this ratio, it has been assumed that it will be zero for the time being.
(3) The G-SIB buffer is dependent on the regulatory assessment of the Group. The Group has been provisionally assessed as requiring additional CET1 of 1.5% in the list published by the Financial Stability Board (FSB) on 1 November 2012. The FSB list is updated annually. The actual requirement will be phased in from 2016, initially for those banks identified (in the list) as G-SIBs in November 2014.

*unaudited

Capital management: Looking forward continued
The changes in the definition of regulatory capital under CRD IV and the capital ratios will be subject to transitional rules:

- The increase in the minimum capital ratios and the new buffer requirements will be phased in over the five years from implementation of the CRD IV;

- The application of the regulatory deductions and adjustments at the level of common equity, including the new deduction for deferred tax assets, will also be phased in over the five years from implementation; the current adjustment for unrealised gains and losses on available-for-sale securities will be phased out; and

- Subordinated debt instruments which do not meet the new eligibility criteria will be will be grandfathered on a reducing basis over ten years.

The Group is well advanced in its preparations to comply with the new requirements based on the draft rules. Given the phasing of both capital requirements and target levels, in advance of needing to comply with the fully loaded end state requirements, the Group will have the opportunity to continue to generate additional capital from earnings and take management actions to mitigate the impact of CRD IV.

The Group's pro forma Core Tier 1 ratio on a fully loaded basis at 31 December 2012, based on its interpretation of the rules and assuming they were applied today, is estimated at 7.7%(1). The pro forma capital ratio reflects the Group's interpretation of the draft July 2011 CRD IV rules and how these rules are expected to be updated for subsequent EU and Basel pronouncements.

The actual impact of CRD IV on capital ratios may be materially different as the requirements and related technical standards have not yet been finalised and will ultimately be subject to application by local regulators. The actual impact will also be dependent on required regulatory approvals and the extent to which further management action is taken prior to implementation.

Models changes
The Group, in conjunction with the FSA, regularly evaluates its models for the assessment of RWAs ascribed to credit risk (including counterparty risk) across various classes. This includes implementing changes to the RWA requirements for commercial real estate portfolios consistent with revised industry guidance from the FSA. The changes to RWA resulting from model changes during 2012 have increased RWA requirements by £44 billion of which £12 billion relates to property guidance. Further uplifts are expected in 2013 totalling c.£10 billion to £15 billion.

Other regulatory capital changes*
The Group is managing the changes to capital requirements from new regulation and model changes and the resulting impact on the common equity Tier 1 ratio, focusing on risk reduction and deleveraging. This is principally being achieved through the continued run-off and disposal of Non-Core assets and deleveraging in Markets, as the business focuses on the most productive returns on capital. Markets RWAs decreased by £19 billion in 2012 which also lessens the increases driven by the counterparty risk changes in CRD IV.

European Banking Authority (EBA) recommendation
The EBA issued a recommendation in 2011 that the national regulators should ensure that credit institutions build up a temporary capital buffer to reach a 9% Core Tier 1 ratio by 30 June 2012 ('the recapitalisation of EU banks'). In its

final report on the recapitalisation exercise in October 2012, the EBA stated that once the CRD IV is finally adopted, the 2011 recommendation would be replaced with a new recommendation. The new recommendation will include the requirement for banks to maintain a nominal amount of Core Tier 1 capital as defined by the EBA for the 2011 stress test and recapitalisation recommendation) corresponding to the amount of 9% of the RWAs at 30 June 2012. The Group does not expect the potential floor to become a limiting factor.

Note:
(1) Based on the following principal assumptions: (i) divestment of Direct Line Group (ii) deductions for financial holdings of less than 10% of common equity Tier 1 capital have been excluded pending the finalisation of CRD IV rules (iii) RWA uplifts assume approval of all regulatory models and completion of planned management actions (iv) RWA uplifts include the impact of credit valuation adjustments (CVA) and asset valuation correlation on banks and central clearing counterparties (v) EU corporates, pension funds and sovereigns are assumed to be exempt from CVA volatility charge in calculating RWA impacts.

*unaudited

Liquidity, funding and related risks

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Liquidity, funding and related risks

Introduction

Liquidity risk is the risk that the Group is unable to meet its financial obligations, including financing wholesale maturities or customer deposit withdrawals, as and when they fall due. Liquidity risk is highly dependent on company specific characteristics such as the maturity profile and composition of the Group's assets and liabilities, the quality and marketable value of its liquidity buffer and broader market factors, such as wholesale market conditions alongside depositor and investor behaviour.

Safety and soundness of the balance sheet is one of the central pillars of the Group's restructuring strategy. Effective management of liquidity risk is central to the safety and soundness agenda. The Group's experiences in 2008 have heavily influenced both the Group's and other stakeholders' approach to this area.

2012 achievements and looking forward*

The Group continued to make solid progress in pursuit of its safety and soundness agenda throughout 2012, with the majority of its medium-term balance sheet targets now met or exceeded. This is despite particularly volatile wholesale market conditions during most of the year due to ongoing stresses emanating from the eurozone.

The Group has actively reduced short-term wholesale funding and has a lower wholesale funding need compared to earlier years. Progress has largely been due to the continued success in executing the Group's restructuring efforts, as well as by attracting deposits and continuing to deleverage via the run down of Non-Core and risk reductions in Markets. The Group has a smaller balance sheet that is funded by a diverse and stable deposit base.

The Group is expected to have a lower wholesale funding requirement going forward. The Group will continue to look at accessing the market opportunistically from time to time to further support the Group's overall funding strategy.

Highlights of 2012 include:

- The Group's credit profile improved markedly during the year reflecting the success of its restructuring efforts. Credit default swaps spreads fell by 60% from their 2011 peak and secondary bond spreads on five year maturity have narrowed from c.450 basis points to c.100 basis points.

- The Group repaid all the remaining emergency UK Government funding and liquidity support that was provided to it during 2008-2009 under the Credit Guarantee Scheme and Special Liquidity Scheme.

- Τηε Γρουπ ρεσυμεδ χουπον παψμεντσ ον ηψβριδ χαπιταλ σεχυριτιεσ φολλοωινγ τηε ενδ οφ τηε τωο ψεαρ χουπον παψμεντ βαν ιμποσεδ βψ τηε Ευροπεαν Χομμισσιον ασ παρτ οφ ιτσ 2009 Στατε Αιδ ρυλινγ. Χουπονσ ρεμαιν συσπενδεδ ον Τιερ 1 ινστρυμεντσ ισσυεδ βψ ΡΒΣ Ηολδινγσ Ν.ς. υντιλ τηε ενδ οφ Απριλ 2013.

- The Group and RBS plc issued a combined £1.0 billion in term debt net of buy-backs, a fraction of the £20.9 billion issued in 2011. Short-term wholesale funding was actively managed down to £41.6 billion from £102.4 billion.

- The overall size of the liquidity buffer reduced modestly to £147.2 billion from £155.3 billion reflecting the lower levels of short-term wholesale funding and a smaller balance sheet. This also allowed the Group to alter the ratio of primary to secondary liquid assets within the liquidity buffer to 62%:38% from 77%:23%. This re-weighting, by reducing the holdings of the lowest yielding liquid assets, benefited the Group's net interest margin, whilst maintaining a higher quality buffer.

- Retail & Commercial deposits grew by £8 billion to £401 billion, with particularly strong growth in UK Retail following successful savings campaigns. Wholesale deposits were allowed to run-off, declining by £11 billion to leave Group deposits £3 billion lower at £434 billion.

- The Group’s loan:deposit ratio improved from 108% in 2011 to reach management’s medium-term target of 100% at 31 December 2012, with lending fully funded by customer deposits and a corresponding reduction in more volatile short-term wholesale funding.

- The Group has taken advantage of market conditions through the course of the year to further supplement its capital base.

- RBS Group plc, RBS plc, RBS Citizens Financial Group Inc. and Direct Line Insurance Group plc in aggregate issued £4.8 billion of subordinated liabilities in 2012.

- The Group successfully undertook two public liability management exercises targeting Lower Tier 2 and senior unsecured debt in support of ongoing balance sheet restructuring initiatives.

Liquidity risk

The Group has in place a comprehensive set of policies to manage liquidity risk that reflects internal risk appetite, best market practice and complies with prevailing regulatory strictures. These policies have been comprehensively updated since 2008 reflecting:

- the Group's experiences in 2008 and 2009;
- the Group's restructuring plan and revised risk appetite and framework;
- regulatory developments and enhancements;
- ongoing instability in global financial markets; and
- more conservative expectations from the Group's various stakeholders.

These policies are designed to address three broad issues which ensure that:

- the Group's main legal entities maintain adequate liquidity resources at all times to meet liabilities as and when they fall due;
- the Group maintains an adequate liquidity buffer appropriate to the business activities of the Group and its risk profile; and
- the Group has in place robust strategies, policies, systems and procedures for identifying, measuring, monitoring and managing liquidity risk.

At its simplest, these policies and the governance and actions they mandate, determine the sources of liquidity risk and the steps the Group can take when these risks exceed certain tolerances which are actively monitored. These include not only when and how to use the Group's liquidity buffer but also what other adjustments to the Group's balance sheet could be undertaken to manage these risks within Group appetite.

These policies are reviewed at least annually or sooner if the Group's own liquidity position changes or if market conditions and/or regulatory rules warrant further amendment or refinement.

During 2012, the Group's liquidity risk management was tested by two different events, the lowering of the Group's credit rating and the technology incident. These two events highlight the variety of circumstances and events through which liquidity risk can materialise.

In the case of the credit rating downgrade by Moody's, the Group was given adequate notice to plan for such an outcome and challenge Moody's analytical approach. Potential or actual changes in the Group's or any of its subsidiaries ratings prompt an intensive internal review of the likelihood and magnitude of such an outcome on customer and counterparty behaviours. These include stress testing and scenario modelling. This analysis was reviewed internally and shared with the FSA. As a precautionary measure the Group increased the size of its liquidity buffer in the period leading up the conclusion of the rating review. Such actions proved unnecessary once Moody's concluded their rating review as there was very limited impact on customer or counterparty behaviour.

Conversely, the technology event could not be foreseen and whilst similar steps to understand the full impact needed to be taken, the process was performed under a vastly compacted timeframe. Both events have demonstrated the considerable progress the Group has made in addressing the sources of liquidity risk and mitigating any impacts, real or reputational.

Policy, framework and governance
Governance
The Group has in place a robust and comprehensive set of policies and procedures for assessing, measuring and controlling the liquidity risk within the Group. This ensures that the Group always maintain sufficient eligible and appropriate financial resources to meet its forward looking financial commitments as they fall due.

The Group's appetite for liquidity risk is set by the Board and then managed by various functions within the business. For example, measurement of the Group's liquidity risk is managed on a daily basis within Group Finance, policy compliance and development is managed within the Group Risk framework.

In setting risk limits the Board takes into account the nature of the Group's various activities, the Groups overall risk appetite, market best practice and regulatory compliance.

Analogous provisions and requirements exist for each member of the Group, who must comply with both internal standards and local regulatory frameworks for the different jurisdictions in which they operate.

The Group's principal regulator, the FSA, has a comprehensive set of liquidity policies the cornerstone of which is Policy Statement (PS) 09/16. In order to comply with the FSA regulatory process, the Group:

- Must complete and keep updated an Individual Liquidity Adequacy Assessment (ILAA);

- Submit itself to the Supervisory Liquidity Review Process which is a review of the ILAA and the Group's liquidity policies and operational capacity and capability; and

- This in turn leads to the Group and the FSA agreeing the parameters of Group's Individual Liquidity Guidance (ILG). Which influences the overall size of the Group's liquidity buffer.

Liquidity risk: Policy, framework and governance continued
The ILAA is the cornerstone of the Group's assessment process and informs the Group Board and the FSA of the assessment and quantification of the Group's liquidity risks and their mitigation and how much current and future liquidity is required to manage those risks.

The Group has identified ten specific liquidity risk factors which range from the risk associated with both behavioural and contractual customer deposit outflows, through to firm-specific reputational factors that could impact the Group's liquidity position from time to time.

In addition, the Group follows the broader market developments in respect of the ongoing evolution of industry and regulatory liquidity risk policies that are currently being debated at an international level and adjusts its policies and processes where appropriate.

Finally, external stakeholders such as market counterparties, debt and equity investors and credit rating agencies actively review and challenge the Group's approach, their views being reflected through their ongoing support of the Group.

The Group actively monitors ongoing regulatory developments in the international arena. Whilst most individual country regulators have implemented or refined specific country liquidity regulations, much work continues at an international level to agree common standards.

The majority of this work is conducted under the auspices of the Basel Committee on Bank Supervision and includes discussion on important measures such as the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR). The Group will always look to proactively adopt such measures into its reporting capabilities provided that there is an alignment and agreement between domestic and international regulators on these issues and specific country regulatory rules are updated to reflect these agreements.

In January 2013, the Basel Committee on Banking Supervision issued its revised draft guidance for calculating the LCR, which is currently expected to come into force from 1 January 2015 on a phased basis. Pending the finalisation of the definitions, the Group monitors the LCR and the NSFR in its internal reporting framework based on its interpretation and expectation of the final rules. On this basis, as of 31 December 2012, the Groups LCR was over 100% and the NSFR 117%.

At present there is a broad range of interpretations on how to calculate the NSFR and, especially, the LCR due to the lack of a commonly agreed market standard. There are also inconsistencies between the current regulatory approach of the FSA and that being proposed in the LCR with respect to the treatment of unencumbered assets that could be pledged to central banks via a discount window facility. This makes meaningful comparisons of the LCR between institutions difficult. The Group will continue to work with regulators and industry groups to measure and report the impact of the rules as they are finalised. Assumptions will be refined as regulatory interpretations evolve.

Liquidity measurement and monitoring
Liquidity risk is measured and assessed on a daily basis at Group level. The Group uses a set of internal and regulatory metrics and analysis to assess liquidity risk.

The Group uses limits to manage and control the overall extent of liquidity risk within the balance sheet. Limits focus on the aggregate risk, the amount and composition of particular sources of liabilities, asset liability mismatches and

third party counterparty concentrations. Reported balance sheet metrics such as loan:deposit ratio targets or the percentage of short-term wholesale funding are examples of these limits.

The Group also uses appropriate transfer pricing of liquidity costs to foster appropriate pricing behaviour and decision making. The Group’s internal transfer pricing policy helps to manage the balance sheet mix and composition of contingent and actual liabilities and to ensure that liquidity risk is reflected in product pricing and divisional business performance measurement. This also ensures that divisions are being correctly incentivised to source the most appropriate mix of funding.

Stress and scenario testing is used to help inform a broader understanding of liquidity risk as well as to model specific liquidity risks events, for example the secession of a country from the euro.

The Group actively monitors a range of market and firm-specific early warning indicators of emerging liquidity stresses. Some of these indicators will be actual performance of the business against pre-agreed limits, for example customer deposit outflows. Others will be based around general or specific market movements such as movements in the Group’s credit default swap spreads.

Liquidity risks are reviewed at legal entity daily, and performance reported to Divisional and Group Asset and Liability Committees. Any breach or material deterioration of these metrics will set in motion a series of actions and escalations that could lead to activation of the contingency funding plan. Any breach of these metrics that subsequently means that the Group can no longer comply with its ILG will necessitate notification to the FSA and the eventual submission of a liquidity remediation plan.

The Group’s liquidity risk framework is subject to internal oversight, challenge and governance both at Board level and via internal control functions such as Internal Audit. The Group is also subject to regulatory review and challenge from the FSA through its supervisory programme.

Stress testing*

The strength of any bank's liquidity risk management can only be evaluated on the Group's ability to survive under stress.

Simulated liquidity stress testing is regularly performed for each business as well as the major operating subsidiaries. Stress tests are designed to look at the impact of a variety of firm-specific and market-related scenarios on the future adequacy of the Group's liquidity resources. Stress tests can be run at any time in response to the emergence of one of these risks.

Scenarios include assumptions about significant changes in key funding sources, external credit ratings, contingent uses of funding, and political and economic conditions or events in particular countries. For example, during 2012 the Group undertook a specific series of stress tests to assess the likely worst case impact associated with a one notch downgrade to the Group's credit rating by Moody's. Stress scenarios are applied to both on-balance sheet instruments and off-balance sheet activities, to provide a comprehensive view of potential cash flows.

In determining the adequacy of the Group's liquidity resources the Group focuses on the stressed outflows it could be anticipated to experience as a result of any stress scenario occurring. These outflows are measured as occurring over certain time periods which extend from any given day out to two weeks, to as long as three months. The Group is expected to be able to withstand these stressed outflows through its own resources (principally the use of the liquidity buffer) over these time horizons without having to revert to extraordinary central bank or governmental assistance.

The Group's actual experiences from the 2008 and 2009 period have factored heavily into the liquidity analysis in the past, although more recent market conditions and events provide more up-to-date data for scenario modelling. Stress tests are augmented from time to time to reflect firm-specific or emerging market risks that could have a material impact on the Group's liquidity position.

The Group's liquidity risk appetite is measured by reference to the liquidity buffer as a percentage of stressed contractual and behavioural outflows under the worst of three severe stress scenarios as envisaged under the FSA regime. Liquidity risk is expressed as a surplus of liquid assets over three months' stressed outflows under the worst of a market-wide stress, an idiosyncratic stress and a combination of both. At 31 December 2012, the Group's holding of liquid assets was 128% of the worst case stress requirements.

The results of stress testing are an active part of management and strategy in balance sheet management and inform allocation, target and limit discussions. In short, limits in the business-as-usual environment are bounded by capacity to satisfy the Group's liquidity needs in the stress environments.

Key liquidity risk stress testing assumptions

- Net wholesale funding - Outflows at contractual maturity of wholesale funding and conduit commercial paper, with no rollover/new issuance. Prime Brokerage, 100% loss of excess client derivative margin and 100% loss of excess client cash.

- Secured financing and increased haircuts - Loss of secured funding capacity at contractual maturity date and incremental haircut widening, depending upon collateral type.

- Retail and commercial bank deposits - Substantial outflows as the Group could be seen as a greater credit risk than competitors.

- Intra-day cashflows - Liquid collateral held against intra-day requirement at clearing and payment systems is regarded as encumbered with no liquidity value assumed. Liquid collateral is held against withdrawal of unsecured intra-day lines provided by third parties.

- Intra-group commitments and support - Risk of cash within subsidiaries becoming unavailable to the wider Group and contingent calls for funding on Group Treasury from subsidiaries and affiliates.

- Funding concentrations - Additional outflows recognised against concentration of providers of wholesale secured financing.

- Off-balance sheet activities - Collateral outflows due to market movements, and all collateral owed by the Group to counterparties but not yet called; anticipated increase in firm's derivative initial margin requirement in stress scenarios; collateral outflows contingent upon a multi-notch credit rating downgrade of Group firms; drawdown on committed facilities provided to corporates, based on counterparty type, creditworthiness and facility type; and drawdown on retail commitments.

- Franchise viability - Group liquidity stress testing includes additional liquidity in order to meet outflows that are non-contractual in nature, but are necessary in order to support valuable franchise businesses.

- Management action - Unencumbered marketable assets that are held outside of the Core liquidity buffer and are of verifiable liquidity value to the firm, are assumed to be monetised (subject to haircut/valuation adjustment).

Liquidity risk continued

Contingency planning

The Group has a Contingency Funding Plan (CFP), which is updated as the balance sheet evolves and forms the basis of analysis and actions to remediate adverse circumstances as and if they arise. The CFP is linked to stress test results and forms the foundation for liquidity risk limits. The CFP provides a detailed description of the availability, size and timing of all sources of contingent liquidity available to the Group in a stress event. These are ranked in order of economic impact and effectiveness to meet the anticipated stress requirement. The CFP includes documented processes for actions that may be required to meet the outflows. Roles and responsibilities for the effective implementation of the CFP are also documented.

Liquidity reserves

Liquidity risks are mitigated by the Group’s centrally managed liquidity buffer. The size of the reserve is an output from internal modelling and the FSA’s ILG. The majority of the portfolio is held in the FSA regulated UK Defined Liquidity Group (UK DLG) comprising the Group’s five UK banks: The Royal Bank of Scotland plc, National Westminster Bank Plc, Ulster Bank Limited, Coutts & Co and Adam & Company.

Certain of the Group's significant operating subsidiaries - RBS N.V., RBS Citizens Financial Group Inc. (CFG) and Ulster Bank Ireland Limited - hold locally managed portfolios of liquid assets that comply with local regulations but may differ with FSA rules. These portfolios are the responsibility of the local Treasurer who reports to the Group Treasurer.

The Group‘s liquidity buffer is managed by Group Treasury and is the responsibility of the Group Treasurer. The liquidity buffer is ring-fenced from the trading book within the Markets division. The liquidity buffer is actively managed so as to balance its liquidity value relative to the margin impact of maintaining a large and high quality investment portfolio. This is in line with internal liquidity risk policy and appetite and regulatory guidance. The portfolio is accounted for on an available-for-sale basis. The value of the portfolio can move up and down based on a variety of market movements. Gains can and will be taken through sales of portfolios. Such sales and gains are part of normal portfolio management and these gains can be used to offset costs in other parts of the Group.

The Group analyses its liquidity buffer including its locally managed liquidity pools into primary and secondary liquidity groups.

The primary liquidity group generally reflects eligible liquid assets, such as cash and balances at central banks, treasury bills and other high quality government and agency bonds, and other local primary qualifying liquid assets for each of the significant operating subsidiaries that maintain a local liquidity pool.

Secondary liquidity assets represent other qualifying liquid assets that are eligible for local central bank liquidity facilities but do not meet the core local regulatory definition. For example, secondary liquid assets include self-issued securitisations or covered bonds that are retained on balance sheet and pre-positioned with a central bank so that they can be converted into additional sources of liquidity at very short notice.

The Group in consultation with the FSA and subject to the requirements of the FSA’s ILG can change the composition of its liquidity buffer. The change in composition may relate to market specific factors, changes in internal liquidity risk mix or regulatory guidance. This occurred in 2012 when the FSA agreed to recognise an increase in the amount of secondary liquidity assets and a reduction in primary assets. Such a change was made possible in conjunction with the introduction of the Funding for Lending Scheme. The reduction in the balance of primary assets was also beneficial to the Group’s margin.

Regulatory oversight
The Group operates in multiple jurisdictions and is subject to a number of regulatory regimes.

The Group's lead regulator is the UK Financial Services Authority (FSA). The FSA implemented a new liquidity regime as documented in PS 09/16, on 1 June 2010. The new rules provide a standardised approach applied to all UK banks and all building societies as well as branches and subsidiaries of foreign financial firms. The rules focus on the UK DLG and cover adequacy of liquidity resources, controls, stress testing and the Individual Liquidity Adequacy Assessment.

In addition, in the US, the Group's operations must meet liquidity requirements set out by the US Federal Reserve Bank, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Financial Industry Regulatory Authority. In the Netherlands, RBS N.V. is subject to the De Nederlandsche Bank liquidity oversight regime.

Funding risk
As noted earlier, the Group actively participates in the broader international debate and process regarding further reform and refinement of liquidity risk oversight and policies, and will seek to adopt commonly agreed upon measures where there is consistent alignment between domestic and international regulators.

Funding sources
The Group has access to a variety of wholesale funding sources across the globe, including short-term money markets and term debt investors through its secured and unsecured funding programmes. These sources of funding are complementary to the Group's customer deposit gathering activities.

Diversity in funding is provided by its active role in the money markets, along with access to global capital flows through the Group's international client base. These funding programmes allow the Group (or its subsidiaries) to issue secured or unsecured, senior or subordinated securities. Over time the Group's wholesale funding franchise has been diversified by currency, geography, maturity and type.

The Group accesses the market directly or through one of its main operating subsidiaries through established funding programmes. The use of different entities to access the market from time to time allows the Group to further diversify its funding profile, take advantage of different benefits offered by using these entities, and in certain limited circumstances demonstrate to regulators that specific operating subsidiaries enjoy market access in their own right. This flexibility will become increasingly important in the future as the Group moves towards complying with the Independent Commission on Banking recommendations.

Central bank funding*
The Group may access various funding facilities offered by central banks from time to time. The use of such facilities can be both part of a wider strategic objective to support initiatives to help stimulate economic growth or as part of the Group's broader liquidity management and funding strategy. Overall usage and repayment of available central bank facilities will fit within the Group's overall liquidity risk appetite and concentration limits contained therein so as not to create outsized maturity exposures.

During 2012, the Group drew down €10 billion of funding under the European Central Bank's Long Term Refinancing Operation and £750 million of treasury bills under the Bank of England's Funding for Lending Scheme.

Balance sheet composition
The Group's balance sheet composition is a function of the broad array of product offerings and diverse markets served by its Core divisions. The structural composition of the balance sheet is augmented as needed through active management of both asset and liability portfolios. The objective of these activities is to optimise the liquidity profile in normal business environments, while ensuring adequate coverage of all cash requirements under extreme stress conditions.

Diversification of the Group's funding base is central to its balance sheet management strategy. The Group's businesses have developed large customer franchises based on strong relationship management and high quality service. These customer franchises are strongest in the UK, the US and Ireland, but extend into Europe and Asia. Customer deposits provide large pools of stable funding to support the majority of the Group's lending.

The Group also accesses wholesale markets by way of public and private debt issuances on an unsecured and secured basis. These debt issuance programmes are spread across multiple currencies and maturities, to appeal to a broad range of investor types and preferences around the world. This market-based funding supplements the Group's structural liquidity needs and, in some cases, achieves certain capital objectives.

Liquidity and funding risk: Analyses

Funding sources

The table below shows the Group's principal funding sources excluding repurchase agreements.

	2012 £m	2011 £m	2010 £m
Deposits by banks			
derivative cash collateral	28,585	31,807	28,074
other deposits	28,489	37,307	38,243
	57,074	69,114	66,317
Debt securities in issue			
conduit asset-backed commercial paper (ABCP)	—	11,164	17,320
other commercial paper (CP)	2,873	5,310	8,915
certificates of deposit (CDs)	2,996	16,367	37,855
medium-term notes (MTNs)	66,603	105,709	131,026
covered bonds	10,139	9,107	4,100
securitisations	11,981	14,964	19,156
	94,592	162,621	218,372
Subordinated liabilities	27,302	26,319	27,053
Notes issued	121,894	188,940	245,425
Wholesale funding	178,968	258,054	311,742
Customer deposits			
cash collateral	7,949	9,242	10,433
other deposits	426,043	427,511	420,433
Total customer deposits	433,992	436,753	430,866
Total funding	612,960	694,807	742,608

The table below shows the Group's wholesale funding by source.

	Short-term wholesale funding (1)		Total wholesale funding		Net inter-bank funding (2)		
	Excluding derivative collateral £bn	Including derivative collateral £bn	Excluding derivative collateral £bn	Including derivative collateral £bn	Deposits £bn	Loans (3) £bn	Net inter-bank funding £bn
2012	41.6	70.2	150.4	179.0	28.5	(18.6)	9.9
2011	102.4	134.2	226.2	258.1	37.3	(24.3)	13.0
2010	129.7	157.8	283.7	311.7	38.2	(31.3)	6.9

Notes:

(1) Short-term wholesale balances denote those with a residual maturity of less than one year and include longer-term issuances.

(2) Excludes derivative collateral.

(3) Primarily short-term balances.

Notes issued

The table below shows the Group’s debt securities in issue and subordinated liabilities by residual maturity.

	Debt securities in issue								
	Conduit ABCP	Other CP and CDs	MTNs	Covered bonds	Securitisations	Total	Subordinated liabilities	Total notes issued	Total notes issued
2012	£m	£m	£m	£m	£m	£m	£m	£m	%
Less than 1 year	—	5,478	13,019	1,038	761	20,296	2,351	22,647	18
1-3 years	—	385	20,267	2,948	540	24,140	7,252	31,392	26
3-5 years	—	1	13,374	2,380	—	15,755	756	16,511	14
More than 5 years	—	5	19,943	3,773	10,680	34,401	16,943	51,344	42
	—	5,869	66,603	10,139	11,981	94,592	27,302	121,894	100
2011									
Less than 1 year	11,164	21,396	36,302	—	27	68,889	624	69,513	37
1-3 years	—	278	26,595	2,760	479	30,112	3,338	33,450	18
3-5 years	—	2	16,627	3,673	—	20,302	7,232	27,534	14
More than 5 years	—	1	26,185	2,674	14,458	43,318	15,125	58,443	31
	11,164	21,677	105,709	9,107	14,964	162,621	26,319	188,940	100

Business review Risk and balance sheet management continued

	Debt securities in issue								
	Conduit ABCP	Other CP and CDs	MTNs	Covered bonds	Securitisations	Total	Subordinated liabilities	Total notes issued	Total notes issued
2010	£m	£m	£m	£m	£m	£m	£m	£m	%
Less than 1 year	17,320	46,051	30,589	—	88	94,048	964	95,012	39
1-3 years	—	702	47,357	1,078	12	49,149	754	49,903	20
1-5 years	—	12	21,466	1,294	34	22,806	8,476	31,282	13
More than 5 years	—	5	31,614	1,728	19,022	52,369	16,859	69,228	28
	17,320	46,770	131,026	4,100	19,156	218,372	27,053	245,425	100

Deposit and repo funding

The table below shows the composition of the Group's deposits excluding repos and repo funding.

	2012		2011		2010	
	Deposits	Repos	Deposits	Repos	Deposits	Repos
	£m	£m	£m	£m	£m	£m
Financial institutions						
- central and other banks	57,074	44,332	69,114	39,691	66,317	32,739
- other financial institutions	64,237	86,968	66,009	86,032	65,532	75,782
Personal and corporate deposits	369,755	1,072	370,744	2,780	365,334	6,312
	491,066	132,372	505,867	128,503	497,183	114,833

£173 billion or 40% of the customer deposits included above are insured through the UK Financial Services Compensation Scheme, US Federal Deposit Insurance Corporation Scheme and other similar schemes. Of the personal and corporate deposits above, 42% related to personal customers and 58% to corporate customers.

Divisional loan:deposit ratios and funding gaps

The table below shows divisional loans, deposits, customer loan:deposit ratios and customer funding gaps.

	Loans (1)	Deposits (2)	Loan:deposit ratio (3)	Funding surplus /(gap) (3)
2012	£m	£m	%	£m
UK Retail	110,970	107,633	103	(3,337)
UK Corporate	104,593	127,070	82	22,477
Wealth	16,965	38,910	44	21,945
International Banking (4)	39,500	46,172	86	6,672
Ulster Bank	28,742	22,059	130	(6,683)
US Retail & Commercial	50,726	59,164	86	8,438
Conduits (4)	2,458	—	—	(2,458)
Retail & Commercial	353,954	401,008	88	47,054
Markets	29,589	26,346	112	(3,243)
Other	3,264	3,340	98	76
Core	386,807	430,694	90	43,887

Non-Core	45,144	3,298	nm	(41,846)
Group	431,951	433,992	100	2,041
2011				
UK Retail	107,983	101,878	106	(6,105)
UK Corporate	108,668	126,309	86	17,641
Wealth	16,834	38,164	44	21,330
International Banking (4)	46,417	45,051	103	(1,366)
Ulster Bank	31,303	21,814	143	(9,489)
US Retail & Commercial	50,842	59,984	85	9,142
Conduits (4)	10,504	—	—	(10,504)
Retail & Commercial	372,551	393,200	95	20,649
Markets	31,254	36,776	85	5,522
Other	1,196	2,496	48	1,300
Core	405,001	432,472	94	27,471
Non-Core	68,516	4,281	nm	(64,235)
Group	473,517	436,753	108	(36,764)

For the notes to this table refer to the following page.

Business review Risk and balance sheet management continued

Liquidity and funding risk: Analyses: Funding sources continued

2010	Loans (1) £m	Deposits (2) £m	Loan:deposit ratio (3) %	Funding surplus /(gap) (3) £m
UK Retail	105,663	96,113	110	(9,550)
UK Corporate	112,037	124,529	90	12,492
Wealth	16,065	36,449	44	20,384
International Banking (4)	49,186	44,271	111	(4,915)
Ulster Bank	35,225	23,117	152	(12,108)
US Retail & Commercial	47,824	59,307	81	11,483
Conduits (4)	13,178	—	—	(13,178)
Retail & Commercial	379,178	383,786	99	4,608
Markets	25,061	38,170	66	13,109
Other	872	658	133	(214)
Core	405,111	422,614	96	17,503
Non-Core	102,650	8,252	nm	(94,398)
Group	507,761	430,866	118	(76,895)

nm = not meaningful

Notes:
(1) Excludes reverse repurchase agreements and stock borrowing and net of impairment provisions.
(2) Excludes repurchase agreements and stock lending.
(3) Based on loans and advances to customers net of provisions and customer deposits as shown.
(4) All conduits relate to International Banking and have been extracted and shown separately as they were funded by commercial paper issuance until the end of the third quarter of 2012.

Long-term debt issuance
The table below shows debt securities issued by the Group during the year with an original maturity of one year or more. The Group also executes other long-term funding arrangements (predominantly term repurchase agreements) which are not reflected in the following table.

	2012 £m	2011 £m	2010 £m
Public			
- unsecured	1,237	5,085	12,887
- secured	2,127	9,807	8,041
Private			
- unsecured	4,997	12,414	17,450
- secured	—	500	—
Gross issuance	8,361	27,806	38,378
Buy-backs (1)	(7,355)	(6,892)	(6,298)
Net issuance	1,006	20,914	32,080

Note:
(1) Excludes liability management exercises.

Business review Risk and balance sheet management continued

Liquidity

Liquidity portfolio

The table below analyses the Group's liquidity portfolio by product and between the UK Defined Liquidity Group (UK DLG), RBS Citizens Financial Group Inc. (CFG) and other subsidiaries, by liquidity value. Liquidity value is lower than carrying value principally as it is stated after the discounts applied by the Bank of England and other central banks to loans, within secondary liquidity portfolio, eligible for discounting.

	Liquidity value				
	Period end				
	UK DLG (1)	CFG	Other	Total	Average*
2012	£m	£m	£m	£m	£m
Cash and balances at central banks	64,822	891	4,396	70,109	81,768
Central and local government bonds					
AAA rated governments and US agencies	3,984	5,354	547	9,885	18,832
AA- to AA+ rated governments (2)	9,189	—	432	9,621	9,300
governments rated below AA	—	—	206	206	596
local government	—	—	979	979	2,244
	13,173	5,354	2,164	20,691	30,972
Treasury bills	750	—	—	750	202
Primary liquidity	78,745	6,245	6,560	91,550	112,942
Other assets (3)					
AAA rated	3,396	7,373	203	10,972	17,304
below AAA rated and other high quality assets	44,090	—	557	44,647	24,674
Secondary liquidity	47,486	7,373	760	55,619	41,978
Total liquidity portfolio	126,231	13,618	7,320	147,169	154,920
Carrying value	157,574	20,524	9,844	187,942	
2011					
Cash and balances at central banks	55,100	1,406	13,426	69,932	74,711
Central and local government bonds					
AAA rated governments and US agencies	22,563	7,044	25	29,632	37,947
AA- to AA+ rated governments (2)	14,102	—	—	14,102	3,074
governments rated below AA	—	—	955	955	925
local government	—	—	4,302	4,302	4,779
	36,665	7,044	5,282	48,991	46,725
Treasury bills	—	—	—	—	5,937
Primary liquidity	91,765	8,450	18,708	118,923	127,373
Other assets (3)					
AAA rated	17,216	4,718	3,268	25,202	21,973
below AAA rated and other high quality assets	6,105	—	5,100	11,205	12,102
Secondary liquidity	23,321	4,718	8,368	36,407	34,075
Total liquidity portfolio	115,086	13,168	27,076	155,330	161,448
Carrying value	135,754	25,624	32,117	193,495	

For the notes to this table refer to the following page.

Business review Risk and balance sheet management continued

Liquidity and funding risk: Analyses: Liquidity continued

	Liquidity value Period end			
2010	UK DLG (1) £m	CFG £m	Other £m	Total £m
Cash and balances at central banks	43,804	2,314	7,543	53,661
Central and local government bonds				
AAA rated governments and US agencies	32,337	4,830	4,268	41,435
AA- to AA+ rated governments (2)	2,404	—	1,340	3,744
governments rated below AA	—	—	1,029	1,029
local government	—	—	5,672	5,672
	34,741	4,830	12,309	51,880
Treasury bills	14,529	—	—	14,529
Primary liquidity	93,074	7,144	19,852	120,070
Other assets (3)				
AAA rated	7,787	—	10,049	17,836
below AAA rated and other high quality assets	8,313	4,601	3,779	16,693
Secondary liquidity	16,100	4,601	13,828	34,529
Total liquidity portfolio	109,174	11,745	33,680	154,599
Carrying value	120,178	18,055	40,857	179,090

Notes:

(1) The FSA regulated UK Defined Liquidity Group (UK DLG) comprises the Group’s five UK banks: The Royal Bank of Scotland plc, National Westminster Bank Plc, Ulster Bank Limited, Coutts & Co and Adam & Company. In addition, certain of the Group's significant operating subsidiaries - RBS N.V., RBS Citizens Financial Group Inc. (CFG) and Ulster Bank Ireland Limited (UBIL) - hold locally managed portfolios of liquid assets that comply with local regulations that may differ from FSA rules.

(2) Includes US government guaranteed and US government sponsored agencies.

(3) Includes assets eligible for discounting at the Bank of England and other central banks.

Business review Risk and balance sheet management continued

Net stable funding ratio*

The table below shows the composition of the Group's net stable funding ratio (NSFR), estimated by applying the Basel III guidance issued in December 2010. The Group's NSFR will also continue to be refined over time in line with regulatory developments and related interpretations. It may also be calculated on a basis that may differ from other financial institutions.

	2012		2011		2010		
		ASF(1)		ASF(1)		ASF(1)	Weighting
	£bn	£bn	£bn	£bn	£bn	£bn	%
Equity	70	70	76	76	77	77	100
Wholesale funding > 1 year	109	109	124	124	154	154	100
Wholesale funding < 1 year	70	—	134	—	157	—	—
Derivatives	434	—	524	—	424	—	—
Repurchase agreements	132	—	129	—	115	—	—
Deposits							
- retail and SME - more stable	203	183	227	204	172	155	90
- retail and SME - less stable	66	53	31	25	51	41	80
- other	164	82	179	89	206	103	50
Other (2)	64	—	83	—	98	—	—
Total liabilities and equity	1,312	497	1,507	518	1,454	530	
Cash	79	—	79	—	57	—	—
Inter-bank lending	29	—	44	—	58	—	—
Debt securities > 1 year							
- governments AAA to AA-	64	3	77	4	89	4	5
- other eligible bonds	48	10	73	15	75	15	20
- other bonds	19	19	14	14	10	10	100
Debt securities < 1 year	26	—	45	—	43	—	—
Derivatives	442	—	530	—	427	—	—
Reverse repurchase agreements	105	—	101	—	95	—	—
Customer loans and advances > 1 year							
- residential mortgages	145	94	145	94	145	94	65
- other	136	136	173	173	211	211	100
Customer loans and advances < 1 year							
- retail loans	18	15	19	16	22	19	85
- other	131	66	137	69	125	63	50
Other (3)	70	70	70	70	97	97	100
Total assets	1,312	413	1,507	455	1,454	513	
Undrawn commitments	216	11	240	12	267	13	5
Total assets and undrawn commitments	1,528	424	1,747	467	1,721	526	
Net stable funding ratio		117%		111%		101%	

Notes:

(1) Available stable funding.

(2) Deferred tax, insurance liabilities and other liabilities.

(3) Prepayments, accrued income, deferred tax, settlement balances and other assets.

Key point

- NSFR improved from 111% at 31 December 2011 to 117% at the end of 2012. Long-term wholesale funding declined by £15 billion in line with Markets' strategy, and funding requirement relating to long-term lending decreased by £37 billion, reflecting de-risking, sales and repayments in Non-Core.

Business review Risk and balance sheet management continued

Liquidity and funding risk: Analyses continued

Maturity analysis

The contractual maturity of balance sheet assets and liabilities highlights the maturity transformation which underpins the role of banks to lend long-term, but to fund themselves predominantly through short-term liabilities such as customer deposits. This is achieved through the diversified funding franchise of the Group across an extensive customer base, and across a wide geographic network. In practice, the behavioural profiles of many liabilities exhibit greater stability and longer maturity than the contractual maturity. This is particularly true of many types of retail and corporate deposits which whilst may be repayable on demand or at short notice, have demonstrated very stable characteristics even in periods of acute stress such as those experienced in 2008.

Retail & Commercial*

The table below illustrates the contractual and behavioural maturity analysis of Retail & Commercial customer deposits.

	Less than 1 year £bn	1-5 years £bn	More than 5 years £bn	Total £bn
Contractual maturity	381	20	1	402
Behavioural maturity	146	219	37	402

Contractual maturity

The following table shows the residual maturity of financial instruments, based on contractual date of maturity. Held-for-trading (HFT) assets and liabilities have been excluded from the maturity analysis in view of their short-term nature and are shown in total in the table below. Hedging derivatives are included within the relevant maturity bands.

	Other than held-for-trading (HFT)									
2012	Less than 1 month £m	1-3 months £m	3-6 months £m	6 months -1 year £m	1-3 years £m	3-5 years £m	More than 5 years £m	Total excluding HFT £m	HFT £m	Total £m
Cash and balances at central banks	79,308	—	—	—	—	—	—	79,308	—	79,308
Bank reverse repos	1,302	87	—	—	—	—	—	1,389	33,394	34,783
Customer reverse repos	22	—	—	—	—	—	—	22	70,025	70,047
Loans to banks (1)	14,519	1,879	1,005	206	269	35	102	18,015	13,265	31,280
Loans to customers (1)	40,883	18,324	19,269	27,377	58,503	52,930	189,824	407,110	24,841	431,951
Debt securities	2,206	1,869	1,279	1,676	11,847	17,929	49,478	86,284	78,340	164,624
Equity shares	—	—	—	—	—	—	1,908	1,908	13,329	15,237
Settlement balances	5,741	—	—	—	—	—	—	5,741	—	5,741
Derivatives	—	571	626	1,252	3,803	1,879	508	8,639	433,279	441,918
Other assets	72	28	32	106	31	38	617	924	—	924
Total financial assets	144,053	22,758	22,211	30,617	74,453	72,811	242,437	609,340	666,473	1,275,813
Bank repos	3,551	3,261	—	—	1,150	—	—	7,962	36,370	44,332
Customer repos	2,733	3,083	—	—	—	—	—	5,816	82,224	88,040

Deposits by banks	15,046	1,409	564	489	7,127	336	1,532	26,503	30,571	57,074
Customer accounts	359,157	14,773	8,933	15,662	18,932	3,660	798	421,915	12,077	433,992
Debt securities in issue	2,248	2,639	7,996	6,263	21,220	12,038	31,309	83,713	10,879	94,592
Settlement balances	5,875	—	—	—	3	—	—	5,878	—	5,878
Short positions	—	—	—	—	—	—	—	—	27,591	27,591
Derivatives	—	310	251	501	1,790	1,262	1,682	5,796	428,544	434,340
Subordinated liabilities	231	184	1,352	620	7,070	862	16,983	27,302	—	27,302
Other liabilities	1,684	—	—	—	8	1	3	1,696	—	1,696
Total financial liabilities	390,525	25,659	19,096	23,535	57,300	18,159	52,307	586,581	628,256	1,214,837

Note:

(1) Excludes reverse repos.

Encumbrance

The Group reviews all assets against the criteria of being able to finance them in a secured form (encumbrance) but certain asset types lend themselves more readily to encumbrance. The typical characteristics that support encumbrance are an ability to pledge those assets to another counterparty or entity through operation of law without necessarily requiring prior notification, homogeneity, predictable and measurable cash flows, and a consistent and uniform underwriting and collection process. Retail assets including residential mortgages, credit card receivables and personal loans display many of these features.

From time to time the Group encumbers assets to serve as collateral to support certain wholesale funding initiatives. The three principal forms of encumbrance are own asset securitisations, covered bonds and securities repurchase agreements. The Group categorises its assets into three broad groups; assets that are:

- already encumbered and used to support funding currently in place via own asset securitisations, covered bonds and securities repurchase agreements.

- not currently encumbered but can for instance be used to access funding from market counterparties or central bank facilities as part of the Group's contingency funding.

- not currently encumbered. In this category, the Group has in place an enablement programme which seeks to identify assets which are capable of being encumbered and to identify the actions to facilitate such encumbrance whilst not impacting customer relationships or servicing.

The Group's encumbrance ratios are set out below.

	2012	2011
Encumbrance ratios	%	%
Total	18	19
Excluding balances relating to derivative transactions	22	26
Excluding balances relating to derivative and securities financing transactions	13	19

Own-asset securitisations

The Group has a programme of own-asset securitisations where assets are transferred to bankruptcy remote special purpose entities (SPEs) funded by the issue of debt securities. The majority of the risks and rewards of the portfolio are retained by the Group and these SPEs are consolidated and all of the transferred assets retained on the Group's balance sheet. In some own-asset securitisations, the Group may purchase all the issued securities which are available to be pledged as collateral for repurchase agreements with major central banks. The following table shows the asset categories together with the carrying amounts of the assets and associated liabilities, for both own-asset securitisations where the debt securities issued are held by third parties and those where the debt securities issued are held by the Group.

Covered bond programme

Certain loans and advances to customers have been assigned to bankruptcy remote limited liability partnerships to provide security for issues of covered bonds by the Group. The Group retains all of the risks and rewards associated with these loans, the partnerships are consolidated, the loans retained on the Group's balance sheet and the related covered bonds in issue included within debt securities in issue. The following table shows the asset categories and the

carrying amounts of those assets and of the covered bonds issued.

Securities repurchase agreements and lending transactions

The Group enters into securities repurchase agreements and securities lending transactions (repos) under which it transfers securities in accordance with normal market practice. Generally, the agreements require additional collateral to be provided if the value of the securities falls below a predetermined level. Under standard terms for repurchase transactions in the UK and US markets, the recipient of collateral has an unrestricted right to sell or repledge it, subject to returning equivalent securities on settlement of the transaction. Securities sold under repurchase transactions are not derecognised if the Group retains substantially all the risks and rewards of ownership. The fair value (which is equivalent to the carrying value) of securities transferred under such repurchase transactions included within debt securities on the balance sheet are set out below. All of these securities could be sold or repledged by the holder.

Business review Risk and balance sheet management continued

Liquidity and funding risk: Analyses: Encumbrance continued
Assets encumbrance

	Encumbered assets relating to:									
	Debt securities in issue		Other secured liabilities							
	Securitisations and conduits £bn	Covered bonds £bn	Derivatives £bn	Repos £bn	Secured borrowings £bn	Total encumbered assets £bn	Encumbered assets as a % of related total assets	Liquidity portfolio £bn	Other £bn	Total £bn
Cash and balances at central banks	5.3	0.5	—	—	—	5.8	7	70.2	3.3	79.3
Loans and advances to banks (1)	—	—	12.8	—	—	12.8	41	—	18.5	31.3
Loans and advances to customers (1)										
- UK residential mortgages	16.4	16.0	—	—	—	32.4	30	58.7	18.0	109.1
- Irish residential mortgages	10.6	—	—	—	1.8	12.4	81	—	2.9	15.3
- US residential mortgages	—	—	—	—	—	—	—	7.6	14.1	21.7
- UK credit cards	3.0	—	—	—	—	3.0	44	—	3.8	6.8
- UK personal loans	4.7	—	—	—	—	4.7	41	—	6.8	11.5
- other	20.7	—	22.5	—	0.8	44.0	16	6.5	217.1	267.6
Debt securities	1.0	—	8.3	91.2	15.2	115.7	70	22.3	26.6	164.6
Equity shares	—	—	0.7	6.8	—	7.5	49	—	7.7	15.2
	61.7	16.5	44.3	98.0	17.8	238.3		165.3	318.8	722.4
Own asset securitisations								22.6		
Total liquidity portfolio								187.9		
Liabilities secured										
Intra-Group - used for secondary liquidity	(22.6)	—	—	—	—	(22.6)				
	(23.9)	—	—	—	—	(23.9)				

Intra-Group - other						
Third-party (2)	(12.0)	(10.1)	(60.4)	(132.4)	(15.3)	(230.2)
	(58.5)	(10.1)	(60.4)	(132.4)	(15.3)	(276.7)
Total assets						1,312
Total assets excluding derivatives						870
Total assets excluding derivatives and reverse repos						766

Notes:

(1) Excludes reverse repos.

(2) In accordance with market practice the Group employs its own assets and securities received under reverse repo transactions as collateral for repos.

Key points

- The Group's encumbrance ratio dropped marginally from 19% to 18%.

- 30% of the Group's residential mortgage portfolio was encumbered at 31 December 2012.

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Non-traded interest rate risk

Introduction and methodology

Non-traded interest rate risk impacts earnings arising from the Group's banking activities. This excludes positions in financial instruments which are classified as held-for-trading, or hedging items.

The Group provides a range of financial products to meet a variety of customer requirements. These products differ with regard to repricing frequency, tenor, indexation, prepayments, optionality and other features. When aggregated, they form portfolios of assets and liabilities with varying degrees of sensitivity to changes in market rates.

Mismatches in these sensitivities give rise to net interest income (NII) volatility as interest rates rise and fall. For example, a bank with a floating rate loan portfolio and largely fixed rate deposits will see its net interest income rise, as interest rates rise and fall as rates decline. Due to the long-term nature of many banking book portfolios, varied interest rate repricing characteristics and maturities, it is likely the NII will vary from period to period, even if interest rates remain the same. New business volumes originated in any period, will alter the interest rate sensitivity of a bank if the resulting portfolio differs from portfolios originated in prior periods.

The Group policy is to manage interest rate sensitivity in banking book portfolios within defined risk limits. With the exception of CFG and Markets, interest rate risk is transferred from the divisions to Group Treasury. Aggregate positions are then hedged externally using cash and derivative instruments, primarily interest rate swaps, to manage exposures within Group Asset and Liability Management Committee (GALCO) approved limits.

The Group assesses interest rate risk in the banking book (IRRBB) using a set of standards to define, measure and report the risk. These standards incorporate the expected divergence between contractual terms and the actual behaviour of fixed rate loan portfolios due to refinancing incentives and the risks associated with structural hedges of interest rate insensitive balances, which relates to the stability of the underlying portfolio.

Key measures used to evaluate IRRBB are subject to approval by divisional Asset and Liability Management Committees (ALCOs) and GALCO. Limits on IRRBB are proposed by the Group Treasurer for approval by the Executive Risk Forum annually. Residual risk positions are reported on a regular basis to divisional ALCOs and monthly to the Group Balance Sheet Management Committee, GALCO, the Executive Risk Forum and the Group Board.

The Group uses a variety of approaches to quantify its interest rate risk encompassing both earnings and value metrics. IRRBB is measured using a version of the same value-at-risk (VaR) methodology that is used for the Group's trading portfolios. Net interest income exposures are measured in terms of earnings sensitivity over time against movements in interest rates.

Analyses

Value-at-risk

VaR metrics are based on interest rate repricing gap reports as at the reporting date. These incorporate customer products and associated funding and hedging transactions as well as non-financial assets and liabilities such as property, plant and equipment, capital and reserves. Behavioural assumptions are applied as appropriate.

The VaR does not provide a dynamic measurement of interest rate risk since static underlying repricing gap positions are assumed. Changes in customer behaviour under varying interest rate scenarios are captured by way of earnings risk measures. IRRBB VaR for the Group's Retail and Commercial banking activities at 99% confidence level and

currency analysis of period end VaR were as follows:

	Average	Period end	Maximum	Minimum
	£m	£m	£m	£m
2012	46	21	65	20
2011	63	51	80	44
2010	58	96	96	30

	2012	2011	2010
	£m	£m	£m
Euro	19	26	33
Sterling	17	57	79
US dollar	15	61	121
Other	4	5	10

Key points

- Interest rate exposure at 31 December 2012 was considerably lower than at 31 December 2011 and average exposure was 27% lower in 2012 than in 2011.

- The reduction in VaR seen across all currencies reflects closer matching of the Group’s structural interest rate hedges to the behavioural maturity profile of the hedged liabilities as well as changes to the VaR methodology (refer to page 203 for more details on VaR methodology improvement).

- It is estimated that the change in methodology reduced VaR by £13.8 million (33%) on implementation.

Liquidity and funding risk: Analyses: Non-traded interest rate risk continued

Sensitivity of net interest income*

Earnings sensitivity to rate movements is derived from a central forecast over a twelve month period. Market implied forward rates and new business volume, mix and pricing consistent with business assumptions are used to generate a base case earnings forecast.

The following table shows the sensitivity of net interest income, over the next twelve months, to an immediate upward or downward change of 100 basis points to all interest rates. In addition, the table includes the impact of a gradual 400 basis point steepening and a gradual 300 basis point flattening of the yield curve at tenors greater than a year.

	Euro	Sterling	US dollar	Other	Total
2012	£m	£m	£m	£m	£m
+ 100 basis points shift in yield curves	(29)	472	119	27	589
− 100 basis points shift in yield curves	(20)	(257)	(29)	(11)	(317)
Bear steepener					216
Bull flattener					(77)
2011					
+ 100 basis points shift in yield curves	(19)	190	59	14	244
− 100 basis points shift in yield curves	25	(188)	(4)	(16)	(183)
Bear steepener					443
Bull flattener					(146)
2010					
+ 100 basis points shift in yield curves	25	186	11	10	232
− 100 basis points shift in yield curves	(33)	(212)	(99)	(8)	(352)
Bear steepener					(30)
Bull flattener					(22)

Key points

- The Group's interest rate exposure remains asset sensitive, in that rising rates have a positive impact on net interest margins. The scale of this benefit has increased since 2011.

- The primary contributors to the increased sensitivity to a 100 basis points parallel shift in the yield curve are changes to underlying business pricing assumptions and assumptions in respect of the risk of early repayment of consumer loans and deposits. The latter incorporates revisions to pricing strategies and consumer behaviour.

- The impact of the steepening and flattening scenarios is largely driven by the reinvestment of structural hedges. The year on year change reflected a change to a longer term hedging programme implemented in 2010.

- The reported sensitivities will vary over time due to a number of factors such as market conditions and strategic changes to the balance sheet mix and should not therefore be considered predictive of future performance.

Business review Risk and balance sheet management continued

Currency risk

Structural foreign currency exposures

The Group does not maintain material non-traded open currency positions other than the structural foreign currency translation exposures arising from its investments in foreign subsidiaries and associated undertakings and their related currency funding.

The table below shows the Group's structural foreign currency exposures.

2012	Net assets of overseas operations £m	RFS MI £m	Net investments in foreign operations £m	Net investment hedges £m	Structural foreign currency exposures pre-economic hedges £m	Economic hedges (1) £m	Residual structural foreign currency exposures £m
US dollar	17,313	1	17,312	(2,476)	14,836	(3,897)	10,939
Euro	8,903	2	8,901	(636)	8,265	(2,179)	6,086
Other non-sterling	4,754	260	4,494	(3,597)	897	—	897
	30,970	263	30,707	(6,709)	23,998	(6,076)	17,922
2011							
US dollar	17,570	1	17,569	(2,049)	15,520	(4,071)	11,449
Euro	8,428	(3)	8,431	(621)	7,810	(2,236)	5,574
Other non-sterling	5,224	272	4,952	(4,100)	852	—	852
	31,222	270	30,952	(6,770)	24,182	(6,307)	17,875
2010							
US dollar	17,137	2	17,135	(1,820)	15,315	(4,058)	11,257
Euro	8,443	33	8,410	(578)	7,832	(2,305)	5,527
Other non-sterling	5,320	244	5,076	(4,135)	941	—	941
	30,900	279	30,621	(6,533)	24,088	(6,363)	17,725

Note:

(1) The economic hedges represent US dollar and euro preference shares in issue that are treated as equity under IFRS and do not qualify as hedges for accounting purposes.

Key points

- The Group's structural foreign currency exposure at 31 December 2012 was £24.0 billion and £17.9 billion before and after economic hedges respectively, broadly unchanged from the end of 2011.

- Changes in foreign currency exchange rates affect equity in proportion to structural foreign currency exposure. A 5% strengthening in foreign currency against sterling would result in a gain of £1.3 billion (2011 and 2010 - £1.3 billion) in equity, while a 5% weakening would result in a loss of £1.1 billion (2011 and 2010 - £1.2 billion) in equity.

- In 2012, the Group recorded a loss through other comprehensive income of £0.9 billion due to the strengthening of sterling against the US dollar and euro.

Liquidity and funding risk: Analyses continued

Non-traded equity risk

Non-traded equity risk is the potential variation in the Group's non-trading income and reserves arising from changes in equity valuations.

Objective

Equity positions in the non-traded book are held to support strategic objectives and venture capital transactions, or in respect of customer restructuring arrangements.

Risk control framework

The commercial decision to take or hold equity positions in the non-trading book, including customer restructurings, is taken by authorised persons with delegated authority under the Group credit approval framework. Investments or disposals of a strategic nature are referred to the Group Acquisitions and Disposals Committee (ADCo), Group Executive Committee (ExCo), and where appropriate the Board for approval. Those involving the purchase or sale by the Group of subsidiary companies require Board approval, after consideration by ExCo and/or ADCo.

The risk arising from these holdings is mitigated by proper controls and identification of risk prior to investing.

Valuation

At Group level, positions are monitored by and reported quarterly to GALCO.

Equity positions are measured at fair value. Fair value calculations are based on available market prices where possible. In the event that market prices are not available, fair value is based on appropriate valuation techniques or management estimates.

The following table shows the balance sheet value and fair value of the Group's non-traded book equity positions.

	Balance sheet value 2012 £m	Fair value 2012 £m	Balance sheet value 2011 £m	Fair value 2011 £m
Exchange-traded equity	472	472	576	576
Private equity	632	632	674	674
Other	799	799	1,094	1,094
	1,903	1,903	2,344	2,344

The exposures may take the form of listed and unlisted equity shares, linked equity fund investments, private equity and venture capital investments, preference shares classified as equity or Federal Home Loan Bank stock. The following table shows the net realised and unrealised gains from these positions:

	2012 £m	2011 £m
Net realised gains arising from disposals	89	150
Unrealised gains included in Tier 1, 2 or 3 capital	168	235

Note:
(1) Includes gains or losses on available-for-sale instruments only.

Cumulative gains on equity shares designated at fair value through profit or loss but not held for trading purposes were £84 million at 31 December 2012 (2011 - £230 million).

Refer to additional analysis of equity shares in Balance sheet analysis on page 177.

Business review Risk and balance sheet management continued

Credit risk

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Credit risk

Introduction

Credit risk is the risk of financial loss due to the failure of a customer or counterparty to meet its obligation to settle outstanding amounts. The credit risk that the Group faces arises mainly from wholesale and retail lending, provision of contingent obligations (such as letters of credit and guarantees) and counterparty credit risk arising from derivative contracts and securities financing transactions entered into with customers. Other material risks covered by the Group's credit risk management framework are:

- Concentration risk - the risk of an outsized loss due to the concentration of credit risk to a specific asset class or product, industry sector, customer or counterparty, or country.
- Settlement risk - the intra-day risk that arises when the Group releases funds prior to confirmed receipt of value from a third party.
- Issuer risk - the risk of loss on a tradable instrument (e.g. a bond) due to default by the issuer.
- Wrong way risk - the risk of loss that arises when the risk factors driving the exposure to a counterparty are positively correlated with the probability of default for that counterparty.
- Credit mitigation risk - the risk that credit risk mitigation (for example, taking a legal charge over property to secure a customer loan) is not enforceable or that the value of such mitigation decreases, thus leading to unanticipated losses.

Top and emerging credit risks*

The quantum and nature of credit risk assumed across the Group's different businesses vary considerably, while the overall credit risk outcome usually exhibits a high degree of correlation with the macroeconomic environment. The Group therefore remains sensitive to the economic conditions within the geographies in which it operates, in particular the UK, Ireland, the US and the eurozone.

The following credit risks continue to be the focus of management attention.

Irish property market

The continuing challenging economic climate within Ireland has resulted in impairment levels for Irish portfolios remaining at elevated levels. In particular, high unemployment, austerity measures and general economic uncertainty have reduced real estate lease rentals. This, together with limited liquidity, has depressed asset values and reduced consumer spending with a consequent downward impact on the commercial real estate portfolio as well as broader impacts on Ulster Bank Group's mortgage and small and medium enterprise (SME) lending portfolios. Further details on Ulster Bank Group's credit risk profile can be found on pages 149 to 152.

Commercial real estate

While progress has been made in reducing the overall exposure and rebalancing the portfolio, commercial real estate remains a key credit concentration risk for the Group. The Group has continued to strengthen its approach to managing sector concentration risk, with a particular focus on additional controls for the commercial real estate portfolio.

However, the credit performance remains sensitive to the economic environment in the UK and Ireland. Although some improvements have been seen in commercial real estate values across prime locations, secondary and tertiary values remain subdued.

Refinancing risk remains a focus of management attention and is assessed throughout the credit risk management life cycle. In particular, it is considered as part of the early problem recognition and impairment assessment processes.

Further details on the Group’s exposure to commercial real estate can be found on pages 140 to 144.

Eurozone troubles

The ongoing impact of the troubles in the eurozone continued to be felt most significantly in the banking sector, where widening credit spreads and regulatory demand for increases in Tier 1 capital and liquidity exacerbated the risk management challenges already posed by the sector’s continued weakness, as provisions and write-downs remain elevated.

A material percentage of global banking activity in risk mitigation now passes through the balance sheets of the top global players, increasing the systemic risks to the banking sector. The Group’s exposures to these banks continue to be closely managed. In particular, the Group has intensified its management of settlement risk through ongoing review of the level of risk and the operational controls in place to manage it, together with proactive actions to reduce limits. The weaker banks in the eurozone also remained subject to heightened scrutiny and the Group’s risk appetite for these banks was adjusted throughout 2012.

The Group has continued to focus on operational preparations for possible sovereign defaults and/or eurozone exits. The Group has also considered initiatives to determine and reduce redenomination risk. Further actions to mitigate risks and strengthen control in the eurozone typically included taking guarantees or insurance, updating collateral agreements, and tightening certain credit pre-approval processes.

The Group has a material exposure to Spanish AFS debt securities issued by banks and other financial institutions of £4.8 billion at 31 December, predominately comprised of covered bonds backed by mortgages. Whilst the exposure was reduced by £1.6 billion during 2012, largely as a result of sales, the portfolio continues to be subject to heightened scrutiny, including undertaking stress analysis.

Further details on the Group’s approach to managing country risk and the risks faced within the eurozone can be found on pages 211 to 239.

* unaudited

Shipping

The downturn observed in the shipping sector since 2008 has continued, with an oversupply of vessels leading to lower asset prices and charter rates. The Group has continued to manage exposures within this portfolio intensively, with an increasing number of customers managed under the Group's Watchlist process (see page 131 for a description of this process). The financed fleet comprises modern vessels with experienced operators and despite the difficult market conditions impairments to date have remained low. However, impairment levels remain vulnerable to a continuing underperforming market.

Further details on the Group's shipping portfolio can be found on page 125.

Retailers

Given the cyclical nature of the retail corporate sector and its sensitivity to stressed economic conditions, the Group has continued to apply heightened scrutiny to this portfolio. Despite some high-profile failures of UK high street retailers, loss experience on the RBS retail portfolio remained low during 2012 as a result of active management. The portfolio is generally well diversified by geography and by counterparty.

Central counterparties (CCPs)

New regulation requiring greater use of CCPs for clearing over-the-counter derivatives across the industry is aimed at reducing systemic risk in the banking sector. RBS welcomes this move but recognises that the Group's concentration risk to CCPs will rise; thus exchanging concentration risk to individual counterparties for concentration risk to CCPs. CCPs are vulnerable to a significant member default, fraud and increased operational risk if their infrastructure and collateral management approaches are not developed commensurate with increased activity they undertake.

In response to this industry change, the Group has developed a tailored risk appetite and risk control framework. The Group's central counterparty exposure is dominated by a small number of well-established, high quality and reputable clearing houses.

Renegotiations and forbearance

Loan modifications take place in a variety of circumstances including but not limited to a customer's current or potential credit deterioration. Where the contractual payment terms of a loan have been changed because of the customer's financial difficulties, it is classified as 'renegotiated' in the wholesale portfolio and as 'forbearance' in the retail portfolio.

RBS uses renegotiations and forbearance as management tools to support viable customers through difficult financial periods in their lives or during business cycles. Used wisely, they can reduce the incidence of personal insolvency, as well as bankruptcies for otherwise successful enterprises. On a broader scale they can also help reduce the impact of "fire sale" pricing on real economic assets. However, they must be used selectively and require additional management vigilance throughout the loan life cycle. The Group has continued to take steps to improve its management and reporting of such loans within both corporate and retail businesses. More details of the Group's approach can be found on pages 131 to 137.

Objectives, organisation and governance

The existence of a strong credit risk management function is vital to support the ongoing profitability of the Group. The potential for loss through economic cycles is mitigated through the embedding of a robust credit risk culture within the business units and through a focus on the importance of sustainable lending practices. The role of the RBS credit risk management function is to own the credit approval, concentration and credit risk control frameworks and to act as the ultimate authority for the approval of credit. This, together with strong independent oversight and challenge, enables the business to maintain a sound lending environment within approved risk appetite.

Responsibility for development of, and compliance with, Group-wide policies and credit risk frameworks and Group-wide assessment of provision adequacy resides with the Group Credit Risk (GCR) function under the management of the Group Chief Credit Officer. Execution of these policies and frameworks is the responsibility of the risk management functions, located within the Group's business divisions.

The divisional credit risk management functions work together with GCR to ensure that the risk appetite set by the Group Board is met, within a clearly defined and managed control environment. The credit risk function within each division is managed by a Chief Credit Officer, who reports jointly to a divisional Chief Risk Officer and to the Group Chief Credit Officer. Divisional activities within credit risk include credit approval, transaction and portfolio analysis, ongoing credit risk stewardship, and early problem recognition and management.

Material aspects of the Group's credit risk management framework, such as credit risk appetite and limits for portfolios of strategic significance, are considered and approved by the Executive Risk Forum (ERF). The ERF has delegated approval authority to the Group Credit Risk Committee, a functional sub-committee of the Group Risk Committee, to act on credit risk matters. These include, but are not limited to, credit risk appetite and limits (within the overall risk appetite set by the Board and the ERF), credit risk strategy and frameworks, credit risk policy and the oversight of the credit profile across the Group.

The Group Credit Risk Committee is chaired by the Group Chief Credit Officer and has representation from each of the Group's divisional credit risk functions. Monthly updates are provided to the Group Risk Committee on key matters approved under delegated authority by the Group Credit Risk Committee, performance against limits, and emerging issues, to enable it to fulfil its role as an oversight committee.

Oversight of the Group's provision adequacy is provided by the Group Audit Committee.

Key trends in the credit risk profile of the Group, performance against limits and emerging risks are set out in the RBS Risk Management Monthly Report provided to the Group Board, the Executive Committee and the Board Risk Committee.

Credit risk management framework

The Group has established an appropriate and comprehensive framework for the management of credit risk that includes governance structures, risk appetite and concentration frameworks, policies, measurement and reporting tools and independent assurance.

In order to strengthen this framework and ensure consistent application across the Group, during 2012 the GCR function launched a set of credit control standards, to supplement the existing policy suite. These standards address divisional governance and policy requirements and reflect a set of behavioural, organisational and management norms that drive a sound divisional control environment and embed a strong risk culture.

Risk appetite and concentration risk management

Risk appetite has been expressed by the Group Board through the setting of specific quantitative risk appetite targets under stress (refer to page 80). Of particular relevance in the management of credit risk are the targets for earnings volatility and capital adequacy. The Group's credit risk framework has therefore been designed around the factors that influence the Group's ability to meet these targets. These include the limiting of excess credit risk concentrations by product/asset class, industry sector, customer or counterparty (i.e. single name) and country any of which could generate higher volatility under stress and, if not adequately controlled, can undermine capital adequacy.

The frameworks are supported by a suite of Group-wide and divisional policies that set out the risk parameters within which business units must operate.

The management of concentration risk and associated limits are firmly embedded in the risk management processes of the Group and form a pivotal part of the Risk function's engagement with the businesses on the appropriateness of risk appetite choices. The ERF, or delegated committee, has reviewed all material industry and product portfolios and agreed a risk appetite commensurate with the franchises represented in these reviews. In particular, limits have been reviewed and re-sized, to refine the Group's risk appetite in areas where it faces significant balance sheet concentrations or franchise challenges. The need to control concentrations must at all times be balanced against the need to ensure sufficient capacity within credit limits to support customers of sound credit quality, in particular within retail and small business customer segments.

During 2012, the credit risk function expanded the scope of its credit risk appetite controls through the active management of non-financial risks in the Group's lending decisions. The development of Environmental, Social and Ethical (ESE) risk policies for sectors considered to present a higher reputational risk (such as the defence, oil and gas sectors) provide a framework within which the Group can better manage its reputational risks. This ESE framework forms part of a wider initiative by the Group to improve reputational risk management and build trust with its stakeholders (for more information on reputational risk management, refer to page 250).

Product/asset class

- Retail - A formal framework establishes Group-level statements and thresholds that are cascaded through all retail franchises in the Group and to granular business lines. These include measures that relate both to aggregate portfolios and to asset quality at origination, which are tracked frequently to ensure consistency with Group standards and appetite. This appetite setting and tracking then informs the processes and parameters employed in origination activities, which require a large volume of small-scale credit decisions, particularly those involving an application for a new product or a change in facilities on an existing product. The majority of these decisions are based upon

automated strategies utilising credit and behaviour scoring techniques. Scores and strategies are typically segmented by product, brand and other significant drivers of credit risk. These scores and strategies are data driven and utilise a wide range of credit information relating to the customer including, where appropriate, information on the customer's credit performance across their existing account holdings both with the bank and with other lenders. A small number of credit decisions are subject to additional manual underwriting by authorised approvers in specialist units. These include higher-value, more complex, small business and personal unsecured transactions and some residential mortgage applications.

- Wholesale - Formal policies, specialised tools and expertise, tailored monitoring and reporting and, in certain cases, specific limits and thresholds are deployed to address certain lines of business across the Group, where the nature of credit risk incurred could represent a concentration or a specific/heightened risk in some other form. Those portfolios identified as potentially representing a concentration or heightened risk are subject to formal governance, including periodic review, at either Group or divisional level, depending on materiality.

Sector concentration

Across wholesale portfolios, exposures are assigned to, and reviewed in the context of, a defined set of industry sectors. Through this sector framework, risk appetite and portfolio strategies are agreed and set at aggregate and more granular levels, where exposures have the potential to represent excessive concentration or where trends in both external factors and internal portfolio performance give cause for concern. Formal periodic reviews are undertaken at Group or divisional level depending on materiality. These may include an assessment of the Group's franchise in a particular sector, an analysis of the outlook (including downside outcomes), identification of key vulnerabilities and stress/scenario tests.

The focus during 2012 was on embedding sector and sub-sector specific appetite within divisional policies and processes and on setting appropriate controls. This includes strengthening portfolio controls on key metrics and lending parameters, and the ongoing development of sector-specific lending policies.

As a result of the reviews carried out in 2012, the Group has reduced its risk appetite in the most material corporate sectors of commercial real estate and retail. For further details on sector-specific strategies, exposure reduction and key credit risks, refer to pages 140 to 152.

Single-name concentration*

Within wholesale portfolios, much of the activity undertaken by the credit risk function is organised around the assessment, approval and management of the credit risk associated with a borrower or group of related borrowers.

A formal single name concentration framework addresses the risk of outsized exposure to a borrower or borrower group. The framework includes specific and sometimes elevated approval requirements, additional reporting and monitoring, and the requirement to develop plans to address and reduce excess exposures over an appropriate timeframe.

Credit approval authority is discharged by way of a framework of individual delegated authorities, which requires at least two individuals to approve each credit decision, one from the business and one from the credit risk management function. Both parties must hold sufficient delegated authority. While both parties are accountable for the quality of each decision taken, the credit risk management approver holds ultimate sanctioning authority. The level of authority granted to individuals is dependent on their experience and expertise, with only a small number of senior executives holding the highest authority provided under the framework.

At a minimum, credit relationships are reviewed and re-approved annually. The renewal process addresses: borrower performance, including reconfirmation or adjustment of risk parameter estimates; the adequacy of security; and compliance with terms and conditions. For certain counterparties, early warning indicators are also in place to detect deteriorating trends in limit utilisation or account performance, and to prompt additional oversight.

A number of credit risk mitigation techniques are available to reduce single name concentrations. To be considered suitable, credit risk mitigants must be effective in terms of legal certainty and enforceability and maturity/expiry dates must be the same or later than the underlying obligations. Typical mitigant types include, cash, bank/government guarantees, and credit default swaps (CDS).

Since 2009, the Group has been managing its corporate exposures to reduce concentrations and align its appetite for future business to the Group's broader strategies for its large corporate franchises. The Group is continually reviewing

its single name concentration framework to ensure that it remains appropriate for current economic conditions and in line with improvements in the Group's risk measurement models.

In 2012, the Group implemented further refinements to the single name exposure management controls already in place which allows the Group to differentiate more consistently between the different product types.

Country

For information on how the Group manages credit risk by country, refer to the Country risk section on pages 211 to 239.

Controls and assurance*

The Group's credit control and assurance framework comprises three key components: credit policy, policy compliance assurance and independent assurance.

The foundation is the Group Credit Policy Standard, which, as part of the Group Policy Framework (GPF) (refer to page 74), sets out the rules the Group's businesses must follow to ensure that credit risks are identified and effectively managed through the credit lifecycle. During 2012, a major revision of the Group's key credit policies was completed ensuring that the Group's control environment is appropriately aligned to the risk appetite that the Group Board has approved, and provides a sound basis for the Group's independent audit and assurance activities across the credit risk function.

The second component is a policy assurance activity that GCR undertakes to provide the Group Chief Credit Officer with evidence of the effectiveness of the controls in place across the Group to manage credit risk. The results of these reviews are presented to the Group Credit Risk Committee on a regular basis in support of the self-certification that GCR is obliged to complete under the GPF.

Finally, a strong independent assurance function is an important element of a sound control environment. During 2011, the Group took the decision to strengthen its credit quality assurance (CQA) activities and moved all divisional CQA resources under the centralised management of GCR. The benefits of this action are already apparent in greater consistency of standards and cross-utilisation of resources, ensuring that subject matter experts bring their expertise to bear where relevant.

Reviews undertaken consistently address the four underlying risk pillars of: risk management, risk appetite, ratings and data integrity, and asset quality. Appropriate identification, escalation, remediation and related tracking of control breaches and improvements in operational processes are firmly embedded in the assurance process to ensure that divisions act upon review findings.

Credit risk management framework continued

Credit risk measurement*

The Group uses credit risk models to support quantitative risk assessments element within the credit approval process, ongoing credit risk management, monitoring and reporting and portfolio analytics. Credit risk models used by the Group may be divided into three categories, as follows.

Probability of default/customer credit grade

These models assess whether a customer will be able to repay its obligations over a one year period.

Wholesale models - As part of the credit assessment process, the Group assigns each counterparty an internal credit grade based on its probability of default (PD). The Group uses a number of credit grading models which consider risk characteristics relevant to the customer. Credit grading models utilise a combination of quantitative inputs, such as recent financial performance and qualitative inputs such as management performance or sector outlook. The Group uses a credit grade in many of its risk management and measurement frameworks, including credit sanctioning and managing single-name concentration risk.

Retail models - Each customer account is scored using models based on the likelihood of default. Scorecards are statistically derived using customer data; customers are given a score that reflects their probability of default, and this score is used to support automated credit decision making.

Exposure at default models

Exposure at default (EAD) models estimate the level of use of a credit facility at the time of a borrower's default, recognising that customers may make more use of their existing credit facilities as they approach default. For revolving and variable draw-down type products that are not fully drawn, the EAD is higher than the current utilisation. This estimate of exposure can be reduced with financial collateral provided by the obligor or a netting agreement.

Models that measure counterparty credit risk exposure are used for derivatives and other traded instruments, where the amount of credit risk exposure may depend on one or more underlying market variables, such as interest or foreign exchange rates. These models drive the Group's internal credit risk management activities.

Loss given default models

Loss given default (LGD) models estimate the amount that cannot be recovered by the Group in the event of default. When estimating LGD, the Group takes into account both borrower and facility characteristics, as well as any security held or credit risk mitigation, such as credit protection or insurance. The cost of collections and a time discount factor for the delay in cash recovery are also incorporated.

Changes to wholesale credit risk models

The Group is updating its wholesale credit risk models, incorporating more recent data and reflecting new regulatory requirements applicable to wholesale internal ratings based (IRB) modelling. In 2012, the Group implemented updates to certain models, such as those used in the sovereign and financial institution asset classes; these updates affected the risk measures in the Group's disclosures. Further updates, primarily of models used for the corporate asset class, are

planned for 2013.

Updates to models have generally affected relatively low-risk segments of the Group's portfolio. For example, the changes stemming from the introduction of updated probability of default models largely affected assets bearing the equivalent of investment-grade ratings.

In anticipation of these changes, the Group modified various risk frameworks, including its risk appetite framework and latent loss assessment. In addition, with the agreement of its regulators, the Group adjusted upwards the risk-weighted assets (RWAs) of some portfolios prior to the introduction of the new models.

Model changes affect year-on-year comparisons of risk measures in certain disclosures. Where meaningful, the Group in its commentary has differentiated between instances where movements in risk measures reflect the impact of model changes, and those that reflect movements in the size of underlying credit portfolios or their credit quality. However, it is not practicable to quantify the impact of model updates on individual asset quality bands.

Separately, as agreed with the Financial Services Authority (FSA), the Group has started to apply a slotting approach to calculate RWAs related to commercial real estate assets; this approach does not use modelled measures to determine RWAs and capital requirements.

* unaudited

Business review Risk and balance sheet management continued

Credit risk assets*

The tables and commentary below refer to credit risk assets, which consist of:

- Lending - Comprises gross loans and advances to: central and local governments; central banks, including cash balances; other banks and financial institutions, incorporating overdraft and other short-term credit lines; corporates, in large part loans and leases; and individuals, comprising mortgages, personal loans and credit card balances.

- Derivatives - Comprises the mark-to-market (mtm) value of such contracts after the effect of enforceable netting agreements, but before the effect of collateral. Figures shown apply counterparty netting within the regulatory capital model used.

- Contingent obligations - Comprises primarily letters of credit and guarantees.

Credit risk assets exclude issuer risk (primarily debt securities) and reverse repurchase arrangements. They take account of legal netting arrangements that provide a right of legal set-off, but do not meet the offset criteria under IFRS.

Divisional analysis

	2012	2011	2010
	£m	£m	£m
UK Retail	114,120	111,070	108,302
UK Corporate	101,148	105,078	108,663
Wealth	19,913	20,079	18,875
International Banking	64,518	72,737	80,166
Ulster Bank	34,232	37,781	40,750
US Retail & Commercial	55,036	56,546	51,779
Retail & Commercial	388,967	403,291	408,535
Markets	106,336	114,327	124,330
Other	65,186	64,517	36,659
Core	560,489	582,135	569,524
Non-Core	65,220	92,709	125,383
	625,709	674,844	694,907

Key points

- 56% of the £49 billion reduction in total credit risk assets was in the Non-Core division. Exposure decreased in all divisions except UK Retail and Group Treasury (shown in 'Other'). At the year end Non-Core accounted for 10% of the overall assets (2011 - 14%).

- Credit risk assets in Retail & Commercial continued to increase as a proportion of the total portfolio. At the year end the Retail & Commercial divisions increased to 62% of the total credit risk assets (2011 - 60%). UK Retail mortgage exposure increased by £4 billion during the year, partially offset by reduced unsecured exposures. The fall in exposure in International Banking was spread across all sectors and geographies.

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The fall in the Markets division predominantly reflected reduction in exposure to banks, other financial institutions and sovereigns in Western Europe.

- Non-Core declined £27 billon (30% of the 2011 portfolio) during 2012 driven by material disposals, repayments and run off. Reduction has taken place across all material segments as the Group continues to de-risk the portfolio. Significant actions were taken to reduce exposure within the property, transport and other financial institution sectors. These sectors accounted for 69% of the reduction in Non-Core.

- Other predominantly relates to Group Treasury's exposure to central banks in the UK, USA and Germany and is a function of the Group's liquidity requirements and cash positions.

* unaudited

Business review Risk and balance sheet management continued

Credit risk assets* continued

Sector and geographical regional analyses

The table below details credit risk assets by sector and geographical region. Sectors are based on the Group's sector concentration framework. Geographical region is based on country of incorporation.

2012 (4)	UK £m	Western Europe (excl. UK) £m	North America £m	Asia Pacific £m	Latin America £m	Other (1) £m	Total £m	Core £m	Non-Core £m
Personal	129,431	19,256	30,664	1,351	39	926	181,667	177,880	3,787
Banks	5,023	36,573	6,421	8,837	1,435	2,711	61,000	60,609	391
Other financial institutions	20,997	13,398	10,189	2,924	4,660	789	52,957	47,425	5,532
Sovereign (2)	38,870	26,002	14,265	2,887	64	1,195	83,283	81,636	1,647
Property	54,831	23,220	7,051	1,149	2,979	1,280	90,510	56,566	33,944
Natural resources	6,103	5,911	6,758	4,129	690	1,500	25,091	21,877	3,214
Manufacturing	9,656	5,587	6,246	2,369	572	1,213	25,643	24,315	1,328
Transport (3)	12,298	5,394	4,722	5,065	2,278	4,798	34,555	26,973	7,582
Retail and leisure	17,229	5,200	4,998	1,103	270	658	29,458	26,203	3,255
Telecoms, media and technology	4,787	3,572	3,188	1,739	127	346	13,759	10,815	2,944
Business services	17,089	3,183	5,999	581	780	154	27,786	26,190	1,596
	316,314	147,296	100,501	32,134	13,894	15,570	625,709	560,489	65,220
2011									
Personal	126,945	20,254	33,087	1,604	158	1,114	183,162	176,201	6,961
Banks	4,720	39,213	3,952	11,132	1,738	3,276	64,031	63,470	561
Other financial institutions	16,549	15,960	13,319	3,103	5,837	1,159	55,927	45,548	10,379
Sovereign (2)	21,053	31,374	31,391	3,399	78	1,581	88,876	87,617	1,259
Property	60,099	27,281	8,052	1,370	3,471	1,480	101,753	58,323	43,430
Natural resources	6,552	7,215	8,116	3,805	1,078	2,508	29,274	25,146	4,128
Manufacturing	9,583	7,391	7,098	2,126	1,011	1,381	28,590	26,525	2,065
Transport (3)	13,789	7,703	4,951	5,433	2,500	5,363	39,739	27,529	12,210
Retail and leisure	22,775	6,101	5,762	1,488	1,041	675	37,842	32,766	5,076
Telecoms, media and technology	5,295	4,941	3,202	1,944	139	609	16,130	12,180	3,950
Business services	17,851	3,719	6,205	910	629	206	29,520	26,830	2,690
	305,211	171,152	125,135	36,314	17,680	19,352	674,844	582,135	92,709
2010									
Personal	124,594	21,973	34,970	1,864	126	1,531	185,058	174,287	10,771
Banks	6,819	35,619	5,097	11,072	1,394	6,713	66,714	65,494	1,220
Other financial institutions	17,550	14,782	14,773	4,200	8,732	1,762	61,799	47,227	14,572
Sovereign (2)	20,209	24,826	18,088	3,243	125	1,789	68,280	66,556	1,724
Property	65,622	30,925	9,573	1,980	3,090	1,750	112,940	60,590	52,350
Natural resources	6,696	7,863	9,771	3,655	1,396	4,143	33,524	24,427	9,097
Manufacturing	10,599	8,532	6,744	2,673	917	2,059	31,524	28,088	3,436
Transport (3)	13,842	8,726	5,389	6,161	2,658	6,347	43,123	27,899	15,224

Retail and leisure	24,716	6,690	5,316	1,438	1,174	918	40,252	34,100	6,152
Telecoms, media and technology	5,495	5,764	3,283	2,187	328	786	17,843	12,076	5,767
Business services	19,757	5,116	6,521	985	1,086	385	33,850	28,780	5,070
	315,899	170,816	119,525	39,458	21,026	28,183	694,907	569,524	125,383

Notes:

(1) Includes Central and Eastern Europe, the Middle East, Central Asia and Africa, and supranationals such as the World Bank.

(2) Includes central bank exposures.

(3) Excludes net investment in operating leases in shipping and aviation portfolios as they are accounted for as property, plant and equipment. However, operating leases are included in the monitoring and management of these portfolios.

(4) Enhancements to Wealth credit systems in the second quarter of 2012 resulted in refinements to sector classifications. The most significant impact has been a reallocation of £2.6 billion from the retail and leisure sector across a number of other sectors. Prior year data has not been revised.

* unaudited

Key points

Financial markets and the Group's focus on risk appetite and sector concentration had a direct impact on the portfolio during the year with the following key trends observed:

- Total credit risk assets fell 7%, with reductions in all wholesale sectors. Exposure to the personal sector remained broadly flat.

- Credit risk assets fell in all geographic regions, except the UK. This was driven by the Group's continued focus on reducing exposures to the peripheral eurozone countries and appropriate management of liquidity requirements reflected in the reduced exposures to Western European and US central banks.

- UK exposure, as a proportion of the total portfolio, increased during the year and now comprises 51% of credit risk assets, driven by continued growth in UK personal sector assets and increased UK sovereign risk exposure.

- Exposure to the property sector fell by 11% during the year driven by tighter portfolio controls in all regions and a £9.5 billion reduction in Non-Core resulting from focussed action on early and contractual repayments.

- Exposure to banks and financial institutions declined by 5% as a result of subdued borrowing activity and a reduction in lending and derivatives to finance companies, financial services companies, funds, monoline insurers and Credit Derivative Product Companies (CDPCs).

- Reported exposures are affected by currency movements. During 2012, sterling appreciated 4.4% against the US dollar and 2.6% against the euro resulting in a decrease in sterling terms of exposures denominated in these currencies (and in other currencies linked to the US dollar or euro).

- The Group's sovereign portfolio comprises exposures to central governments, central banks and sub-sovereigns such as local authorities, primarily in the Group's key markets of the UK, Western Europe and the USA. The asset quality is high as exposures are largely cash balances placed with central banks such as the Bank of England, the Federal Reserve and the Eurosystem (including the European Central Bank and central banks in the eurozone). Exposure to sovereigns fluctuates according to Group liquidity requirements and cash positions. These are driven by inflows and outflows of deposits which determine the level of cash placed with central banks and have contributed to higher exposures at the Bank of England and lower exposures at European and US central banks. Information on the Group's exposure to governments, including peripheral eurozone sovereigns, can be found in the Risk management section on Country risk.

- Exposure to the banking sector is one of the largest in the Group's portfolio. The sector is well diversified geographically with derivative exposures being largely collateralised. Exposures are tightly controlled through the combination of the single name concentration framework, bespoke credit policies and country limits. Exposures to the banking sector decreased by £3 billion in 2012 as a result of reduced interbank lending and derivative activity, and a reduction in limits to banks in countries under stress, such as the peripheral eurozone countries.

- Exposure to other financial institutions comprising traded and non-traded products is spread across a range of financial companies including insurance, securitisation vehicles, financial intermediaries including broker dealers and CCPs, financial guarantors - monolines and CDPCs - and funds comprising unleveraged, hedge and leveraged funds. The size and asset quality of the Core portfolio have not changed materially since 2011. However, entities in

this sector remain vulnerable to market shocks or contagion from the banking sector. Credit risk is managed through the single name concentration, sector concentration and asset and product class frameworks, with specific sector and product caps in place where there is a perception of heightened credit risk. The Group is also actively managing down its exposures to monolines and CDPCs with a view to exiting these portfolios. Exposures to CDPCs and monolines have decreased materially during 2012 as trades are commuted and exposures reduce due to tightening credit spread of the assets protected by CDPCs and monolines.

- The Group's exposure to the property sector was £91 billion (a fall of 11% during the year), the majority of which was commercial real estate in Ireland and the UK (see section on commercial real estate on pages 140 and 141 for further details). The remainder comprised lending to construction companies and building materials groups, which fell by £1.9 billion (15%), and housing associations, which remained stable. Most of the Group's Core property exposure is within UK Corporate (73%).

- The 22% decline in exposure to the retail and leisure sectors, was driven by the de-leveraging by customers and refinements in sector classifications within the Wealth division. Excluding the impact of sector reclassifications, the reduction in the retail and leisure portfolios was 15% in 2012. While the market outlook for this sector remains challenging and despite some high-profile failures among UK high street retailers, losses on the Group's retail portfolio remained low during 2012. The sector continues to show wide variation in performance, however, credit metrics overall remained broadly stable. The leisure sector displayed weaker credit metrics than the wider corporate portfolio, in line with the industry trend. The Group's risk appetite is driven by the importance of the leisure sector to the UK franchise, especially for the UK Corporate division, but is mitigated through tighter origination policies and a reduction in exposure to high risk sub-sectors. Leisure sector exposure fell by 8% in 2012 driven predominantly by Non-Core. The gambling sub-sector is subject to specific controls due to its high credit and reputational risk profile.

* unaudited

Business review Risk and balance sheet management continued

Credit risk assets*: Sector and geographical regional analysis continued

- The Group's transport sector portfolio includes £10.6 billion of asset-backed exposure to ocean-going vessels. Conditions remained poor across the major shipping market segments in 2012, with low charter rates and vessel values. A key protection for the Group is the minimum security covenant. This covenant is tested each quarter on an individual vessel basis to ensure prompt remedial action is taken if values fall significantly below agreed loan coverage ratios. There was an increase in the number of clients suffering liquidity issues or failing to meet their minimum security covenant and a commensurate rise in referrals to the Watchlist and the Global Restructuring Group (GRG). At 31 December 2012, 20% of the Group's exposure to this sector was in Watchlist Red and the amount of loans in default were £687 million. The impairment charge for the year was c.£0.1 billion and the provision balance as at 31 December 2012 stood at c.£0.2 billion. The Group's exposure to the shipping sector (including shipping related infrastructure) declined by 3.5% in 2012 as a result of amortisation and foreign exchange movements.

- Εξποσυρε το ηεαλτηχαρε οφ ≤10.0 βιλλιον ατ ψεαρ ενδ ισ ινχλυδεδ ιν τηε βυσινεσσ σερϖιχεσ σεχτορ. Ιτ ισ ηεαϖιλψ βιασεδ τοωαρδσ τηε ΥΚ ηεαλτη σεχτορ ωηιχη ρεπρεσεντσ 68% οφ τηε εξποσυρε. Τηερε ωασ νο σιγνιφιχαντ χηανγε ιν τηε ασσετ θυαλιτψ ορ σιζε οφ τηισ πορτφολιο ιν 2012. Χηαλλενγινγ μαρκετ χονδιτιονσ περσιστ ιν τηε νυρσινγ ηομε συβ–σεχτορ ανδ ασ α ρεσυλτ τηε Γρουπ ηασ τιγητενεδ ιτσ ρισκ αππετιτε ανδ φυρτηερ στρενγτηενεδ ιτσ τρανσαχτιοναλ χοντρολσ ανδ πολιχιεσ δυρινγ τηε ψεαρ.

- Core personal lending continued to rise, driven by UK mortgages. This expansion is in line with Group strategy and has no detrimental impact on credit quality (for more commentary refer to Key credit portfolios: Residential mortgages on page 145). The increase was partially offset by reduced unsecured exposures.

Asset quality

Internal reporting and oversight of risk assets is principally differentiated by credit grades. Customers are assigned credit grades based on various credit grading models that reflect the key drivers of default for each customer type. All credit grades across the Group map to both a Group level asset quality scale, used for external financial reporting, and a master grading scale for wholesale exposures, used for internal management reporting across portfolios. Accordingly, measures of risk exposure may be readily aggregated and reported at increasing levels of granularity depending on stakeholder or business need. Performing loans are defined as AQ1-AQ9 (where the PD is less than 100%) and non-performing loans as AQ10 (where the PD is 100%).

Exposures are allocated to asset quality bands on the basis of statistically driven models which produce an estimate of default rate. The variables included in the models vary by product and geography. For portfolios secured on residential property these models typically include measures of delinquency and loan to value as well as other differentiating characteristics such as bureau score, product features or associated account performance information.

The table below shows credit risk assets by asset quality (AQ) band:

		2012				2011				2010			
Asset quality band	Probability of default range	Core £m	Non-Core £m	Total £m	Total %	Core £m	Non-Core £m	Total £m	Total %	Core £m	Non-Core £m	Total £m	T
AQ1	0% - 0.034%	131,772	7,428	139,200	22.2	195,826	13,732	209,558	31.1	175,793	17,728	193,521	2

AQ2	0.034% - 0.048%	25,334	2,241	27,575	4.4	18,366	2,915	21,281	3.2	18,274	2,526	20,800	
AQ3	0.048% - 0.095%	43,925	2,039	45,964	7.3	27,082	2,883	29,965	4.4	26,244	4,259	30,503	
AQ4	0.095% - 0.381%	112,589	6,438	119,027	19.0	65,491	9,636	75,127	11.1	64,277	15,052	79,329	
AQ5	0.381% - 1.076%	92,130	7,588	99,718	15.9	92,503	10,873	103,376	15.3	90,639	18,767	109,406	
AQ6	1.076% - 2.153%	45,808	5,525	51,333	8.2	67,260	6,636	73,896	11.0	73,367	12,913	86,280	
AQ7	2.153% - 6.089%	32,720	5,544	38,264	6.1	36,567	8,133	44,700	6.6	41,399	10,451	51,850	
AQ8	6.089% - 17.222%	13,091	1,156	14,247	2.4	11,921	3,320	15,241	2.3	15,300	4,308	19,608	
AQ9	17.222% - 100%	8,849	2,073	10,922	1.8	12,710	5,024	17,734	2.6	11,398	8,621	20,019	
AQ10	100%	21,562	22,845	44,407	7.1	20,017	25,020	45,037	6.7	17,994	25,005	42,999	
Other (1)		32,709	2,343	35,052	5.6	34,392	4,537	38,929	5.7	34,839	5,753	40,592	5.9
		560,489	65,220	625,709	100	582,135	92,709	674,844	100	569,524	125,383	694,907	100

Note:

(1) Largely comprises certain of the Group's portfolios covered by the standardised approach, for which a probability of default equivalent to those assigned to assets covered by the internal ratings based approach is not available.

* unaudited

	2012		2011		2010	
		Divisional credit		Divisional credit		Divisional credit
	AQ10	risk assets	AQ10	risk assets	AQ10	risk assets
AQ10 credit risk assets by division	£m	%	£m	%	£m	%
UK Retail	4,998	4.4	5,097	4.6	5,017	4.6
UK Corporate	6,310	6.2	5,484	5.2	5,198	4.8
International Banking	612	0.9	1,736	2.4	2,227	2.8
Ulster Bank	8,236	24.1	6,305	16.7	4,348	10.7
US Retail & Commercial	633	1.2	646	1.1	599	1.2
Retail & Commercial	20,789	5.3	19,268	4.8	17,389	4.3
Markets	773	0.7	749	0.7	605	0.5
Core	21,562	3.8	20,017	3.4	17,994	3.2
Non-Core	22,845	35.0	25,020	27.0	25,005	19.9
	44,407	7.1	45,037	6.7	42,999	6.2

Key points

- Trends in the asset quality of the Group's credit risk exposures during 2012 reflected changes in the composition of the Core portfolio and the run-off and disposals of Non-Core assets as well as regrading through new and updated models, particularly in relation to the bank and personal sectors. Adjusting for those factors, the overall asset quality of the Group's corporate exposure was broadly unchanged despite difficult external conditions in the UK and ongoing uncertainty in the eurozone.

- The decrease in the Group's Core exposures within the AQ1 band reflects the decrease in the Group's exposure to sovereigns in Western Europe and North America and the change in the bank and sovereign Probability of Default (PD) rating models noted on page 121. The credit outlook for banks and sovereigns continues to be challenging and the transition to the updated PD models creates additional credit migration causing assets to move to higher PDs. While the nominal value and appearance of migration out of AQ1 is material most of the migration continues to occur within the range of stronger credit grades and hence the change in the credit quality of the portfolio is modest. The weighted PD percentage for banks and sovereigns increased by 5 basis points to 0.13% and 3 basis points to 0.04% respectively. The AQ composition of the Corporate portfolio has not changed materially during the year.

- The increase in AQ4 is partly driven by the change to the bank and sovereign PD models noted above, and partly due to the improvement in the UK Retail mortgage asset quality band distribution. This followed updates to the Group's models which were delayed whilst long term recalibrations were made to the capital rating system. These PD recalibrations reflect improvements in the underlying credit quality of the UK mortgage portfolio.

- On a sector basis, the proportion of non-performing assets in the property sector increased slightly to 58% of total AQ10 exposure (2011 - 57%). Non-performing assets relating to property represent a material proportion of AQ10 exposure in Non-Core (85%), UK Corporate (56%) and Ulster Bank (30%). In particular, continued weakness in the Irish economy meant non-performing assets in the Ulster Bank portfolio continued to grow, driven by exposures in the personal and property sectors. Refer to the Key credit portfolios: Ulster Bank Group (pages 149 to 152) for more details. A small number of significant individual non-performing property cases led to the overall increase in the AQ10 population in UK Corporate.

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Non-performing assets (AQ10) in Non-Core increased as a percentage of the overall Non-Core portfolio due to the run-off and disposals of better performing assets. The overall level of AQ10 assets in Non-Core fell due to repayments, assets returning to the performing book and the write off of certain real estate exposures in 2012.

- In UK Retail non-performing assets (AQ10) reduced slightly during the year predominantly as a result of lower flows of unsecured assets into non-performing. Recovery activity on non-performing assets is pursued over a number of years during which time the assets remain on balance sheet along with the appropriate impairment provision.

- Non-performing credit risk assets within International Banking decreased markedly as renegotiations led to the return of significant exposure in the transport sector to the performing book.

* unaudited

Credit risk mitigation

Approaches and methodologies*

The Group employs a number of structures and techniques to mitigate credit risk. Netting of debtor and creditor balances is undertaken in accordance with relevant regulatory and internal policies. Exposure on OTC derivative and secured financing transactions is further mitigated by the exchange of financial collateral and the use of market standard documentation. Further mitigation may occur in a range of transactions, from retail mortgage lending to large wholesale financing. This can include: structuring a security interest in a physical or financial asset; use of credit derivatives, including credit default swaps, credit-linked debt instruments and securitisation structures; and use of guarantees and similar instruments (for example, credit insurance) from related and third parties. Such techniques are used in the management of credit portfolios, typically to mitigate credit concentrations in relation to an individual obligor, a borrower group or a collection of related borrowers.

The use and approach to credit risk mitigation varies by product type, customer and business strategy. Minimum standards applied across the Group cover:

- The suitability of qualifying credit risk mitigation types and any conditions or restrictions applicable to those mitigants;
- The means by which legal certainty is to be established, including required documentation, supportive independent legal opinions and all necessary steps required to establish legal rights;
- Acceptable methodologies for initial and any subsequent valuations of collateral and the frequency with which collateral is to be revalued and the use of collateral haircuts;
- Actions to be taken in the event that the value of mitigation falls below required levels;
- Management of the risk of correlation between changes in the credit risk of the customer and the value of credit risk mitigation;
- Management of concentration risks, for example, by setting thresholds and controls on the acceptability of credit risk mitigants and on lines of business that are characterised by a specific collateral type or structure; and
- Collateral management to ensure that credit risk mitigation remains legally effective and enforceable.

Secured portfolios

Within its secured portfolios, the Group has recourse to various types of collateral and other credit enhancements to mitigate credit risk and reduce the loss to the Group arising from the failure of a customer to meet its obligations. These include: cash deposits; charges over residential and commercial property, debt securities and equity shares; and third-party guarantees. The existence of collateral may affect the pricing of a facility and its regulatory capital requirement. When a collateralised financial asset becomes impaired, the impairment charge directly reflects the realisable value of collateral and any other credit enhancements.

Corporate exposures

The type of collateral taken by the Group's commercial and corporate businesses and the manner in which it is taken will vary according to the activity and assets of the customer.

- Physical assets - These include business assets such as stock, plant and machinery, vehicles, ships and aircraft. In general, physical assets qualify as collateral only if they can be unambiguously identified, located or traced, and segregated from uncharged assets. Assets are valued on a number of bases according to the type of security that is granted.

- Real estate - The Group takes collateral in the form of real estate, which includes residential and commercial properties. The market value of the collateral will typically exceed the loan amount at origination date. The market value is defined as the estimated amount for which the asset could be sold in an arms length transaction by a willing seller to a willing buyer.

- Receivables - When taking a charge over receivables, the Group assesses their nature and quality and the borrower's management and collection processes. The value of the receivables offered as collateral will typically be adjusted to exclude receivables that are past their due dates.

The security charges may be floating or fixed, with the type of security likely to impact: (i) the credit decision; and (ii) the potential loss upon default. In the case of a general charge such as a mortgage debenture, balance sheet information may be used as a proxy for market value if the information is deemed reliable.

The Group does not recognise certain asset classes as collateral: for example, short leasehold property and equity shares of the borrowing company. Collateral whose value is correlated to that of the obligor is assessed on a case-by-case basis and, where necessary, over-collateralisation may be required.

The Group uses industry-standard loan and security documentation wherever possible. Non-standard documentation is typically prepared by external lawyers on a case-by-case basis. The Group's business and credit teams are supported by in-house specialist documentation teams.

The existence of collateral has an impact on provisioning. Where the Group no longer expects to recover the principal and interest due on a loan in full or in accordance with the original terms and conditions, it is assessed for impairment. If exposures are secured, the current net realisable value of the collateral will be taken into account when assessing the need for a provision. No impairment provision is recognised in cases where all amounts due are expected to be settled in full on realisation of the security.

* unaudited

Business review Risk and balance sheet management continued

Commercial real estate

The table below analyses commercial real estate (Core and Non-Core) lending by loan-to-value (LTV) which represents loan value before provisions. Due to market conditions in Ireland and to a lesser extent in the UK, there is a shortage of market-based data. In the absence of external valuations, the Group deploys a range of alternative approaches to assess property values, including internal expert judgement and indexation.

	Ulster Bank			Rest of the Group			Group		
	Performing	Non-performing	Total	Performing	Non-performing	Total	Performing	Non-performing	Total
Loan-to-value	£m	£m	£m	£m	£m	£m	£m	£m	£m
2012									
<= 50%	183	24	207	7,210	281	7,491	7,393	305	7,698
> 50% and <= 70%	326	102	428	12,161	996	13,157	12,487	1,098	13,585
> 70% and <= 90%	462	250	712	6,438	1,042	7,480	6,900	1,292	8,192
> 90% and <= 100%	466	141	607	1,542	2,145	3,687	2,008	2,286	4,294
> 100% and <= 110%	103	596	699	1,019	1,449	2,468	1,122	2,045	3,167
> 110% and <= 130%	326	630	956	901	1,069	1,970	1,227	1,699	2,926
> 130% and <= 150%	274	878	1,152	322	913	1,235	596	1,791	2,387
> 150%	963	7,290	8,253	595	1,962	2,557	1,558	9,252	10,810
Total with LTVs	3,103	9,911	13,014	30,188	9,857	40,045	33,291	19,768	53,059
Minimal security (1)	7	1,461	1,468	3	13	16	10	1,474	1,484
Other (2)	97	715	812	6,494	1,191	7,685	6,591	1,906	8,497
Total	3,207	12,087	15,294	36,685	11,061	47,746	39,892	23,148	63,040
Total portfolio average LTV (3)	131%	286%	249%	65%	125%	80%	71%	206%	122%
2011									
<= 50%	272	32	304	7,091	332	7,423	7,363	364	7,727
> 50% and <= 70%	479	127	606	14,105	984	15,089	14,584	1,111	15,695
> 70% and <= 90%	808	332	1,140	10,042	1,191	11,233	10,850	1,523	12,373
> 90% and <= 100%	438	201	639	2,616	1,679	4,295	3,054	1,880	4,934
> 100% and <= 110%	474	390	864	1,524	1,928	3,452	1,998	2,318	4,316
> 110% and <= 130%	527	1,101	1,628	698	1,039	1,737	1,225	2,140	3,365
> 130% and <= 150%	506	1,066	1,572	239	912	1,151	745	1,978	2,723
> 150%	912	7,472	8,384	433	2,082	2,515	1,345	9,554	10,899

Total with LTVs	4,416	10,721	15,137	36,748	10,147	46,895	41,164	20,868	62,032
Minimal security (1)	72	1,086	1,158	—	—	—	72	1,086	1,158
Other (2)	193	625	818	8,994	1,844	10,838	9,187	2,469	11,656
Total	4,681	12,432	17,113	45,742	11,991	57,733	50,423	24,423	74,846
Total portfolio average LTV (3)	120%	264%	222%	69%	129%	82%	75%	203%	116%

Notes:

(1) In 2012, the Group reclassified loans with limited or non-physical security (defined as LTV>1,000%) as minimal security, for which a majority are commercial real estate development loans in Ulster Bank. Total portfolio average LTV is quoted net of loans with minimal security given that the anticipated recovery rate is less than 10%. Provisions are marked against these loans where required to reflect asset quality and recovery profile. 2011 presentation has been revised.

(2) Other performing loans of £6.6 billion (2011 - £9.2 billion) include general corporate lending, typically unsecured, to commercial real estate companies, and major UK homebuilders. The credit quality of these exposures is consistent with that of the performing portfolio overall. Other non-performing loans of £1.9 billion (2011 - £2.5 billion) are subject to the Group's standard provisioning policies.

(3) Weighted average by exposure.

Other corporate

Corporate risk elements in lending and potential problem loans (excluding commercial real estate)	2012 Loans £m	2012 Provisions	2011 Loans £m	2011 Provisions £m	2010 Loans £m	2010 Provisions £m
Secured	9,936	4,704	7,782	3,369	6,526	2,564
Unsecured	1,894	1,170	2,712	1,836	2,769	1,762

Credit risk mitigation continued

Wholesale market exposures

As set out in the table below, the Group receives collateral for reverse repurchase transactions and for derivatives, typically in the form of cash, quoted debt securities or equities. The risks inherent in both types of transaction are further mitigated through master bilateral netting arrangements. Industry standard documentation such as master repurchase agreements and credit support annexes accompanied by legal opinion, is used for financial collateral taken as part of trading activities.

	2012 £bn	2011 £bn	2010 £bn
Reverse repurchase agreements	104.8	100.9	95.1
Securities received as collateral (1)	(104.7)	(98.9)	(94.3)
Derivative assets gross exposure	441.9	530.1	432.2
Counterparty netting	(373.9)	(441.6)	(330.4)
Cash collateral held	(34.1)	(37.2)	(31.1)
Securities received as collateral	(5.6)	(5.3)	(2.9)

Note:
(1) In accordance with normal market practice, at 31 December 2012 £100.7 billion (2011 - £95.4 billion; 2010 - £93.5 billion) had been resold or re-pledged as collateral for the Group's own transactions.

Retail

Within the Group's retail book, mortgage and home equity lending portfolios are secured by residential property. The Group's portfolio of US automobile loans is secured by motor cars or other vehicles. Student loans and credit card lending are all unsecured. The vast majority of personal loans are also unsecured.

All borrowing applications, whether secured or not, are subject to appropriate credit risk underwriting processes including affordability assessment. Pricing is typically higher on unsecured than secured loans. For secured loans, pricing will typically vary by LTV. Higher LTV products are typically subject to higher interest rates commensurate with the associated risk.

The value of a property intended to secure a mortgage is assessed during the loan underwriting process using industry-standard methodologies. Property values supporting home equity lending reflect either an individual appraisal or valuations generated by statistically valid automated valuation models. Property values are updated each quarter
using the relevant house price index (the Halifax Quarterly Regional House Price Index in the UK, the Case-Shiller Home Value Index in the US, and the Central Statistics Office Residential Property Price Index in ROI (monthly) and the Nationwide House Price Index in Northern Ireland).

For automobile lending in the US, new vehicles are valued at cost and used vehicles at the average trade-in value. At 31 December 2012, this portfolio amounted to £5.4 billion (2011 - £4.8 billion; 2010 - £5.1 billion).

The existence of collateral has an impact on provisioning levels. Once a secured loan is classified as non-performing, the realisable value of the underlying collateral and the costs associated with repossession are used to estimate the

provision required.

Residential mortgages

The table below shows LTVs for the Group's residential mortgage portfolio split between performing (AQ1-AQ9) and non-performing (AQ10), with the average calculated on a weighted value basis. Loan balances are as at the end of the year whereas property values are calculated using the appropriate index.

	UK Retail			Ulster Bank			RBS Citizens (1)		
	Performing	Non-performing	Total	Performing	Non-performing	Total	Performing	Non-performing	Total
Loan-to-value	£m	£m	£m	£m	£m	£m	£m	£m	£m
2012									
<= 50%	22,306	327	22,633	2,182	274	2,456	4,167	51	4,218
> 50% and <= 70%	27,408	457	27,865	1,635	197	1,832	4,806	76	4,882
> 70% and <= 90%	34,002	767	34,769	2,019	294	2,313	6,461	114	6,575
> 90% and <= 100%	7,073	366	7,439	1,119	156	1,275	2,011	57	2,068
> 100% and <= 110%	3,301	290	3,591	1,239	174	1,413	1,280	43	1,323
> 110% and <= 130%	1,919	239	2,158	2,412	397	2,809	1,263	42	1,305
> 130% and <= 150%	83	26	109	2,144	474	2,618	463	14	477
> 150%	—	—	—	3,156	1,290	4,446	365	14	379
Total with LTVs	96,092	2,472	98,564	15,906	3,256	19,162	20,816	411	21,227
Other (2)	486	12	498	—	—	—	292	19	311
Total	96,578	2,484	99,062	15,906	3,256	19,162	21,108	430	21,538
Total portfolio average LTV (3)	66%	80%	67%	108%	132%	112%	75%	86%	75%
Average LTV on new originations during the year			65%			74%			64%

* unaudited

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Business review Risk and balance sheet management continued

	UK Retail			Ulster Bank			RBS Citizens (1)		
	Performing	Non-performing	Total	Performing	Non-performing	Total	Performing	Non-performing	Total
2011	£m	£m	£m	£m	£m	£m	£m	£m	£m
<= 50%	21,537	285	21,822	2,568	222	2,790	4,745	49	4,794
> 50% and <= 70%	25,598	390	25,988	1,877	157	2,034	4,713	78	4,791
> 70% and <= 90%	33,738	671	34,409	2,280	223	2,503	6,893	125	7,018
> 90% and <= 100%	7,365	343	7,708	1,377	128	1,505	2,352	66	2,418
> 100% and <= 110%	3,817	276	4,093	1,462	130	1,592	1,517	53	1,570
> 110% and <= 130%	1,514	199	1,713	2,752	322	3,074	1,536	53	1,589
> 130% and <= 150%	60	15	75	2,607	369	2,976	626	28	654
> 150%	—	—	—	2,798	748	3,546	588	27	615
Total with LTVs	93,629	2,179	95,808	17,721	2,299	20,020	22,970	479	23,449
Other (2)	567	13	580	—	—	—	681	23	704
Total	94,196	2,192	96,388	17,721	2,299	20,020	23,651	502	24,153
Total portfolio average LTV (3)	67%	80%	67%	104%	125%	106%	76%	91%	77%
Average LTV on new originations during the year			63%			74%			63%
2010									
<= 50%	19,568	246	19,814	3,385	186	3,571	5,193	45	5,238
> 50% and <= 70%	24,363	345	24,708	2,534	152	2,686	4,902	79	4,981
> 70% and <= 90%	31,711	588	32,299	3,113	179	3,292	7,029	137	7,166
> 90% and <= 100%	7,998	319	8,317	1,958	121	2,079	2,459	67	2,526
> 100% and <= 110%	4,083	260	4,343	2,049	137	2,186	1,534	53	1,587
> 110% and <= 130%	1,722	202	1,924	4,033	358	4,391	1,425	61	1,486
> 130% and <= 150%	57	16	73	2,174	297	2,471	599	28	627
> 150%	—	—	—	355	131	486	589	36	625
Total with LTVs	89,502	1,976	91,478	19,601	1,561	21,162	23,730	506	24,236
Other (2)	1,090	24	1,114	—	—	—	762	30	792
Total	90,592	2,000	92,592	19,601	1,561	21,162	24,492	536	25,028
Total portfolio average LTV (3)	68%	81%	68%	91%	106%	92%	75%	94%	76%

Average LTV on new originations during the year	68%	79%	66%

Notes:
(1) Includes residential mortgages and home equity loans and lines (refer to page 147 for a breakdown of balances).
(2) Where no indexed LTV is held.
(3) Average LTV weighted by value is arrived at by calculating the LTV on each individual mortgage and applying a weighting based on the value of each mortgage.
(4) Excludes mortgage lending in Wealth. This portfolio totalled £8.8 billion (2011 - £8.3 billion; 2010 - £7.8 billion) and continues to perform in line with expectations with minimal provisions of £248 million.

Early problem identification and problem debt management

While the principles of identifying, managing and providing for problem debts are broadly similar for wholesale and retail customers, the procedures differ based on the nature of the assets, as discussed below.

Wholesale customers

The controls and processes for managing wholesale problem debts are embedded within the divisions' credit approval frameworks and form an essential part of the ongoing credit assessment of customers. Any necessary approvals will be required in accordance with the delegated authority grid governing the extension of credit.

Early problem recognition

Each division has established Early Warning Indicators (EWIs) designed to identify those performing exposures that require close attention due to financial stress or heightened operational issues. Such identification may also take place as part of the annual review cycle. EWIs vary from division to division and comprise both internal parameters (such as account level information) and external parameters (such as the share price of publicly listed customers).

Customers identified through either the EWIs or annual review are assessed by portfolio management and/or credit officers within the division to determine whether or not the customer's circumstances warrant placing the exposure on the Watchlist (detailed below).

Watchlist *

There are three Watchlist ratings - amber, red and black - reflecting progressively deteriorating conditions. Watchlist Amber loans are performing loans where the counterparty or sector shows early signs of potential stress or has other characteristics such that they warrant closer monitoring. Watchlist Red loans are performing loans where indications of the borrower's declining creditworthiness are such that the exposure requires active management, usually by the Global Restructuring Group (GRG). Watchlist Black loans comprise risk elements in lending and potential problem loans.

Once on the Watchlist process, customers come under heightened scrutiny. The relationship strategy is reassessed by a forum of experienced credit, portfolio management and remedial management professionals within the division. In accordance with Group-wide policies, a number of mandatory actions are taken, including a review of the customer's credit grade and facility security documentation. Other appropriate corrective action is taken when circumstances emerge that may affect the customer's ability to service its debt. Such circumstances include deteriorating trading performance, an imminent breach of covenant, challenging macroeconomic conditions, a late payment or the expectation of a missed payment.

For all Watchlist Red cases, the division is required to consult with GRG on whether the relationship should be transferred to GRG (see more on GRG below). Relationships managed by the divisions tend to be with companies operating in niche sectors, such as airlines or products such as securitisation special purpose vehicles. The divisions may also manage those exposures when subject matter expertise is available in the divisions rather than within GRG.

At 31 December 2012, exposures to customers reported as Watchlist Red and managed within the divisions totalled £4.3 billion (2011 - £4.9 billion).

Strategies that are available within divisions include granting a customer various types of concessions. Any decision to approve a concession will be a function of the division's specific country and sector appetite, the key credit metrics of the customer, the market environment and the loan structure/security. Refer to the section below on Wholesale renegotiations.

Other potential outcomes of the review of the relationship are to: take the customer off the Watchlist and return them to the mainstream loan book; offer further lending and maintain ongoing reviews; transfer the relationship to GRG for those customers requiring such stewardship; or exit the relationship altogether.

The following table shows a sector breakdown of credit risk assets of Watchlist Red counterparties under GRG management:

	2012			2011		
	Core	Non-Core	Total	Core	Non-Core	Total
Watchlist Red credit risk assets under GRG management	£m	£m	£m	£m	£m	£m
Property	5,605	4,377	9,982	6,561	6,011	12,572
Transport	2,238	478	2,716	1,159	2,252	3,411
Retail and leisure	1,542	432	1,974	1,528	669	2,197
Services	870	84	954	808	141	949
Other	3,087	1,177	4,264	1,952	916	2,868
Total	13,342	6,548	19,890	12,008	9,989	21,997

Global Restructuring Group (GRG)

In cases where the Group's exposure to the customer exceeds £1 million, the relationship may be transferred to GRG following consultation with the originating division. The primary function of GRG is active management of the exposures to minimise loss for the Group and where feasible return the exposure to the Group's mainstream loan book following an assessment by GRG that no further losses are expected.

At 31 December 2012, credit risk assets relating to exposures under GRG management (excluding those placed under GRG stewardship for operational reasons rather than concerns over credit quality and those in the AQ10 internal asset quality (AQ) band) totalled £19.9 billion. Credit risk assets are defined on page 122. The internal asset quality bands are defined on page 125.

* unaudited

Wholesale renegotiations

Loan modifications take place in a variety of circumstances including but not limited to a customer's current or potential credit deterioration. Where the contractual payment terms of a loan have been changed because of the customer's financial difficulties, it is classified as 'renegotiated' in the wholesale portfolio.

Loans modified in the normal course of business where there is no evidence of financial difficulties and any changes to terms and conditions are within acceptable credit parameters, within credit risk appetite and/or reflective of improving conditions for the customer in the credit markets, are not considered to have been renegotiated.

A number of options are available to the Group when a wholesale customer is facing financial difficulties and corrective action is deemed necessary. Such actions are tailored to the individual circumstances of the customer. The aim of such actions is to assist the customer in restoring its financial health and to minimise risk to the Group. To ensure that the renegotiations are appropriate for the needs and financial profile of the customer, the Group requires minimum standards to be applied when assessing, recording, monitoring and reporting this type of activity.

Wholesale renegotiations involve the following types of concessions:

- Variation in margin - The contractual margin may be amended to bolster the customer's day-to-day liquidity, with the aim of helping to sustain the customer's business as a going concern. This would normally be seen as a short-term solution and is typically accompanied by the Group receiving an exit payment, a payment in kind or a deferred fee.

- Payment concessions and loan rescheduling - payment concessions or changes to the contracted amortisation profile including extensions in contracted maturity may be granted to improve the customer's liquidity. Such concessions often depend on the expectation that the customer's liquidity will recover when market conditions improve or will benefit from access to alternative sources of liquidity, such as an issue of equity capital. These types of concessions are common in commercial real estate transactions, particularly where a shortage of market liquidity rules out immediate refinancing and makes short-term forced collateral sales unattractive.

- Forgiveness of all or part of the outstanding debt - debt may be forgiven or exchanged for equity in cases where a fundamental shift in the customer's business or economic environment means that the customer is incapable of servicing current debt obligations and other forms of renegotiations are unlikely to succeed in isolation. Debt forgiveness is often an element in leveraged finance transactions, which are typically structured on the basis of projected cash flows from operational activities, rather than underlying tangible asset values. Provided that the underlying business model and strategy are considered viable, maintaining the business as a going concern with a sustainable level of debt is the preferred option, rather than realising the value of the underlying assets.

In addition, the Group may offer a temporary covenant waiver, a recalibration of covenants and/or a covenant amendment to cure a potential or actual covenant breach. Such relief is usually granted in exchange for fees, increased margin, additional security, or a reduction in maturity profile of the original loan. These financial covenant concessions are monitored internally, but are not included in the renegotiated loans data (when this is the sole concession granted to a customer) as we believe that such concessions are qualitatively different from other renegotiations: The loan's payment terms are unchanged. Covenant concessions provide an early warning indicator rather than firm evidence of a significant deterioration in credit quality.

The impact on the credit quality of any change in terms and conditions of a loan is assessed at the time of granting such changes, and the appropriateness of the credit metrics reviewed at such time. For performing counterparties,

credit metrics are an integral part of the latent provision methodology and therefore the impact of covenant concessions will be reflected in the latent provision. For non-performing counterparties, covenant concessions will be considered in the overall provision adequacy for these loans.

Covenant waivers and amendments are predominantly undertaken prior to transfer to GRG. The vast majority of the other types of renegotiations undertaken by the Group take place within GRG. Forgiveness of debt and exchange for equity is only available to customers in GRG.

Loans may be renegotiated more than once, generally where a temporary concession has been granted and circumstances warrant another temporary or permanent revision of the loan’s terms. Where renegotiation is no longer viable, the Group will consider other options such as the enforcement of security and or insolvency proceedings.

Early problem identification and problem debt management: Wholesale renegotiations continued

The data presented in the tables below include loans renegotiated during 2011 and 2012 which individually exceed thresholds set at divisional level, ranging from nil to £10 million. This population captures approximately 68% of that proportion of the wholesale portfolio which is either on Watchlist or under GRG stewardship. We continue to refine our reporting processes relating to renegotiated loans and as part of the 2012 review, the amounts in-progress and completed renegotiations relating to 2011 have been revised.

Wholesale renegotiations

The table below shows the value of loans (excluding loans where the Group has initiated recovery procedures) where renegotiations were completed during the year by sector and renegotiation types.

	2012			2011 - Revised		
Wholesale renegotiations during the year by sector	Performing £m	Non-performing £m	Non-performing provision coverage %	Performing £m	Non-performing £m	Non-performing provision coverage %
Property	1,954	3,288	18	2,166	3,215	25
Transport	832	99	23	771	670	10
Telecommunications, media and technology	237	341	46	57	33	30
Retail and leisure	487	111	34	331	433	10
Other (1)	792	245	28	893	792	42
Total	4,302	4,084	22	4,218	5,143	25

Note:
(1) SME business within Wealth is now reported within Wholesale forbearance.

Renegotiation agreements

The table below analyses the incidence of the main types of renegotiation by loan value:

	Loans by value	
Arrangement type	2012 %	Revised 2011 %
Variation in margin	9	12
Payment concessions and loan rescheduling	69	92
Forgiveness of all or part of the outstanding debt	29	33
Other (2)	20	9

Notes:
(1) The total above exceeds 100% as an individual case can involve more than one type of arrangement.
(2) Main types of “other” concessions include formal “standstill” agreements, release of security and amendments to negative pledge. 2012 saw the completion of a small number of material standstill agreements, accounting for the higher proportion of the “Other” modification type.

Key points

- Renegotiations completed during 2012, subject to thresholds as explained above, were £8.4 billion (2011 - £9.4 billion). The volume of renegotiations continues at a high level as difficult economic conditions persist in the UK and Ireland, particularly in real estate markets and the Group continues its active problem debt management. Renegotiations are likely to remain significant: at 31 December 2012 loans totalling £13.7 billion (2011 - £11.7 billion) were in the process of being renegotiated but had not yet reached legal completion (these loans are not included in the tables above). Of these 69% were non-performing loans, with an associated provision coverage of 32%, and 31% were performing loans. The principal types of arrangements being offered include variation in margin, payment concessions and loan rescheduling and forgiveness of all or part of the outstanding debt

- Loans renegotiated during 2011 and 2012 outstanding at 31 December 2012 were £17.7 billion, of which £9.3 billion relates to arrangements completed during 2011.

- Additional provisions charged in 2012 relating to loans renegotiated during 2011 totalled £0.2 billion and provision coverage of those loans at 31 December 2012 was 25%.

- Of the loans renegotiated by GRG during 2011 and 2012 (£14.5 billion), 6% had been returned to performing portfolios managed by the business by 31 December 2012.

- Renegotiated loans disclosed in the table above may have been the subject of one or more covenant waivers or modifications. In addition loans totalling £3.5 billion granted financial covenant concessions only during the year are not included in the table above as these concessions do not affect a loan’s contractual cash flows.

- Year-on-year analysis of renegotiated loans may be skewed by individual material cases reaching legal completion during a given year. This is particularly relevant when comparing the value of renegotiations completed in the property and transport sectors in 2012 with previous years.

Key points continued

- In 2012 renegotiations were more prevalent in the Group's most significant corporate sectors and in those industries experiencing difficult markets, notably property and transport as the Group seeks to support viable customers. The majority of renegotiations granted to borrowers in the property sector were payment concessions and loan rescheduling. During 2012 there has been an increase in the number of renegotiations in the shipping sector as poor economic conditions persist.

- 84% of 'completed' and 93% of 'in progress' renegotiated cases were managed by GRG.

- Provisions for the non-performing loans disclosed above are individually assessed and renegotiations are taken into account when determining the level of provision. The provision coverage is affected by the timing of write-offs and provisions. In some cases loans are fully or partially written off on the completion of a renegotiation. Non-performing renegotiated loans also include loans against which no provision is held and where these cases are large they can have a significant impact on the provision coverage within a specific sector.

Provisioning for wholesale renegotiated customers

Wholesale renegotiations are predominantly individually assessed and are not therefore segregated into a separate risk pool.

Provisions for renegotiated wholesale loans are assessed in accordance with the Group's normal provisioning policies (refer to Impairment loss provision methodology on page 138). For the non-performing population, provisions on exposures greater than £1 million are individually assessed by GRG. The provision required is calculated based on the difference between the debt outstanding and the present value of the estimated future cash flows. Exposures smaller than £1 million are deemed not to be individually significant and are assessed collectively by the originating division. Within the performing book, latent loss provisions are held for those losses that are incurred, but not yet identified.

Any one of the above types of renegotiation may result in the value of the outstanding debt exceeding the present value of the estimated future cash flows from the renegotiated loan resulting in the recognition of an impairment loss. Renegotiations that include forgiveness of all or part of the outstanding debt account for the majority of such cases. The customer's financial position, anticipated prospects and the likely effect of the renegotiation, including any concessions granted, are considered in order to establish whether an impairment provision is required.

In the case of non-performing loans that are renegotiated, the loan impairment provision assessment almost invariably takes place prior to the renegotiation. The quantum of the loan impairment provision may change once the terms of the renegotiation are known, resulting in an additional provision charge or a release of the provision in the period the renegotiation takes place.

The transfer of renegotiated wholesale loans from impaired to performing status follows assessment by relationship managers in GRG. When no further losses are anticipated and the customer is expected to meet the loan's revised terms, any provision is written off and the balance of the loan returned to performing status.

Performing loans that are renegotiated will be included in the calculation of the latent loss provisions. To the extent that the renegotiation event has affected the customer's estimated probably of default or loss given default, this will be reflected in the underlying calculation.

Recoveries and active insolvency management

The ultimate outcome of a renegotiation strategy is unknown at the time of execution. It is highly dependent on the cooperation of the borrower and the continued existence of a viable business. The following are generally considered to be options of last resort:

- Enforcement of security or otherwise taking control of assets - Where the Group holds collateral or other security interest and is entitled to enforce its rights, it may take ownership or control of the assets. The Group's preferred strategy is to consider other possible options prior to exercising these rights.

- Insolvency - Where there is no suitable renegotiation option or the business is no longer regarded as sustainable, insolvency will be considered. Insolvency may be the only option that ensures that the assets of the business are properly and efficiently distributed to relevant creditors.

Early problem identification and problem debt management: Wholesale renegotiations continued

Retail customers

Collections and recoveries

There are collections functions in each of the retail businesses. Their role is to provide support and assistance to customers who are experiencing difficulties in meeting their financial obligations to the Group. Evidence of such difficulties includes, for example, a missed payment on their loan, or a balance that is in excess of the agreed credit limit. Additionally, in UK Retail and Ulster Bank, a dedicated support team aims to identify and help customers who may be facing financial difficulty but who are current with their payments.

Within collections, a range of tools is deployed to initiate contact with the customer, establish the cause of their financial difficulty and, aim to support them where possible including the use of a range of forbearance options. If these strategies are unsuccessful, the customer is transferred to the recoveries team.

The goal of the recoveries function is to collect the total amount outstanding and reduce the loss to the Group by maximising the level of cash recovery while treating customers fairly. A range of treatment options are available within recoveries, including litigation. In UK Retail and Ulster Bank, no repossession procedures are initiated until at least six months following the emergence of arrears. In Ulster Bank, new regulations further prohibit taking legal action for an extended period. Additionally, certain forbearance options are made available to customers within recoveries.

Retail forbearance

Within the Group's retail businesses, forbearance generally occurs when the business, for reasons relating to the actual or potential financial stress of a borrower, grants a permanent or temporary concession to that borrower. Forbearance is granted following an assessment of the customer's ability to pay. It is granted principally to customers with mortgages. Granting of forbearance to unsecured customers is less extensive.

Identification of forbearance

Customers are identified for forbearance treatment following initial contact from the customer, in the event of payment arrears or when the customer is transferred to collections or recoveries.

Types of retail forbearance

A number of forbearance options are utilised by the Group's retail businesses. These include, but are not limited to, payment concessions, capitalisations of arrears over the remaining term of the mortgage, extension to the mortgage term and temporary conversions to interest only.

In payment concession arrangements a temporary reduction in, or elimination of, the periodic (usually monthly) loan repayment is agreed with the customer. At the end of the concessionary period, forborne principal and accrued interest outstanding is scheduled for repayment over an agreed period.

For UK Retail, interest only conversions have not been used as a tool to support customers in financial stress since 2009. Following a change to policy in 2012, switching to interest only is no longer permitted for residential mortgage

customers who are up to date on payments. For Ulster Bank, interest only conversions are only offered to customers in financial stress on a temporary basis.

As a result of the economic difficulties in the Republic of Ireland market and responding to regulatory intervention in the Irish mortgage market, Ulster Bank has developed additional treatment options to support customers in overcoming financial difficulties, over an extended period of time.

The principal types of forbearance granted in RBS Citizens' mortgage portfolio are the US government mandated HAMP (Home Affordable Modification Program) and RBS Citizens' proprietary modification programme. Both programmes typically feature a combination of term extensions, capitalisations of arrears, temporary interest rate reductions and conversions from interest only to amortising. These tend to be permanent changes to contractual terms. Borrowers seeking a modification must meet government-specified qualifications for HAMP and internal qualifications for RBS Citizens' modification programme. Both are designed to evidence that the borrower is in financial difficulty as well as demonstrating willingness to pay.

For forbearance loans that are performing, the aim is to enable the customer to continue to service the loan. For forbearance loans classified as non-performing only those for which capitalisation of arrears has been agreed can qualify for return to the performing book. Transfer of such loans takes place currently once the customer has met the revised payment terms for at least six months and is expected to continue to do so.

The mortgage forbearance population is reviewed regularly to ensure that customers are meeting the agreed terms of the arrangement. Key metrics have been developed to record the proportion of customers who fail to meet the agreed terms over time, as well as the proportion of customers who return to a performing state with no arrears.

* unaudited

Business review Risk and balance sheet management continued

Arrears status and provisions

Mortgage arrears information for retail accounts in forbearance and related provision are shown in the tables below.

	No missed payments		1-3 months in arrears		>3 months in arrears		Total		
	Balance	Provision	Balance	Provision	Balance	Provision	Balance	Provision	Forborne balances
	£m	£m	£m	£m	£m	£m	£m	£m	%
2012									
UK Retail (1,2)	4,006	20	388	16	450	64	4,844	100	4.9
Ulster Bank (1,2)	915	100	546	60	527	194	1,988	354	10.4
RBS Citizens (3)	—	—	179	25	160	10	339	35	1.6
Wealth (4)	38	—	—	—	7	—	45	—	0.5
	4,959	120	1,113	101	1,144	268	7,216	489	4.9
2011									
UK Retail (1,2)	3,677	16	351	13	407	59	4,435	88	4.7
Ulster Bank (1,2)	893	78	516	45	421	124	1,830	247	9.1
RBS Citizens (3)	—	—	91	10	89	10	180	20	0.8
Wealth	121	—	—	—	2	—	123	—	1.3
	4,691	94	958	68	919	193	6,568	355	4.4

Notes:
(1) Includes all forbearance arrangements whether relating to the customer's lifestyle changes or financial difficulty.
(2) Includes the current stock position of forbearance deals agreed since early 2008 for UK Retail and early 2009 for Ulster Bank.
(3) Forbearance stock reported at 31 December 2012 now includes home equity loans and lines as well as the residential mortgage portfolio.
(4) SME business within Wealth is now reported within Wholesale forbearance.

Forbearance arrangements

The incidence of the main types of retail forbearance as at 31 December 2012 and 31 December 2011 are analysed below. For a small proportion of mortgages, more than one forbearance type applies.

	UK Retail	Ulster Bank	RBS Citizens (1)	Wealth (2)	Total (3)
2012	£m	£m	£m	£m	£m
Interest only conversions - temporary and permanent	1,220	924	—	6	2,150
Term extensions - capital repayment and interest only	2,271	183	—	27	2,481
Payment concessions	215	762	339	9	1,325
Capitalisation of arrears	932	119	—	—	1,051
Other	452	—	—	3	455
	5,090	1,988	339	45	7,462

2011					
Interest only conversions - temporary and permanent	1,269	795	—	3	2,067
Term extensions - capital repayment and interest only	1,805	58	—	97	1,960
Payment concessions	198	876	180	—	1,254
Capitalisation of arrears	864	101	—	—	965
Other	517	—	—	23	540
	4,653	1,830	180	123	6,786

The table below shows forbearance agreed during 2012 analysed between performing and non-performing.

2012	UK Retail £m	Ulster Bank £m	RBS Citizens (1) £m	Wealth (2) £m	Total (3)
Performing forbearance in the year	1,809	2,111	88	18	4,026
Non-performing forbearance in the year	184	1,009	71	2	1,266
Total forbearance in the year (4)	1,993	3,120	159	20	5,292

Notes:

(1) Forbearance stock reported at 31 December 2012 now includes home equity loans and lines as well as the residential mortgage portfolio.

(2) SME business within Wealth is now reported within Wholesale forbearance.

(3) As an individual case can include more than one type of arrangement, the analysis in the table on forbearance arrangements exceeds the total value of cases subject to forbearance.

(4) Includes all deals agreed during the year (new customers and renewals) regardless of whether they remain active at the year end.

Early problem identification and problem debt management: Retail customers continued

Key points

UK Retail

- The reported numbers for forbearance in UK Retail capture all instances where a change has been made to the contractual payment terms including those where the customer is up-to-date on payments and there is no obvious evidence of financial stress. The reported figures include stock dating back to 1 January 2008.

- At 31 December 2012, stock levels of £4.8 billion represent 4.9% of the total mortgage assets; this represents a 9.2% increase in forbearance stock since 31 December 2011. Of these, approximately 83% were up-to-date with payments (compared with approximately 97% of the mortgage population not subject to forbearance activity). The flow of forbearance arrangements has remained stable year on year.

- The most frequently occurring forbearance types were term extensions (47% of assets subject to forbearance at 31 December 2012), interest only conversions (25%) and capitalisations of arrears (19%). The stock of cases subject to interest only conversions reflects legacy policy. In 2009, UK Retail ceased providing this type of forbearance treatment for customers in financial difficulty and no longer permits interest only conversions on residential mortgages where the customer is current on payments.

- The provision cover on performing assets subject to forbearance was about five times that on assets not subject to forbearance.

Ulster Bank

- The reported numbers for forbearance in Ulster Bank Group capture all instances where a change has been made to the contractual payment terms including those where the customer is up-to-date on payments and there is no obvious evidence of financial stress. The reported figures include stock dating back to early 2009.

- Ulster Bank Group continues to assist customers in the difficult economic environment. Mortgage forbearance treatments have been in place since 2009 and are aimed at assisting customers in financial difficulty. At 31 December 2012, 10.4% of total mortgage assets (£1.9 billion) were subject to a forbearance arrangement, an increase from 9.1% (£1.8 billion) at 31 December 2011. The majority of these forbearance arrangements were in the performing book (73%).

- The majority of forbearance arrangements offered by Ulster Bank currently are temporary concessions, accounting for 85% of assets subject to forbearance at 31 December 2012. These are offered for periods of one to three years and incorporate different levels of repayment based on the customer’s ability to pay. The additional treatment options developed by Ulster Retail will lead to a shift to more long term arrangements over time.

- Of these temporary forbearance types, the largest category at 31 December 2012 was interest only conversions, which accounted for 46% of total assets subject to forbearance. The other categories of temporary forbearance were payment concessions: reduced repayments (36%); and payment holidays (3%).

- The flow by forbearance type remained stable when compared with 2011 and there was a modest reduction, 3%, in customers seeking assistance for the first time year on year.

- The provision cover on performing assets subject to forbearance is approximately eight times higher than that on performing assets not subject to forbearance.

Unsecured portfolios

For unsecured portfolios in UK Retail and Ulster Bank, forbearance treatments comprise either debt consolidation loans provided to customers subject to collections activity who do not meet the Group's standard underwriting criteria, longer-term financial hardship plans, or repayment arrangements to facilitate the repayment of overdraft excesses. Additionally, support is provided to customers experiencing financial difficulties through breathing space initiatives on all unsecured products, including credit cards, whereby the Group suspends collections activity for a 30-day period to allow customers to establish a debt repayment plan. Arrears continue to accrue for customer loans benefiting from breathing space.

- For unsecured portfolios in UK Retail, £162 million of balances (1.1% of the total unsecured balances) were subject to forbearance at 2012 year end.

- For unsecured portfolios in Ulster Bank, £20 million (3.4% by value) of the population was subject to forbearance at 31 December 2012.

Within RBS Citizens, granting of forbearance is significantly less extensive for non real-estate portfolios, as it is predominantly restricted to the granting of short-term (1-3 months) loan extensions to customers to alleviate the financial burden caused by temporary hardship. Such extensions are offered only if a customer has demonstrated a capacity and willingness to pay following the extension term. The number and frequency of extensions available to a given customer are limited per customer. Additionally, in the case of loans secured by vehicles and credit cards, RBS Citizens may offer temporary interest rate modifications, but no principal reduction. RBS Citizens may also provide forbearance to student loan borrowers consistent with the policy guidelines of the US Office of the Comptroller of the Currency.

Provisioning for retail customers

Provisions are assessed in accordance with the Group's provisioning policies.

The majority of retail forbearance takes place in the performing book and, for the purposes of the latent loss provisions, these constitute a separate risk pool. They are subject to higher provisioning rates than the remainder of the performing book. These rates are reviewed regularly in both divisions. Once forbearance is granted, the account continues to be assessed separately for latent provisioning for 24 months (UK Retail only) or until the forbearance period expires. After that point, the account is no longer separately identified for latent provisioning. In the non-performing portfolio, assets are grouped into homogeneous portfolios sharing similar credit characteristics according to the asset type. Further characteristics such as LTVs, arrears status and default vintage are also considered when assessing recoverable amount and calculating the related provision requirement. Whilst non-performing forbearance retail loans do not form a separate risk pool, the LGD models used to calculate the collective impairment provision will be affected by agreements made under forbearance arrangements.

In RBS Citizens, consumer loans subject to forbearance are segmented from the rest of the non-forborne population and assessed individually for impairment loan throughout their lives until the accounts are repaid or fully written-off. The amount of recorded impairment depends upon whether the loan is collateral dependent. If the loans are considered collateral dependent, the excess of the loan's carrying amount over the fair value of the collateral is the impairment amount. If the loan is not deemed collateral dependent, the excess of the loans' carrying amount over the present value of expected future cash flows is the impairment amount. Any confirmed losses are charged off immediately.

Impairment loss provision methodology

A financial asset or portfolio of financial assets is impaired and an impairment loss incurred if there is objective evidence that an event or events since initial recognition of the asset has adversely affected the amount or timing of future cash flows from the asset.

For retail loans, which are segmented into collective, homogenous portfolios, time-based measures, such as days past due, are typically used as evidence of impairment. For these portfolios, the Group recognises an impairment at 90 days past due.

For corporate portfolios, given their complexity and nature, the Group relies not only on time-based measures, but also on management judgement to identify evidence of impairment. Other factors considered may include: significant financial difficulty of the borrower; a breach of contract; a loan restructuring; a probable bankruptcy; and any observable data indicating a measurable decrease in estimated future cash flows.

Early problem identification and problem debt management: Impairment loss provision methodology continued

Depending on various factors as explained below, the Group uses one of the following three different methods to assess the amount of provision required: individual; collective; and latent.

- Individually assessed provisions - Provisions required for individually significant impaired assets are assessed on a case-by-case basis. If there is objective evidence that an impairment loss has been incurred, the amount of the loss is measured as the difference between the assets carrying amount and the present value of the estimated future cash flows discounted at the financial asset's original effective interest rate. Future cash flows are estimated through a case-by-case analysis of individually assessed assets.

  This assessment takes into account the benefit of any guarantees or other collateral held. The value and timing of cash flow receipts are based on available estimates in conjunction with facts available at that time. Timings and amounts of cash flows are reviewed on subsequent assessment dates, as new information becomes available. The asset continues to be assessed on an individual basis until it is repaid in full, transferred to the performing portfolio or written-off.

- Collectively assessed provisions - Provisions on impaired credits below an agreed threshold are assessed on a portfolio basis to reflect the homogeneous nature of the assets. The Group segments impaired credits in its collectively assessed portfolios according to asset type, such as credit cards, personal loans, mortgages and smaller homogenous wholesale portfolios, such as business or commercial banking. A further distinction is made between those impaired assets in collections and those in recoveries (refer to Problem debt management on page 131 for a discussion of the collections and recoveries functions).

  The provision is determined based on a quantitative review of the relevant portfolio, taking account of the level of arrears, the value of any security, historical and projected cash recovery trends over the recovery period. The provision also incorporates any adjustments that may be deemed appropriate given current economic and credit conditions. Such adjustments may be determined based on: a review of the current cash collections profile performance against historical trends; updates to metric inputs, including model recalibrations; and monitoring of operational processes used in managing exposures, including the time taken to process non-performing exposures.

- Latent loss provisions - A separate approach is taken for provisions held against impairments in the performing portfolio that have been incurred as a result of events occurring before the balance sheet date but which have not been identified at the balance sheet date.

The Group's methodologies to estimate latent loss provisions reflect:

- the probability that the performing customer will default - historical loss experience, adjusted, where appropriate, to take into account current economic and credit conditions; and

- the emergence period, defined as the period between an impairment event occurring and a loan being identified and reported as impaired.

Emergence periods are estimated at a portfolio level and reflect the portfolio product characteristics such as the repayment terms and the duration of the loss mitigation and recovery processes. They are based on internal systems and processes within the particular portfolio and are reviewed regularly.

Refer to pages 183 to 199 for analysis of impaired loans, related provisions and impairments.

* unaudited

Business review Risk and balance sheet management continued

Key credit portfolios*

Commercial real estate

The commercial real estate lending portfolio totalled £63.0 billion at 31 December 2012, an £11.8 billion or 16% decrease over the year and £24.4 billion or 28% decrease in the last two years. The commercial real estate sector comprises exposures to entities involved in the development of, or investment in, commercial and residential properties (including housebuilders). The analysis of lending utilisations below excludes rate risk management and contingent obligations.

	2012			2011			2010		
	Investment	Development	Total	Investment	Development	Total	Investment	Development	Total
By division (1)	£m	£m	£m	£m	£m	£m	£m	£m	£m
Core									
UK Corporate	22,504	4,091	26,595	25,101	5,023	30,124	24,879	5,819	30,698
Ulster Bank	3,575	729	4,304	3,882	881	4,763	4,284	1,090	5,374
US Retail & Commercial	3,857	3	3,860	4,235	70	4,305	4,322	93	4,415
International Banking	849	315	1,164	872	299	1,171	940	369	1,309
Markets	630	57	687	141	61	202	191	275	466
	31,415	5,195	36,610	34,231	6,334	40,565	34,616	7,646	42,262
Non-Core									
UK Corporate	2,651	983	3,634	3,957	2,020	5,977	7,591	3,263	10,854
Ulster Bank	3,383	7,607	10,990	3,860	8,490	12,350	3,854	8,760	12,614
US Retail & Commercial	392	—	392	901	28	929	1,325	70	1,395
International Banking	11,260	154	11,414	14,689	336	15,025	19,906	379	20,285
	17,686	8,744	26,430	23,407	10,874	34,281	32,676	12,472	45,148
Total	49,101	13,939	63,040	57,638	17,208	74,846	67,292	20,118	87,410

	Investment		Development			Investment		Development		
By geography (1)	Commercial £m	Residential £m	Commercial £m	Residential £m	Total £m	Core £m	Non-Core £m	Core £m	Non-Core £m	Total £m
2012										
UK (excluding NI) (2)	25,864	5,567	839	4,777	37,047	23,312	8,119	4,184	1,432	37,047
Ireland (ROI and NI) (2)	4,651	989	2,234	5,712	13,586	2,877	2,763	665	7,281	13,586
Western Europe (other)	5,995	370	22	33	6,420	403	5,962	24	31	6,420
US	4,230	981	—	15	5,226	4,629	582	15	—	5,226

RoW	454	—	65	242	761	194	260	307	—	761
	41,194	7,907	3,160	10,779	63,040	31,415	17,686	5,195	8,744	63,040
2011										
UK (excluding NI) (2)	28,653	6,359	1,198	6,511	42,721	25,904	9,108	5,118	2,591	42,721
Ireland (ROI and NI) (2)	5,146	1,132	2,591	6,317	15,186	3,157	3,121	793	8,115	15,186
Western Europe (other)	7,649	1,048	9	52	8,758	422	8,275	20	41	8,758
US	5,552	1,279	59	46	6,936	4,521	2,310	71	34	6,936
RoW	785	35	141	284	1,245	227	593	332	93	1,245
	47,785	9,853	3,998	13,210	74,846	34,231	23,407	6,334	10,874	74,846
2010										
UK (excluding NI) (2)	32,334	7,255	1,520	8,288	49,397	26,168	13,421	5,997	3,811	49,397
Ireland (ROI and NI) (2)	5,056	1,148	2,785	6,578	15,567	3,160	3,044	962	8,401	15,567
Western Europe (other)	10,568	643	25	42	11,278	409	10,802	25	42	11,278
US	7,345	1,296	69	175	8,885	4,636	4,005	173	71	8,885
RoW	1,622	25	138	498	2,283	243	1,404	489	147	2,283
	56,925	10,367	4,537	15,581	87,410	34,616	32,676	7,646	12,472	87,410

For the notes to this table refer to the following page.

* unaudited

Business review Risk and balance sheet management continued

Key credit portfolios*: Commercial real estate continued

By sub-sector (1)	UK (excl NI) (2) £m	Ireland (ROI and NI) (2) £m	Western Europe (other) £m	US £m	RoW (2) £m	Total £m
2012						
Residential	10,344	6,701	403	996	242	18,686
Office	6,112	1,132	1,851	99	176	9,370
Retail	7,529	1,492	1,450	117	129	10,717
Industrial	3,550	476	143	4	39	4,212
Mixed/other	9,512	3,785	2,573	4,010	175	20,055
	37,047	13,586	6,420	5,226	761	63,040
2011						
Residential	12,870	7,449	1,100	1,325	319	23,063
Office	7,155	1,354	2,246	404	352	11,511
Retail	8,709	1,641	1,891	285	275	12,801
Industrial	4,317	507	520	24	105	5,473
Mixed/other	9,670	4,235	3,001	4,898	194	21,998
	42,721	15,186	8,758	6,936	1,245	74,846
2010						
Residential	15,543	7,726	685	1,471	523	25,948
Office	8,539	1,178	2,878	663	891	14,149
Retail	10,607	1,668	1,888	1,025	479	15,667
Industrial	4,912	515	711	80	106	6,324
Mixed/other	9,796	4,480	5,116	5,646	284	25,322
	49,397	15,567	11,278	8,885	2,283	87,410

Notes:

(1) Excludes commercial real estate lending in Wealth as these loans are generally supported by personal guarantees in addition to collateral. This portfolio, which totalled £1.4 billion at 31 December 2012 (2011 - £1.3 billion) continues to perform in line with expectations and requires minimal provisions.

(2) ROI: Republic of Ireland; NI: Northern Ireland; RoW: rest of world.

Key points

- In line with the Group’s strategy, the overall exposure to commercial real estate fell during 2012, across all geographies. The overall mix in terms of geography, sub-sector and investment versus development remained broadly unchanged.

- Most of the decrease was in Non-Core and was due to repayments, asset sales, and write-offs. The Non-Core portfolio totalled £26.4 billion (42% of the portfolio) at 31 December 2012 (2011 - £34.3 billion or 46% of the portfolio).

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The growth in Markets was caused by an increase in the inventory of US commercial real estate loans earmarked for securitisation as commercial mortgage-backed securities (CMBS). CMBS warehouse activity is tightly controlled with limits on maximum portfolio size and holding period, and marked-to-market on a daily basis.

- With the exception of exposure in Spain and Ireland, the Group had minimal commercial real estate exposure in the peripheral eurozone countries. Exposure in Spain was predominantly in the Non-Core portfolio and totalled £1.6 billion (2011 - £2.3 billion), of which 31% (2011 - 55%) was in default. The majority of the portfolio is managed by GRG. The Spanish portfolio has already been subject to material provisions, which are regularly assessed by reference to re-appraised asset values. Asset values vary significantly by type and geographic location. Refer to the Ulster Bank Group (Core and Non-Core) section on page 151 for details on the exposure in Ireland.

- The UK portfolio is focused on London and the South East at approximately 43% in 2012 (2011 - 44%) with the remainder spread across other UK Regions.

- Speculative lending, defined by the Group as short-term lending to property developers without sufficient pre-let revenue at origination to support investment financing after practical completion, represented less than 1% of the portfolio at 31 December 2012. The Group’s appetite for originating speculative commercial real estate lending is very limited and any such business requires senior management approval.

- The commercial real estate sector is expected to remain challenging in key markets and new business will be accommodated from run-off of existing Core exposure. Over £5.5 billion of loans in UK Corporate (Core and Non-Core) have been repaid over the last 12 months whilst the risk profile of the remaining performing book has remained relatively unchanged.

* unaudited

Business review Risk and balance sheet management continued

Maturity profile of portfolio	UK Corporate £m	Ulster Bank £m	US Retail & Commercial £m	International Banking £m	Markets £m	Total £m
2012						
Core						
< 1 year (1)	8,639	3,000	797	216	59	12,711
1-2 years	3,999	284	801	283	130	5,497
2-3 years	3,817	215	667	505	—	5,204
> 3 years	9,597	805	1,595	160	498	12,655
Not classified (2)	543	—	—	—	—	543
Total	26,595	4,304	3,860	1,164	687	36,610
Non-Core						
< 1 year (1)	2,071	9,498	138	4,628	—	16,335
1-2 years	192	1,240	79	3,714	—	5,225
2-3 years	99	38	43	1,137	—	1,317
> 3 years	1,058	214	132	1,935	—	3,339
Not classified (2)	214	—	—	—	—	214
Total	3,634	10,990	392	11,414	—	26,430
2011						
Core						
< 1 year (1)	8,268	3,030	1,056	142	—	12,496
1-2 years	5,187	391	638	218	60	6,494
2-3 years	3,587	117	765	230	133	4,832
> 3 years	10,871	1,225	1,846	581	9	14,532
Not classified (2)	2,211	—	—	—	—	2,211
Total	30,124	4,763	4,305	1,171	202	40,565
Non-Core						
< 1 year (1)	3,224	11,089	293	7,093	—	21,699
1-2 years	508	692	163	3,064	—	4,427
2-3 years	312	177	152	1,738	—	2,379
> 3 years	1,636	392	321	3,126	—	5,475
Not classified (2)	297	—	—	4	—	301
Total	5,977	12,350	929	15,025	—	34,281
2010						
Core						
< 1 year (1)	7,563	2,719	1,303	448	442	12,475
1-2 years	5,154	829	766	223	24	6,996
2-3 years	4,698	541	751	221	—	6,211
> 3 years	10,361	1,285	1,595	417	—	13,658
Not classified (2)	2,922	—	—	—	—	2,922
Total	30,698	5,374	4,415	1,309	466	42,262

Non-Core						
< 1 year (1)	4,829	10,809	501	3,887	—	20,026
1-2 years	1,727	983	109	6,178	—	8,997
2-3 years	831	128	218	3,967	—	5,144
> 3 years	2,904	694	567	6,253	—	10,418
Not classified (2)	563	—	—	—	—	563
Total	10,854	12,614	1,395	20,285	—	45,148

Notes:
(1) Includes on demand and past due assets.
(2) Predominantly comprises overdrafts and multi-option facilities for which there is no single maturity date.

* unaudited

Business review Risk and balance sheet management continued

Key credit portfolios*: Commercial real estate continued

Key points

- The overall maturity profile has remained relatively unchanged over the last 12 months.

- Non-Core exposure maturing in under 1 year has reduced from £21.7 billion in 2011 to £16.3 billion in 2012.

- The majority of Ulster Bank's commercial real estate portfolio was categorised as under 1 year, owing to the high level of non-performing assets in the portfolio as Ulster Bank includes most renegotiated facilities as on demand.

- Refinancing risk remains a focus of management attention and is assessed throughout the credit risk management lifecycle.

Portfolio by asset quality (AQ) band	AQ1-AQ2 £m	AQ3-AQ4 £m	AQ5-AQ6 £m	AQ7-AQ8 £m	AQ9 £m	AQ10 £m	Total £m
2012							
Core	767	6,011	16,592	6,575	1,283	5,382	36,610
Non-Core	177	578	3,680	3,200	1,029	17,766	26,430
	944	6,589	20,272	9,775	2,312	23,148	63,040
2011							
Core	1,094	6,714	19,054	6,254	3,111	4,338	40,565
Non-Core	680	1,287	5,951	3,893	2,385	20,085	34,281
	1,774	8,001	25,005	10,147	5,496	24,423	74,846
2010							
Core	1,055	7,087	20,588	7,829	2,171	3,532	42,262
Non-Core	1,003	2,694	11,249	7,608	4,105	18,489	45,148
	2,058	9,781	31,837	15,437	6,276	22,021	87,410

Key points

- There has been an overall decrease in AQ10 during the year with reductions in Non-Core partially offset by increases in Ulster Bank and UK Corporate. The increase in defaulted exposure in UK Corporate is a result of a small number of significant individual cases. The high proportion of the portfolio in the AQ10 band was driven by exposures in Non-Core (Ulster Bank and International Banking) and Core (Ulster Bank).

- Of the total portfolio of £63.0 billion at 31 December 2012, £28.1 billion (2011 - £34.7 billion) was managed within the Group's standard credit processes and £5.1 billion (2011 - £5.9 billion) was receiving varying degrees of heightened credit management under the Group's Watchlist process. A further £29.8 billion (2011 - £34.3 billion) was managed within GRG and included Watchlist and non-performing exposures. The decrease in the portfolio managed by GRG was driven by Non-Core reductions.

* unaudited

Business review Risk and balance sheet management continued

The table below analyses commercial real estate (Core and Non-Core) lending by loan-to-value (LTV) which represents loan value before provisions. Due to market conditions in Ireland and to a lesser extent in the UK, there is a shortage of market-based data. In the absence of external valuations, the Group deploys a range of alternative approaches to assess property values, including internal expert judgement and indexation.

	Ulster Bank			Rest of the Group			Group		
	Performing	Non-performing	Total	Performing	Non-performing	Total	Performing	Non-performing	Total
Loan-to-value	£m	£m	£m	£m	£m	£m	£m	£m	£m
2012									
<= 50%	183	24	207	7,210	281	7,491	7,393	305	7,698
> 50% and <= 70%	326	102	428	12,161	996	13,157	12,487	1,098	13,585
> 70% and <= 90%	462	250	712	6,438	1,042	7,480	6,900	1,292	8,192
> 90% and <= 100%	466	141	607	1,542	2,145	3,687	2,008	2,286	4,294
> 100% and <= 110%	103	596	699	1,019	1,449	2,468	1,122	2,045	3,167
> 110% and <= 130%	326	630	956	901	1,069	1,970	1,227	1,699	2,926
> 130% and <= 150%	274	878	1,152	322	913	1,235	596	1,791	2,387
> 150%	963	7,290	8,253	595	1,962	2,557	1,558	9,252	10,810
Total with LTVs	3,103	9,911	13,014	30,188	9,857	40,045	33,291	19,768	53,059
Minimal security (1)	7	1,461	1,468	3	13	16	10	1,474	1,484
Other (2)	97	715	812	6,494	1,191	7,685	6,591	1,906	8,497
Total	3,207	12,087	15,294	36,685	11,061	47,746	39,892	23,148	63,040
Total portfolio average LTV (3)	131%	286%	249%	65%	125%	80%	71%	206%	122%
2011									
<= 50%	272	32	304	7,091	332	7,423	7,363	364	7,727
> 50% and <= 70%	479	127	606	14,105	984	15,089	14,584	1,111	15,695
> 70% and <= 90%	808	332	1,140	10,042	1,191	11,233	10,850	1,523	12,373
> 90% and <= 100%	438	201	639	2,616	1,679	4,295	3,054	1,880	4,934
> 100% and <= 110%	474	390	864	1,524	1,928	3,452	1,998	2,318	4,316
> 110% and <= 130%	527	1,101	1,628	698	1,039	1,737	1,225	2,140	3,365
> 130% and <= 150%	506	1,066	1,572	239	912	1,151	745	1,978	2,723
> 150%	912	7,472	8,384	433	2,082	2,515	1,345	9,554	10,899
Total with LTVs	4,416	10,721	15,137	36,748	10,147	46,895	41,164	20,868	62,032
Minimal security (1)	72	1,086	1,158	—	—	—	72	1,086	1,158
Other (2)	193	625	818	8,994	1,844	10,838	9,187	2,469	11,656
Total	4,681	12,432	17,113	45,742	11,991	57,733	50,423	24,423	74,846
Total portfolio average LTV (3)	120%	264%	222%	69%	129%	82%	75%	203%	116%

Notes:
(1)

In 2012, the Group reclassified loans with limited or non-physical security (defined as LTV>1,000%) as minimal security, for which a majority are commercial real estate development loans in Ulster Bank. Total portfolio average LTV is quoted net of loans with minimal security given that the anticipated recovery rate is less than 10%. Provisions are marked against these loans where required to reflect asset quality and recovery profile. 2011 presentation has been revised.

(2) Other performing loans of £6.6 billion (2011 - £9.2 billion) include general corporate lending, typically unsecured, to commercial real estate companies, and major UK housebuilders. The credit quality of these exposures is consistent with that of the performing portfolio overall. Other non-performing loans of £1.9 billion (2011 - £2.5 billion) are subject to the Group's standard provisioning policies.

(3) Weighted average by exposure.

Key points

- 81% of the commercial real estate portfolio categorised as LTV > 100% was in Ulster Bank Group (Core - 15%; Non-Core - 43%) and International Banking (Non-Core - 23%). A majority of the portfolios are managed within GRG and are subject to review at least quarterly. Significant levels of provisions have been taken against these portfolios. Provisions as a percentage of REIL for the Ulster Bank Group commercial real estate portfolio were 58% at 31 December 2012 (2011 - 53%).

- The average interest coverage ratios for UK Corporate (Core and Non-Core) and International Banking (Non-Core) were 2.96x and 1.30x respectively, at 31 December 2012 (2011 - 2.71x and 1.25x, respectively). The US Retail & Commercial portfolio is managed on the basis of debt service coverage, which includes scheduled principal amortisation. The average debt service coverage for this portfolio was 1.34x at 31 December 2012 (2011 - 1.24x). As a number of different approaches are used within the Group and across geographies to calculate interest coverage ratios, they may not be comparable for different portfolio types and organisations.

Key credit portfolios* continued

Residential mortgages

The majority of the Group's secured lending exposures were in the UK, Ireland and the US. The analysis below includes both Core and Non-Core.

	2012	2011	2010
	£m	£m	£m
UK Retail	99,062	96,388	92,592
Ulster Bank	19,162	20,020	21,162
RBS Citizens (1)	21,538	24,153	25,028
	139,762	140,561	138,782

Note:

(1) 2011 and 2010 have been revised to include the legacy serviced by others portfolio.

The table below shows LTVs for the Group's residential mortgage portfolio split between performing (AQ1-AQ9) and non-performing (AQ10), with the average calculated on a weighted value basis. Loan balances are as at the end of the year whereas property values are calculated using property index movements since the last formal valuation (refer to page 129 for details).

	UK Retail			Ulster Bank			RBS Citizens (1)		
	Performing	Non-performing	Total	Performing	Non-performing	Total	Performing	Non-performing	Total
Loan-to-value	£m	£m	£m	£m	£m	£m	£m	£m	£m
2012									
<= 50%	22,306	327	22,633	2,182	274	2,456	4,167	51	4,218
> 50% and <= 70%	27,408	457	27,865	1,635	197	1,832	4,806	76	4,882
> 70% and <= 90%	34,002	767	34,769	2,019	294	2,313	6,461	114	6,575
> 90% and <= 100%	7,073	366	7,439	1,119	156	1,275	2,011	57	2,068
> 100% and <= 110%	3,301	290	3,591	1,239	174	1,413	1,280	43	1,323
> 110% and <= 130%	1,919	239	2,158	2,412	397	2,809	1,263	42	1,305
> 130% and <= 150%	83	26	109	2,144	474	2,618	463	14	477
> 150%	—	—	—	3,156	1,290	4,446	365	14	379
Total with LTVs	96,092	2,472	98,564	15,906	3,256	19,162	20,816	411	21,227
Other (2)	486	12	498	—	—	—	292	19	311
Total	96,578	2,484	99,062	15,906	3,256	19,162	21,108	430	21,538
Total portfolio average LTV (3)	66%	80%	67%	108%	132%	112%	75%	86%	75%
			65%			74%			64%

Average LTV on new originations during the year

2011									
<= 50%	21,537	285	21,822	2,568	222	2,790	4,745	49	4,794
> 50% and <= 70%	25,598	390	25,988	1,877	157	2,034	4,713	78	4,791
> 70% and <= 90%	33,738	671	34,409	2,280	223	2,503	6,893	125	7,018
> 90% and <= 100%	7,365	343	7,708	1,377	128	1,505	2,352	66	2,418
> 100% and <= 110%	3,817	276	4,093	1,462	130	1,592	1,517	53	1,570
> 110% and <= 130%	1,514	199	1,713	2,752	322	3,074	1,536	53	1,589
> 130% and <= 150%	60	15	75	2,607	369	2,976	626	28	654
> 150%	—	—	—	2,798	748	3,546	588	27	615
Total with LTVs	93,629	2,179	95,808	17,721	2,299	20,020	22,970	479	23,449
Other (2)	567	13	580	—	—	—	681	23	704
Total	94,196	2,192	96,388	17,721	2,299	20,020	23,651	502	24,153
Total portfolio average LTV (3)	67%	80%	67%	104%	125%	106%	76%	91%	77%
Average LTV on new originations during the year			63%			74%			63%

For the notes to this table refer to the following page.

* unaudited

Business review Risk and balance sheet management continued

	UK Retail			Ulster Bank			RBS Citizens (1)		
	Performing	Non-performing	Total	Performing	Non-performing	Total	Performing	Non-performing	Total
2010	£m	£m	£m	£m	£m	£m	£m	£m	£m
<= 50%	19,568	246	19,814	3,385	186	3,571	5,193	45	5,238
> 50% and <= 70%	24,363	345	24,708	2,534	152	2,686	4,902	79	4,981
> 70% and <= 90%	31,711	588	32,299	3,113	179	3,292	7,029	137	7,166
> 90% and <= 100%	7,998	319	8,317	1,958	121	2,079	2,459	67	2,526
> 100% and <= 110%	4,083	260	4,343	2,049	137	2,186	1,534	53	1,587
> 110% and <= 130%	1,722	202	1,924	4,033	358	4,391	1,425	61	1,486
> 130% and <= 150%	57	16	73	2,174	297	2,471	599	28	627
> 150%	—	—	—	355	131	486	589	36	625
Total with LTVs	89,502	1,976	91,478	19,601	1,561	21,162	23,730	506	24,236
Other (2)	1,090	24	1,114	—	—	—	762	30	792
Total	90,592	2,000	92,592	19,601	1,561	21,162	24,492	536	25,028
Total portfolio average LTV (3)	68%	81%	68%	91%	106%	92%	75%	94%	76%
Average LTV on new originations during the year			68%			79%			66%

Notes:
(1) Includes residential mortgages and home equity loans and lines (refer to page 147 for a breakdown of balances).
(2) Where no indexed LTV is held.
(3) Average LTV weighted by value is arrived at by calculating the LTV on each individual mortgage and applying a weighting based on the value of each mortgage.
(4) Excludes mortgage lending in Wealth. This portfolio totalled £8.8 billion (2011 - £8.3 billion; 2010 - £7.8 billion) and continues to perform in line with expectations with minimal provision of £248 million.

Key points

UK Retail

- The UK Retail mortgage portfolio totalled approximately £99.1 billion at 31 December 2012, an increase of 2.8% from 31 December 2011.

- The assets are prime mortgages and include £7.9 billion, 8% (2011 - £6.9 billion) of residential buy-to-let lending. There is a small legacy portfolio of self-certified mortgages (0.2% of the total mortgage portfolio). Self-certified mortgages were withdrawn in 2004. The interest rate product mix is approximately one third fixed rate with the remainder on variable rate products including those on managed rates.

- UK Retail's mortgage business is subject to prudent underwriting standards. These include an affordability test using a stressed interest rate, credit scoring with different pass marks depending on LTV as well as a range of specific criteria, for example, LTV thresholds. Changes over the last few years include: a reduction in maximum LTV for prime residential mortgage lending from 100% to 95% in the first quarter of 2008 and from 95% to 90% in the third quarter of 2008 and a tightening of credit scoring pass marks: credit score thresholds were increased in the third quarter of 2009 and again in the third quarter of 2010. In the first quarter of 2011, new scorecards were introduced alongside a further tightening of thresholds, these were tightened still further in the second quarter of 2012.

- Gross new mortgage lending remained strong at £14 billion. The average of individual LTV on new originations was 65.2% weighted by value of lending (2011 - 63.0%) and 61.3% by volume (2011 - 58.4%). The ratio of total lending to total property valuations was 56.3% (2011 - 52.9%). Average LTV by volume is arrived at by calculating the LTV on each individual mortgage with no weighting applied in the calculation of the average. The ratio approach is the sum of all lending divided by the value of all properties held as security against the lending.

- The maximum LTV available to new customers remains at 90%, except for those buying properties under the government-sponsored, and indemnity backed, new build schemes that were launched during the year, where the maximum LTV is 95%. These schemes aim to support the mortgage market, particularly first time buyers, and completions under the scheme totalled £35 million during the year.

- Based on the Halifax Price Index at September 2012, the portfolio average indexed LTV by weighted value of debt outstanding was 66.8% (2011 - 67.2%) and 58.1% by volume (2011 - 57.8%). The ratio of total outstanding balances to total indexed property valuations is 48.5% (2011 - 48.4%).

- The arrears rate (more than three payments in arrears, excluding repossessions and shortfalls post property sale) improved marginally to 1.5% at 31 December 2012 from 1.6% at 31 December 2011. The number of properties repossessed in 2012 was 1,426 compared with 1,671 in 2011. Arrears rates remain sensitive to economic developments and are currently benefiting from the low interest rate environment.

- The mortgage impairment charge was £92 million for 2012 compared with £182 million in 2011 primarily due to lower loss rate adjustments on the non-performing back book, and a stable underlying rate of defaults.

- 25.6% of the residential owner occupied UK Retail mortgage book is on interest only terms down from 27.3% in 2011. A further 9.1% are on mixed repayments split between a combination of interest only and capital repayments (2011 - 9.6%). UK Retail withdrew interest only repayment products from sale to residential owner occupied customers with effect from 1 December 2012. Interest only repayment remains an option on buy-to-let mortgages. At 1.6%, the percentage of accounts more than 3 payments in arrears was similar to the 1.4% observed on capital repayment mortgages.

Key credit portfolios*: Residential mortgages: Key points continued

Ulster Bank

- Ulster Bank's residential mortgage portfolio totalled £19.2 billion at 31 December 2012, with 88% in the Republic of Ireland and 12% in Northern Ireland. At constant exchange rates, the portfolio decreased 2% from 31 December 2011 as a result of natural amortisation and limited growth due to low market demand.

- The assets include £2.3 billion of exposure (12%) of residential buy-to-let loans. The interest rate product mix is approximately 91% on a variable rate product (including tracker products) and 9% on a fixed rate.

- 16% of the total portfolio is on interest only which reflects legacy policy and is no longer available to residential mortgage customers on a permanent basis. Interest only is permitted on a temporary basis under the suite of forbearance treatments available within Ulster Bank (refer to page 137 for further information). Interest only repayment remains an option for private customers within Northern Ireland on an exception basis.

- Average LTVs increased from 31 December 2011 to 31 December 2012, on a value basis, as a result of decreases in the Central Statistics Office house price index (4%) impacting the Ulster Bank portfolio. The average of individual LTV on new originations was stable in 2012 at 74% (weighted by value of lending) and 69.4% by volume (2011 - 67.3%). The volume of business remains very low. The maximum LTV available to Ulster Bank customers is 90% with the exception of a specific Northern Ireland scheme which permits LTVs of up to 95%, in which Ulster Bank's exposure is capped at 85% LTV.

- Refer to the Ulster Bank Group (Core and Non-Core) section on page 151 for commentary on mortgage REIL and repossessions.

RBS Citizens

- RBS Citizens' mortgage portfolio totalled £21.5 billion at 31 December 2012, a reduction of 11% from 2011 (£24.2 billion). The Core business comprises 89% of the portfolio.

- The portfolio comprises £6.2 billion (Core - £5.8 billion; Non-Core - £0.4 billion) of residential mortgages, of which 1% are in second lien position. There is also £15.3 billion (Core - £13.3 billion; Non-Core - £2.0 billion) of home equity loans and lines. Home equity Core consists of 47% in first lien position while Non-Core consists of 95% in second lien position.

- RBS Citizens' lending originates predominantly in the 'footprint states' of New England, Mid Atlantic and Mid West regions. At 31 December 2012, £17.9 billion (83% of the total portfolio) was within footprint.

- The Non-Core portfolio comprises 11% of the mortgage portfolio with the serviced by others (SBO) portfolio being the largest component (75%). The SBO portfolio consists of purchased pools of home equity loans and lines. The full year charge-off rate was 7.4% for 2012 (excluding one-time events, the charge-off rate was 6.8%), which represents a year-on-year improvement (2011 - 8.6%). It is characterised by out-of-footprint geographies, high (95%) second lien concentration, and high LTV exposure (111% weighted average LTV at 31 December 2012). The SBO book has been closed to new purchases since the third quarter of 2007 and is in run-off, with exposure down from £2.3 billion at 31 December 2011 to £1.8 billion at 31 December 2012. The arrears rate of the SBO portfolio has decreased from 2.3% at 31 December 2011 to 1.9% at 31 December 2012 due primarily to portfolio liquidation (highest risk borrowers have been charged-off), as well as more effective account servicing and collections.

- The current weighted average LTV of the mortgage portfolio decreased from 77% at 31 December 2011 to 75% at 31 December 2012, driven by increases in the Case-Shiller home price index from the third quarter of 2011 to the third quarter of 2012. The current weighted average LTV of the mortgage portfolio, excluding SBO, is 71%.

* unaudited

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Personal lending

The Group's personal lending portfolio includes credit cards, unsecured loans, auto finance and overdrafts. The majority of personal lending exposures exist in the UK and the US. Impairment charge as a proportion of average loans and receivables are shown in the following table.

	2012		2011		2010	
	Average loans and receivables	Impairment charge as a % of average loans and receivables	Average loans and receivables	Impairment charge as a % of average loans and receivables	Average loans and receivables	Impairment charge as a % of average loans and receivables
	£m	%	£m	%	£m	%
UK Retail cards (1)	5,624	2.3	5,675	3.0	6,025	5.0
UK Retail loans (1)	6,513	2.5	7,755	2.8	9,863	4.8
RBS Citizens cards (2)	916	3.8	936	5.1	1,005	9.9
RBS Citizens auto loans (2)	5,289	0.1	4,856	0.2	5,256	0.6

Notes:
(1) The ratio for UK Retail assets refers to the impairment charge for the year.
(2) The ratio for RBS Citizens refers to the impairment charge in the year, net of recoveries realised in the year.

Key points

UK Retail

- The UK personal lending portfolio, comprises credit cards, unsecured loans and overdrafts, and totalled £14.7 billion at 31 December 2012 (2011 - £16.0 billion).

- The decrease in portfolio size of 8.1% was driven by continued subdued loan recruitment activity and a continuing general market trend of customers repaying unsecured debt.

- The impairment charge on unsecured lending was £440 million for the year, down 24% on 2011, reflecting the continued benefit of risk appetite tightening in prior years, lower unsecured balances and also the investment in collections and recoveries capability. UK Retail continues to support customers experiencing financial difficulties including the provision of 'breathing space', refer to the disclosures on forbearance on page 137 for more information. Impairments remain sensitive to the external environment, including unemployment levels and interest rates.

- Industry benchmarks for cards arrears remain stable, with the Group continuing to perform favourably.

RBS Citizens

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RBS Citizens' credit card portfolio totalled £948 million at 31 December 2012 (2011 - £968 million). RBS Citizens' credit card business lends predominantly within the Bank's 12 state footprint and has traditionally adopted conservative risk strategies. Given the external climate, tighter lending criteria has been introduced leading to an improvement in credit quality. The portfolio's quarterly annualised loss performance in the third quarter of 2012 was 3.4% and ranked seventh out of 20 large and regional banks tracked.

- RBS Citizens' auto loan portfolio totalled £5.4 billion at 31 December 2012 (2011 - £4.8 billion). The auto loan business originates secured loans through a closely managed network of dealerships mainly located in the bank's footprint. The portfolio continues to possess strong credit risk fundamentals. The business purchased a £608 million auto loan portfolio from a large financial institution in the first quarter of 2012 that possessed a comparable credit and collateral profile. The acquired portfolio continues to outperform its delinquency and loss forecast. The portfolio's quarterly annualised loss performance in the third quarter of 2012 was 0.18% and continues to perform favourable against industry.

Key credit portfolios* continued

Ulster Bank Group (Core and Non-Core)

Overview

At 31 December 2012, Ulster Bank Group accounted for 10% of the Group's total gross loans to customers (2011 and 2010 - 10%) and 8% of the Group's Core gross loans to customers (2011 - 8%; 2010 - 9%). Ulster Bank's financial performance continues to be overshadowed by the challenging economic climate in Ireland, with impairments remaining elevated as high unemployment, coupled with higher taxation and limited liquidity in the economy, continues to depress the property market and domestic spending.

The impairment charge of £2,340 million for 2012 (2011 - £3,717 million; 2010 - £3,843 million) was driven by a combination of new defaulting customers and higher provisions on existing defaulted cases due primarily to deteriorating security values. Provisions as a percentage of risk elements in lending increased from 53% in 2011, to 57% in 2012, predominantly as a result of the deterioration in the value of the Non-Core commercial real estate development portfolio. Ulster Bank impairment provisions take into account recovery strategies for its commercial real estate portfolio, as currently there is very limited liquidity in Irish commercial and development property.

Core

The impairment charge for the year of £1,364 million (2011 - £1,384 million; 2010 - £1,161 million) reflects the difficult economic climate in Ireland, with elevated default levels across both mortgage and other corporate portfolios. The mortgage sector accounted for £646 million (47%) of the total 2012 impairment charge.

Non-Core

The impairment charge for the year was £976 million, a decrease of £1,357 million (2011 - £2,333 million; 2010 - £2,682 million), with the commercial real estate sector accounting for £899 million (92%) of the total 2012 impairment charge.

				Credit metrics				
Sector analysis	Gross loans £m	REIL £m	Provisions £m	REIL as a % of gross loans %	Provisions as a % of REIL %	Provisions as a % of gross loans %	Impairment charge £m	Amounts written-off £m
2012								
Core								
Mortgages	19,162	3,147	1,525	16.4	48	8.0	646	22
Commercial real estate								
- investment	3,575	1,551	593	43.4	38	16.6	221	—
- development	729	369	197	50.6	53	27.0	55	2
Other corporate	7,772	2,259	1,394	29.1	62	17.9	389	15
Other lending	1,414	207	201	14.6	97	14.2	53	33
	32,652	7,533	3,910	23.1	52	12.0	1,364	72

Non-Core								
Commercial real estate								
- investment	3,383	2,800	1,433	82.8	51	42.4	288	15
- development	7,607	7,286	4,720	95.8	65	62.0	611	103
Other corporate	1,570	1,230	711	78.3	58	45.3	77	23
	12,560	11,316	6,864	90.1	61	54.6	976	141
Ulster Bank Group								
Mortgages	19,162	3,147	1,525	16.4	48	8.0	646	22
Commercial real estate								
- investment	6,958	4,351	2,026	62.5	47	29.1	509	15
- development	8,336	7,655	4,917	91.8	64	59.0	666	105
Other corporate	9,342	3,489	2,105	37.3	60	22.5	466	38
Other lending	1,414	207	201	14.6	97	14.2	53	33
	45,212	18,849	10,774	41.7	57	23.8	2,340	213

* unaudited

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Business review Risk and balance sheet management continued

				Credit metrics				
Sector analysis	Gross loans	REIL	Provisions	REIL as a % of gross loans	Provisions as a % of REIL	Provisions as a % of gross loans	Impairment charge	Amounts written-off
	£m	£m	£m	%	%	%	£m	£m
2011								
Core								
Mortgages	20,020	2,184	945	10.9	43	4.7	570	11
Commercial real estate								
- investment	3,882	1,014	413	26.1	41	10.6	225	—
- development	881	290	145	32.9	50	16.5	99	16
Other corporate	7,736	1,834	1,062	23.7	58	13.7	434	72
Other lending	1,533	201	184	13.1	92	12.0	56	25
	34,052	5,523	2,749	16.2	50	8.1	1,384	124
Non-Core								
Commercial real estate								
- investment	3,860	2,916	1,364	75.5	47	35.3	609	1
- development	8,490	7,536	4,295	88.8	57	50.6	1,551	32
Other corporate	1,630	1,159	642	71.1	55	39.4	173	16
	13,980	11,611	6,301	83.1	54	45.1	2,333	49
Ulster Bank Group								
Mortgages	20,020	2,184	945	10.9	43	4.7	570	11
Commercial real estate								
- investment	7,742	3,930	1,777	50.8	45	23.0	834	1
- development	9,371	7,826	4,440	83.5	57	47.4	1,650	48
Other corporate	9,366	2,993	1,704	32.0	57	18.2	607	88
Other lending	1,533	201	184	13.1	92	12.0	56	25
	48,032	17,134	9,050	35.7	53	18.8	3,717	173
2010								
Core								
Mortgages	21,162	1,566	439	7.4	28	2.1	294	7
Commercial real estate								
- investment	4,284	598	332	14.0	56	7.7	259	—
- development	1,090	65	37	6.0	57	3.4	116	—
Other corporate	9,039	1,205	667	13.3	55	7.4	444	11
Other lending	1,282	185	158	14.4	85	12.3	48	30
	36,857	3,619	1,633	9.8	45	4.4	1,161	48
Non-Core								
Mortgages	—	—	—	—	—	—	42	—
Commercial real estate								

- investment	3,854	2,391	1,000	62.0	42	25.9	630	—
- development	8,760	6,341	2,783	72.4	44	31.8	1,759	—
Other corporate	1,970	1,310	561	66.5	43	28.5	251	—
	14,584	10,042	4,344	68.9	43	29.8	2,682	—
Ulster Bank Group								
Mortgages	21,162	1,566	439	7.4	28	2.1	336	7
Commercial real estate								
- investment	8,138	2,989	1,332	36.7	45	16.4	889	—
- development	9,850	6,406	2,820	65.0	44	28.6	1,875	—
Other corporate	11,009	2,515	1,228	22.8	49	11.2	695	11
Other lending	1,282	185	158	14.4	85	12.3	48	30
	51,441	13,661	5,977	26.6	44	11.6	3,843	48

* unaudited

Business review Risk and balance sheet management continued

Key credit portfolios*: Ulster Bank Group (Core and Non-Core) continued

Key points

- Core REIL increased by £2.0 billion during the year, which reflects continued difficult conditions in both the commercial and residential property sectors in Ireland.

- Core mortgage REIL accounted for £1.0 billion of the overall increase, the trend reflecting continued deterioration of macroeconomic factors. However, the number of properties repossessed in 2012 was 127 (81 on a voluntary basis) compared with 161 (123 on a voluntary basis) in 2011.

- Core corporate REIL accounted for £1.0 billion of the overall increase, the movement driven by a small number of renegotiated arrangements for higher value real estate customers.

- Core coverage increased from 50% to 52% as a result of additional impairment charges on the non-performing book due to further deterioration in collateral values. Core coverage is diluted due to the increased REIL relating to corporate renegotiations with lower provision requirements. Adjusting for these cases Core coverage would be 56%.

- Non-Core REIL decreased by £0.3 billion reflecting lower defaults as well as recoveries and write-offs of £0.2 billion.

- At 31 December 2012, 60% of REIL was in Non-Core (2011 - 68%). The majority of the Non-Core commercial real estate development portfolio is non-performing with provision coverage of 65%.

Geographical analysis

Commercial real estate

The commercial real estate lending portfolio for Ulster Bank Group (Core and Non-Core) totalled £15.3 billion at 31 December 2012, of which £11.0 billion or 72% was in Non-Core. The geographic split of the total Ulster Bank Group commercial real estate portfolio, based on the location of the underlying security, remained similar to 2011, with 63% in the Republic of Ireland, 26% in Northern Ireland and 11% in the UK (excluding Northern Ireland).

	Investment		Development		
	Commercial	Residential	Commercial	Residential	Total
Exposure by geography	£m	£m	£m	£m	£m
2012					
ROI	3,546	779	1,603	3,653	9,581
NI	1,083	210	631	2,059	3,983
UK (excluding NI)	1,239	86	82	290	1,697
RoW	14	1	8	10	33
	5,882	1,076	2,324	6,012	15,294
2011					
ROI	3,775	853	1,911	4,095	10,634
NI	1,322	279	680	2,222	4,503
UK (excluding NI)	1,371	111	95	336	1,913
RoW	27	4	—	32	63

	6,495	1,247	2,686	6,685	17,113
2010					
Ireland (ROI and NI)	5,032	1,098	2,785	6,578	15,493
UK (excluding NI)	1,869	115	110	359	2,453
RoW	23	1	—	18	42
	6,924	1,214	2,895	6,955	17,988

* unaudited

Key points

- Commercial real estate continues to be the primary sector driving the Ulster Bank Group non-performing loan book. A reduction over the year of £1.8 billion primarily reflects Ulster Bank's continuing strategy to reduce concentration risk to this sector.

- The outlook for the property sector remains challenging. While there may be some signs of stabilisation in main urban centres, the outlook continues to be negative for secondary property locations on the island of Ireland.

- During the year, Ulster Bank experienced further migration of commercial real estate exposures to its problem management framework, where various measures may be agreed to assist customers whose loans are performing but who are experiencing temporary financial difficulties. For further details on Wholesale renegotiations refer to page 132.

Residential mortgages

The mortgage lending portfolio analysis by country of location of the underlying security is set out below.

	2012	2011
	£m	£m
ROI	16,873	17,767
NI	2,289	2,253
	19,162	20,020

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Business review Risk and balance sheet management continued

Balance sheet analysis

Credit risk assets analysed on the pages 122 to 126 are reported internally to senior management. However, they exclude certain exposures, primarily securities and reverse repurchase agreements, and take account of legal netting agreements, that provide a right of legal set-off but do not meet the criteria for offset in IFRS. The table below is therefore provided to supplement the credit risk assets analysis and other analysis to reconcile to the balance sheet grossed up for disposal groups.

Financial assets

Exposure summary

The table below analyses the Group's financial asset exposures, both gross and net of offset arrangements.

	Gross exposure	IFRS offset (1)	Carrying value	Non-IFRS offset (2)	Exposure post offset
2012	£m	£m	£m	£m	£m
Cash and balances at central banks	79,308	—	79,308	—	79,308
Reverse repos	143,207	(38,377)	104,830	(17,439)	87,391
Lending (3)	464,691	(1,460)	463,231	(34,941)	428,290
Debt securities	164,624	—	164,624	—	164,624
Equity shares	15,237	—	15,237	—	15,237
Derivatives (4)	815,394	(373,476)	441,918	(408,004)	33,914
Settlement balances	8,197	(2,456)	5,741	(1,760)	3,981
Other financial assets	924	—	924	—	924
Total	1,691,582	(415,769)	1,275,813	(462,144)	813,669
Short positions	(27,591)	—	(27,591)	—	(27,591)
Net of short positions	1,663,991	(415,769)	1,248,222	(462,144)	786,078
2011					
Cash and balances at central banks	79,396	—	79,396	—	79,396
Reverse repos	138,539	(37,605)	100,934	(15,246)	85,688
Lending (3)	517,474	—	517,474	(41,129)	476,345
Debt securities	209,080	—	209,080	—	209,080
Equity shares	15,188	—	15,188	—	15,188
Derivatives (4)	1,074,548	(544,491)	530,057	(478,848)	51,209
Settlement balances	9,144	(1,359)	7,785	(2,221)	5,564
Other financial assets	1,309	—	1,309	—	1,309
Total	2,044,678	(583,455)	1,461,223	(537,444)	923,779
Short positions	(41,039)	—	(41,039)	—	(41,039)
Net of short positions	2,003,639	(583,455)	1,420,184	(537,444)	882,740
2010					
Cash and balances at central banks	57,198	—	57,198	—	57,198
Reverse repos	135,105	(39,986)	95,119	(10,712)	84,407
Lending (3)	566,323	—	566,323	(44,801)	521,522
Debt securities	217,480	—	217,480	—	217,480
Equity shares	22,218	—	22,218	—	22,218

Derivatives (4)	882,803	(450,578)	432,225	(361,493)	70,732
Settlement balances	14,182	(2,022)	12,160	(1,539)	10,621
Other financial assets	1,306	—	1,306	—	1,306
Total	1,896,615	(492,586)	1,404,029	(418,545)	985,484
Short positions	(43,118)	—	(43,118)	—	(43,118)
Net of short positions	1,853,497	(492,586)	1,360,911	(418,545)	942,366

Notes:

(1) Relates to offset arrangements that comply with IFRS criteria and to transactions cleared through and novated to central clearing houses, primarily London Clearing House and US Government Securities Clearing Corporation.

(2) This reflects the amount by which the Group's credit risk exposure is reduced through arrangements, such as master netting agreements, which give the Group a legal right to set off the financial asset against a financial liability due to the same counterparty. In addition, the Group holds collateral in respect of individual loans and advances to banks and customers. This collateral includes mortgages over property (both personal and commercial); charges over business assets such as plant, inventories and trade debtors; and guarantees of lending from parties other than the borrower. The Group obtains collateral in the form of securities relating to reverse repurchase agreements. Cash and securities are received as collateral in respect of derivative transactions..

(3) Lending non-IFRS offset includes cash collateral posted against derivative liabilities of £24.6 billion, (2011 - £31.4 billion; 2010 - £31.0 billion) and cash management pooling of £10.3 billion, (2011 - £9.7 billion; 2010 - £13.8 billion).

(4) Derivative non-IFRS offset includes cash collateral received against derivative assets of £34.1 billion (2011 - £37.2 billion; 2010 - £31.1 billion). Refer to page 179.

Business review Risk and balance sheet management continued

Balance sheet analysis: Financial assets continued
Sector and geographic concentration
The following tables provide an analysis of credit concentration of financial assets by sector and geography. Geographical regions are based on the location of the lending or issuer.

	Reverse	Lending			Securities				Balance sheet	Non-IFRS	Ex
	repos	Core	Non-Core	Total	Debt	Equity	Derivatives	Other	value	offset (1)	
2012	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	
Government (2)	441	8,485	1,368	9,853	97,339	—	5,791	591	114,015	(5,151)	1
Financial institutions - banks (3)	34,783	30,917	477	31,394	11,555	1,643	335,521	79,308	494,204	(341,103)	1
- other (4)	69,256	39,658	2,540	42,198	50,104	2,672	80,817	5,591	250,638	(97,589)	1
Personal - mortgages	—	146,770	2,855	149,625	—	—	—	—	149,625	—	1
- unsecured	—	31,247	965	32,212	—	—	—	4	32,216	—	
Property	—	43,602	28,617	72,219	774	318	4,118	—	77,429	(1,333)	
Construction	—	6,020	2,029	8,049	17	264	820	—	9,150	(1,687)	
Manufacturing	326	22,234	1,553	23,787	836	1,639	1,759	144	28,491	(3,775)	
Finance leases (5)	—	9,201	4,408	13,609	82	1	13	—	13,705	—	
Retail, wholesale and repairs	—	20,842	1,094	21,936	461	1,807	914	41	25,159	(1,785)	
Transport and storage	—	14,590	3,751	18,341	659	382	3,397	2	22,781	(3,240)	
Health, education and leisure	—	15,770	935	16,705	314	554	904	59	18,536	(964)	
Hotels and restaurants	—	6,891	986	7,877	144	51	493	11	8,576	(348)	
Utilities	—	5,131	1,500	6,631	1,311	638	3,170	50	11,800	(2,766)	
Other	24	26,315	3,742	30,057	1,886	5,380	4,201	172	41,720	(2,403)	
Total gross of provisions	104,830	427,673	56,820	484,493	165,482	15,349	441,918	85,973	1,298,045	(462,144)	8
Provisions	—	(10,062)	(11,200)	(21,262)	(858)	(112)	—	—	(22,232)	n/a	(
Total	104,830	417,611	45,620	463,231	164,624	15,237	441,918	85,973	1,275,813	(462,144)	8
2011											
Government (2)	2,247	8,359	1,383	9,742	125,543	—	5,541	641	143,714	(1,098)	1
Financial institutions - banks (3)	39,345	43,374	706	44,080	16,940	2,218	400,261	79,396	582,240	(407,457)	1
- other (4)	58,478	48,598	3,272	51,870	60,628	2,501	98,255	7,451	279,183	(119,717)	1
Personal - mortgages	—	144,171	5,102	149,273	—	—	—	—	149,273	—	1
- unsecured	—	32,868	1,556	34,424	—	—	—	52	34,476	(7)	
Property	—	42,994	38,064	81,058	573	175	4,599	1	86,406	(1,274)	
Construction	—	7,197	2,672	9,869	50	53	946	—	10,918	(1,139)	
Manufacturing	254	23,708	4,931	28,639	664	1,938	3,786	306	35,587	(2,214)	
Finance leases (5)	—	8,440	6,059	14,499	145	2	75	—	14,721	(16)	
Retail, wholesale and repairs	—	22,039	2,339	24,378	645	2,652	1,134	18	28,827	(1,671)	

Transport and storage	436	16,581	5,477	22,058	539	74	3,759	—	26,866	(241)	
Health, education and leisure	—	16,073	1,419	17,492	310	21	885	—	18,708	(973)	
Hotels and restaurants	—	7,709	1,161	8,870	116	5	671	—	9,662	(184)	
Utilities	—	6,557	1,849	8,406	1,530	554	3,708	30	14,228	(450)	
Other	174	28,769	4,721	33,490	3,785	5,136	6,437	595	49,617	(1,003)	
Total gross of provisions	100,934	457,437	80,711	538,148	211,468	15,329	530,057	88,490	1,484,426	(537,444)	9
Provisions	—	(9,187)	(11,487)	(20,674)	(2,388)	(141)	—	—	(23,203)	n/a	(
Total	100,934	448,250	69,224	517,474	209,080	15,188	530,057	88,490	1,461,223	(537,444)	9

For the notes to these tables refer to page 163.

Business review Risk and balance sheet management continued

	Reverse	Lending			Securities				Balance sheet	Non-IFRS	E
	repos	Core	Non-Core	Total	Debt	Equity	Derivatives	Other	value	offset (1)	
2010	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	
Government (2)	645	6,781	1,671	8,452	130,123	—	7,560	291	147,071	(3,916)	
Financial institutions - banks (3)	42,571	57,033	1,654	58,687	22,474	3,259	315,297	57,198	499,486	(312,327)	
- other (4)	51,297	47,161	7,791	54,952	54,726	4,366	84,042	12,740	262,123	(91,059)	
Personal - mortgages	—	140,359	6,142	146,501	—	—	—	—	146,501	(19)	
- unsecured	—	33,581	3,891	37,472	—	—	—	48	37,520	(11)	
Property	—	42,455	47,948	90,403	2,700	237	3,830	28	97,198	(1,046)	
Construction	—	8,680	3,425	12,105	56	31	780	—	12,972	(1,406)	
Manufacturing	389	25,797	7,688	33,485	784	113	3,229	—	38,000	(2,156)	
Finance leases (5)	—	8,321	8,529	16,850	13	2	14	—	16,879	(134)	
Retail, wholesale and repairs	—	21,974	3,191	25,165	520	41	1,124	—	26,850	(2,468)	
Transport and storage	—	15,946	8,195	24,141	879	54	2,703	—	27,777	(224)	
Health, education and leisure	—	17,456	1,975	19,431	1,495	42	1,198	—	22,166	(1,047)	
Hotels and restaurants	—	8,189	1,492	9,681	276	123	525	—	10,605	(253)	
Utilities	—	7,098	2,948	10,046	1,714	229	2,491	2	14,482	(985)	
Other	217	29,053	8,115	37,168	3,021	13,897	9,432	386	64,121	(1,494)	
Total gross of provisions	95,119	469,884	114,655	584,539	218,781	22,394	432,225	70,693	1,423,751	(418,545)	1,
Provisions	—	(7,866)	(10,352)	(18,218)	(1,301)	(176)	—	(29)	(19,724)	n/a	
Total including disposal groups before RFS MI	95,119	462,018	104,303	566,321	217,480	22,218	432,225	70,664	1,404,027	(418,545)	
RFS minority interests	—	—	2	2	—	—	—	—	2		—
Total	95,119	462,018	104,305	566,323	217,480	22,218	432,225	70,664	1,404,029	(418,545)	

For the notes to this table refer to page 163.

Key points

- Financial asset exposures after offset including disposal groups decreased by £110 billion or 12% to £814 billion, reflecting the Group's focus on reducing its funded balance sheet, primarily in Non-Core, Markets and International Banking.

- Reductions were across all major balance sheet categories: lending (£54 billion), debt securities (£44 billion) and derivatives (£88 billion). Conditions in the financial markets and the Group's focus on risk appetite and sector concentration had a direct impact on the composition of its portfolio during the year.

- Exposures to central and local governments decreased by £34 billion principally in debt securities. This was driven by Markets de-risking its balance sheet, management of the Group Treasury liquidity portfolio as well as overall risk reduction in respect of eurozone exposures. The Group's portfolio comprises exposures to central governments and sub-sovereigns such as local authorities, primarily in the Group's key markets in the UK, Western Europe and the US.

- Exposure to financial institutions was £28 billion lower, across securities, loans and derivatives, driven by economy-wide subdued activity.

- The banking sector is one of the largest in the Group's portfolio. The sector is well diversified geographically and by exposure with derivative exposures being largely collateralised. The sector is tightly controlled through the combination of the single name concentration framework, a suite of credit policies specifically tailored to the sector and country limits. Exposures to the banking sector decreased by £22 billion during the period, primarily due to reduced interbank lending and derivative activity, and a reduction in limits to banks in countries under stress, such as the peripheral eurozone countries.

- Exposure to other financial institutions comprising traded and non traded products is spread across a wide range of financial companies including insurance, securitisation vehicles, financial intermediaries including broker dealers and central counterparties (CCPs), financial guarantors - monolines and credit derivative product companies (CDPCs) - and funds comprising unleveraged, hedge and leveraged funds. The size of the Core portfolio has decreased marginally since 2011. Entities in this sector remain vulnerable to market shocks or contagion from the banking sector. Credit risk in these sectors is managed through the single name concentration, sector concentration and asset and product class frameworks, with specific sector and product caps in place where there is a perception of heightened credit risk, such as committed lending to banks, leveraged funds and insurance holding companies. The Group continues to develop its risk appetite framework for CCPs to reflect increased activity with these entities driven by regulatory requirements. The Group is also managing down its exposures to monolines and CDPCs with the aim of exiting these portfolios.

Balance sheet analysis: Financial assets: Sector and geographic concentration continued

Key points continued

- The Group's exposure to property and construction sector decreased by £11 billion, principally in commercial real estate lending. The majority of the Group's Core property exposure is within UK Corporate (73%). In relation to property exposure, the UK Corporate and Ulster Bank divisions saw further deterioration in asset quality during the year.

- Retail, wholesale and repairs sector decreased by £4 billion, reflecting de-leveraging of customers in the retail sector.

- Manufacturing exposure reduced by £9 billion primarily reflecting Non-Core reductions.

- Transport and storage includes the Group's shipping exposures of £11 billion which comprises asset-backed exposures to ocean-going vessels. Conditions remained poor across the major shipping market segments in 2012, with low charter rates and vessel values. A key protection for the Group is the minimum security covenant. This covenant is tested each quarter on an individual vessel basis to ensure prompt remedial action is taken if values fall significantly below agreed loan coverage ratios. There was an increase in the number of clients suffering liquidity issues or failing to meet their minimum security covenant and a commensurate rise in referrals to the Watchlist and the GRG. At 31 December 2012, 20% of the Group's exposure to this sector was in Watchlist Red. The Group's exposure to the shipping sector (including shipping related infrastructure) declined by 3.5% in 2012 as a result of amortisation and foreign exchange movements. At 31 December 2012, £0.7 billion of loans were included in risk elements in lending with an associated provision of £0.2 billion and impairment charge of £0.1 billion for 2012.

Within lending:
UK Retail increased its lending to homeowners by £4.1 billion, including first-time buyers, reflecting the impact of the UK Government's Funding for Lending Scheme (FLS); unsecured lending balances fell.

UK Corporate lending decreased by £3.8 billion, reflecting a combination of customer deleveraging with low business confidence and portfolio de-risking, particularly in commercial real estate, which fell by £3.5 billion.

Non-Core continued to make significant progress on its balance sheet strategy by reducing lending by £24 billion across all sectors, principally property and construction, where commercial real estate lending decreased by £9.4 billion, reflecting repayments and asset sales.

For further discussion on debt securities and derivatives, refer to pages 168 to 175 respectively.

Business review Risk and balance sheet management continued

The tables on pages 158 to 163 analyse financial assets by geographical region (based on location of transaction office) and sector.

2012		Reverse	Lending			Securities				Balance sheet	Non-IFRS	Expos
		repos	Core	Non-Core	Total	Debt	Equity	Derivatives	Other	value	offset (1)	of
		£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	
UK												
Government (2)		441	8,079	8	8,087	62,722	—	5,582	47	76,879	(5,028)	71,8
Financial institutions	- banks (3)	24,856	22,551	100	22,651	6,110	1,175	193,892	40,851	289,535	(202,189)	87,3
	- other (4)	42,203	32,024	1,931	33,955	16,834	2,069	62,810	2,946	160,817	(78,976)	81,8
Personal	- mortgages	—	109,511	19	109,530	—	—	—	—	109,530	—	109,3
	- unsecured	—	20,443	55	20,498	—	—	—	4	20,502	—	20,3
Property		—	35,532	18,198	53,730	547	282	3,954	—	58,513	(1,328)	57,
Construction		—	5,101	1,406	6,507	14	248	789	—	7,558	(1,666)	5,8
Manufacturing		326	9,416	642	10,058	579	1,553	1,286	111	13,913	(3,542)	10,3
Finance leases (5)		—	6,349	4,183	10,532	81	1	—	—	10,614	—	10,6
Retail, wholesale and repairs		—	11,103	428	11,531	397	1,634	701	41	14,304	(1,590)	12,7
Transport and storage		—	7,958	2,619	10,577	527	361	2,049	2	13,516	(2,279)	11,2
Health, education and leisure		—	11,530	371	11,901	144	548	818	59	13,470	(888)	12,5
Hotels and restaurants		—	5,505	484	5,989	121	51	493	11	6,665	(344)	6,3
Utilities		—	2,780	776	3,556	1,178	492	2,654	30	7,910	(2,515)	5,3
Other		19	13,969	1,874	15,843	1,085	4,757	2,647	140	24,491	(1,885)	22,6
Total gross of provisions		67,845	301,851	33,094	334,945	90,339	13,171	277,675	44,242	828,217	(302,230)	525,9
Provisions		—	(5,637)	(4,124)	(9,761)	(420)	(112)	—	—	(10,293)	n/a	(10,2
Total		67,845	296,214	28,970	325,184	89,919	13,059	277,675	44,242	817,924	(302,230)	515,6
US												
Government (2)		—	151	—	151	22,084	—	23	500	22,758	(17)	22,7
Financial institutions	- banks (3)	5,024	1,295	47	1,342	468	349	116,935	14,066	138,184	(115,459)	22,7
	- other (4)	22,807	4,023	234	4,257	25,483	210	13,397	2,086	68,240	(14,720)	53,5
Personal	- mortgages	—	19,483	2,446	21,929	—	—	—	—	21,929	—	21,9
	- unsecured	—	8,209	539	8,748	—	—	—	—	8,748	—	8,7
Property		—	2,847	496	3,343	8	26	34	—	3,411	—	3,4
Construction		—	384	4	388	3	2	9	—	402	—	4
Manufacturing		—	6,004	17	6,021	156	15	265	—	6,457	(215)	6,2
Finance leases (5)		—	2,471	—	2,471	—	—	—	—	2,471	—	2,4
Retail, wholesale and repairs		—	4,852	53	4,905	58	1	66	—	5,030	(52)	4,9
Transport and storage		—	1,522	406	1,928	37	—	855	—	2,820	(800)	2,0

Health, education and leisure	—	2,822	26	2,848	170	—	73	—	3,091	(70)	3,0
Hotels and restaurants	—	474	16	490	23	—	—	—	513	—	
Utilities	—	929	37	966	100	15	273	—	1,354	(251)	1,
Other	4	5,019	298	5,317	674	324	1,094	—	7,413	(277)	7,
Total gross of provisions	27,835	60,485	4,619	65,104	49,264	942	133,024	16,652	292,821	(131,861)	160,9
Provisions	—	(581)	(335)	(916)	—	—	—	—	(916)	n/a	(9
Total	27,835	59,904	4,284	64,188	49,264	942	133,024	16,652	291,905	(131,861)	160,0

For the notes to these tables refer to page 163.

Business review Risk and balance sheet management continued

Balance sheet analysis: Financial assets: Sector and geographic concentration continued

2012		Reverse	Lending			Securities				Balance sheet	Non-IFRS	Exposur po
		repos	Core	Non-Core	Total	Debt	Equity	Derivatives	Other	value	offset (1)	offse
		£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£r
Europe												
Government (2)		—	224	667	891	5,684	—	54	2	6,631	(15)	6,61
Financial institutions	- banks (3)	375	2,961	190	3,151	4,016	8	55	23,181	30,786	(2)	30,78
	- other (4)	20	1,390	300	1,690	7,222	309	95	134	9,470	—	9,47
Personal	- mortgages	—	17,446	390	17,836	—	—	—	—	17,836	—	17,83
	- unsecured	—	1,540	365	1,905	—	—	—	—	1,905	—	1,90
Property		—	4,896	9,738	14,634	—	2	77	—	14,713	(5)	14,70
Construction		—	513	619	1,132	—	6	—	—	1,138	(21)	1,11
Manufacturing		—	4,771	660	5,431	94	26	25	1	5,577	(9)	5,56
Finance leases (5)		—	292	172	464	—	—	—	—	464	—	46
Retail, wholesale and repairs		—	3,142	607	3,749	—	109	10	—	3,868	(22)	3,84
Transport and storage		—	4,851	599	5,450	1	10	12	—	5,473	(5)	5,46
Health, education and leisure		—	1,170	399	1,569	—	2	—	—	1,571	(6)	1,56
Hotels and restaurants		—	893	486	1,379	—	—	—	—	1,379	(4)	1,37
Utilities		—	993	499	1,492	6	112	65	20	1,695	—	1,69
Other		—	4,492	817	5,309	39	201	44	32	5,625	(53)	5,57
Total gross of provisions		395	49,574	16,508	66,082	17,062	785	437	23,370	108,131	(142)	107,98
Provisions		—	(3,697)	(6,570)	(10,267)	(438)	—	—	—	(10,705)	n/a	(10,70
Total		395	45,877	9,938	55,815	16,624	785	437	23,370	97,426	(142)	97,28
RoW												
Government (2)		—	31	693	724	6,849	—	132	42	7,747	(91)	7,65
Financial institutions	- banks (3)	4,528	4,110	140	4,250	961	111	24,639	1,210	35,699	(23,453)	12,24
	- other (4)	4,226	2,221	75	2,296	565	84	4,515	425	12,111	(3,893)	8,21
Personal	- mortgages	—	330	—	330	—	—	—	—	330	—	33
	- unsecured	—	1,055	6	1,061	—	—	—	—	1,061	—	1,06
Property		—	327	185	512	219	8	53	—	792	—	79
Construction		—	22	—	22	—	8	22	—	52	—	5
Manufacturing		—	2,043	234	2,277	7	45	183	32	2,544	(9)	2,53
Finance leases (5)		—	89	53	142	1	—	13	—	156	—	15
Retail, wholesale and repairs		—	1,745	6	1,751	6	63	137	—	1,957	(121)	1,83
Transport and storage		—	259	127	386	94	11	481	—	972	(156)	81
Health, education and leisure		—	248	139	387	—	4	13	—	404	—	40
Hotels and restaurants		—	19	—	19	—	—	—	—	19	—	1

Utilities	—	429	188	617	27	19	178	—	841	—	84
Other	1	2,835	753	3,588	88	98	416	—	4,191	(188)	4,00
Total gross of provisions	8,755	15,763	2,599	18,362	8,817	451	30,782	1,709	68,876	(27,911)	40,96
Provisions	—	(147)	(171)	(318)	—	—	—	—	(318)	n/a	(31
Total	8,755	15,616	2,428	18,044	8,817	451	30,782	1,709	68,558	(27,911)	40,64

For the notes to these tables refer to page 163.

Business review Risk and balance sheet management continued

2011		Reverse repos £m	Lending Core £m	Non-Core £m	Total £m	Securities Debt £m	Equity £m	Derivatives £m	Other £m	Balance sheet value £m	Non-IFRS offset (1) £m	Expo
UK												
Government (2)		2,130	8,012	25	8,037	77,831	—	5,282	548	93,828	(1,098)	92
Financial institutions	- banks (3)	25,204	29,575	218	29,793	1,950	1,562	258,321	40,396	357,226	(271,500)	85
	- other (4)	39,154	33,020	2,361	35,381	25,954	1,676	43,327	3,259	148,751	(59,160)	89
Personal	- mortgages	—	104,965	1,423	106,388	—	—	—	—	106,388	—	106
	- unsecured	—	21,881	127	22,008	—	—	—	24	22,032	(7)	22
Property		—	35,431	24,610	60,041	278	137	4,332	—	64,788	(1,265)	63
Construction		—	5,707	1,882	7,589	20	26	895	—	8,530	(1,115)	7
Manufacturing		254	10,148	835	10,983	499	1,908	2,259	—	15,903	(2,205)	13
Finance leases (5)		—	5,618	5,598	11,216	1	2	73	—	11,292	(16)	11
Retail, wholesale and repairs		—	11,796	1,441	13,237	574	2,616	952	18	17,397	(1,647)	15
Transport and storage		436	8,716	3,439	12,155	145	67	2,217	—	15,020	(200)	14
Health, education and leisure		—	11,534	757	12,291	72	8	756	—	13,127	(965)	12
Hotels and restaurants		—	6,165	569	6,734	23	—	664	—	7,421	(178)	7
Utilities		—	2,476	922	3,398	1,150	513	3,207	30	8,298	(450)	7
Other		126	17,393	1,723	19,116	2,395	4,704	4,105	593	31,039	(947)	30
Total gross of provisions		67,304	312,437	45,930	358,367	110,892	13,219	326,390	44,868	921,040	(340,753)	580
Provisions		—	(5,349)	(4,754)	(10,103)	(1,170)	(141)	—	—	(11,414)	n/a	(11
Total		67,304	307,088	41,176	348,264	109,722	13,078	326,390	44,868	909,626	(340,753)	568
US												
Government (2)		—	177	14	191	22,936	—	9	1	23,137	—	23
Financial institutions	- banks (3)	7,289	671	40	711	1,245	443	111,240	29,426	150,354	(108,060)	42
	- other (4)	17,368	8,993	341	9,334	29,885	560	54,639	3,510	115,296	(60,556)	54
Personal	- mortgages	—	20,311	2,926	23,237	—	—	—	—	23,237	—	23
	- unsecured	—	7,505	936	8,441	—	—	—	—	8,441	—	8
Property		—	2,413	1,370	3,783	26	23	38	—	3,870	—	3
Construction		—	412	45	457	21	3	11	—	492	—	
Manufacturing		—	6,782	42	6,824	101	12	452	—	7,389	—	7
Finance leases (5)		—	2,471	—	2,471	17	—	—	—	2,488	—	2
Retail, wholesale and repairs		—	4,975	98	5,073	52	—	63	—	5,188	—	5
Transport and storage		—	1,832	937	2,769	26	1	1,084	—	3,880	—	3
Health, education and leisure		—	2,946	88	3,034	74	4	93	—	3,205	—	3
Hotels and restaurants		—	627	57	684	93	3	1	—	781	—	
Utilities		—	1,033	28	1,061	243	16	322	—	1,642	—	1

Other	29	5,135	439	5,574	695	103	1,436	—	7,837	—	7
Total gross of provisions	24,686	66,283	7,361	73,644	55,414	1,168	169,388	32,937	357,237	(168,616)	188
Provisions	—	(787)	(516)	(1,303)	—	—	—	—	(1,303)	n/a	(1
Total	24,686	65,496	6,845	72,341	55,414	1,168	169,388	32,937	355,934	(168,616)	187

For the notes to these tables refer to page 163.

Business review Risk and balance sheet management continued

Balance sheet analysis: Financial assets: Sector and geographic concentration continued

2011		Reverse repos £m	Lending Core £m	Lending Non-Core £m	Lending Total £m	Securities Debt £m	Securities Equity £m	Derivatives £m	Other £m	Balance sheet value £m	Non-IFRS offset (1) £m	Exposure post offset £m
Europe												
Government (2)		—	116	715	831	13,362	—	60	—	14,253	—	14,253
Financial institutions	- banks (3)	247	8,361	250	8,611	10,859	78	—	6,725	26,520	—	26,520
	- other (4)	—	2,534	474	3,008	4,521	165	289	90	8,073	(1)	8,072
Personal	- mortgages	—	18,393	553	18,946	—	—	—	—	18,946	—	18,946
	- unsecured	—	1,972	492	2,464	—	—	—	28	2,492	—	2,492
Property		—	4,846	11,538	16,384	—	—	168	—	16,552	(9)	16,543
Construction		—	1,019	735	1,754	—	22	18	—	1,794	(24)	1,770
Manufacturing		—	4,383	3,732	8,115	57	5	23	—	8,200	(9)	8,191
Finance leases (5)		—	260	435	695	—	—	—	—	695	—	695
Retail, wholesale and repairs		—	3,992	772	4,764	16	2	23	—	4,805	(24)	4,781
Transport and storage		—	5,667	862	6,529	143	—	15	—	6,687	(6)	6,681
Health, education and leisure		—	1,235	349	1,584	164	5	2	—	1,755	(8)	1,747
Hotels and restaurants		—	892	535	1,427	—	—	6	—	1,433	(6)	1,427
Utilities		—	1,569	530	2,099	124	3	85	—	2,311	—	2,311
Other		7	3,766	1,679	5,445	568	70	35	—	6,125	(56)	6,069
Total gross of provisions		254	59,005	23,651	82,656	29,814	350	724	6,843	120,641	(143)	120,498
Provisions		—	(3,003)	(5,895)	(8,898)	(1,218)	—	—	—	(10,116)	n/a	(10,116)
Total		254	56,002	17,756	73,758	28,596	350	724	6,843	110,525	(143)	110,382
RoW												
Government (2)		117	54	629	683	11,414	—	190	92	12,496	—	12,496
Financial institutions	- banks (3)	6,605	4,767	198	4,965	2,886	135	30,700	2,849	48,140	(27,897)	20,243
	- other (4)	1,956	4,051	96	4,147	268	100	—	592	7,063	—	7,063
Personal	- mortgages	—	502	200	702	—	—	—	—	702	—	702
	- unsecured	—	1,510	1	1,511	—	—	—	—	1,511	—	1,511
Property		—	304	546	850	269	15	61	1	1,196	—	1,196
Construction		—	59	10	69	9	2	22	—	102	—	102
Manufacturing		—	2,395	322	2,717	7	13	1,052	306	4,095	—	4,095
Finance leases (5)		—	91	26	117	127	—	2	—	246	—	246
		—	1,276	28	1,304	3	34	96	—	1,437	—	1,437

Retail, wholesale and repairs											
Transport and storage	—	366	239	605	225	6	443	—	1,279	(35)	1,244
Health, education and leisure	—	358	225	583	—	4	34	—	621	—	621
Hotels and restaurants	—	25	—	25	—	2	—	—	27	—	27
Utilities	—	1,479	369	1,848	13	22	94	—	1,977	—	1,977
Other	12	2,475	880	3,355	127	259	861	2	4,616	—	4,616
Total gross of provisions	8,690	19,712	3,769	23,481	15,348	592	33,555	3,842	85,508	(27,932)	57,576
Provisions	—	(48)	(322)	(370)	—	—	—	—	(370)	n/a	(370)
Total	8,690	19,664	3,447	23,111	15,348	592	33,555	3,842	85,138	(27,932)	57,206

For the notes to these tables refer to page 163.

Business review Risk and balance sheet management continued

		Reverse	Lending			Securities				Balance	Non-IFRS	Expo
										sheet		
		repos	Core	Non-Core	Total	Debt	Equity	Derivatives	Other	value	offset (1)	c
2010		£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	
UK												
Government (2)		611	5,728	173	5,901	72,427	—	7,300	173	86,412	(3,916)	82
Financial institutions	- banks (3)	28,370	41,541	481	42,022	5,381	1,828	203,487	28,128	309,216	(210,136)	99
	- other (4)	33,186	28,246	6,023	34,269	27,737	3,617	45,852	5,390	150,051	(46,812)	103
Personal	- mortgages	—	99,928	1,665	101,593	—	—	—	—	101,593	(14)	101
	- unsecured	—	23,035	585	23,620	—	—	—	23	23,643	(11)	23
Property		—	34,970	30,789	65,759	2,302	175	3,739	28	72,003	(1,041)	70
Construction		—	7,041	2,383	9,424	39	—	741	—	10,204	(1,392)	8
Manufacturing		389	12,300	2,353	14,653	354	—	2,159	—	17,555	(2,150)	15
Finance leases (5)		—	5,589	7,785	13,374	13	2	14	—	13,403	(134)	13
Retail, wholesale and repairs		—	12,554	1,853	14,407	343	11	874	—	15,635	(2,452)	13
Transport and storage		—	8,105	5,015	13,120	241	3	1,573	—	14,937	(219)	14
Health, education and leisure		—	13,502	1,149	14,651	160	22	877	—	15,710	(1,047)	14
Hotels and restaurants		—	6,558	808	7,366	172	—	518	—	8,056	(249)	7
Utilities		—	3,101	1,459	4,560	1,040	5	2,112	2	7,719	(985)	6
Other		57	17,732	2,618	20,350	1,051	13,648	2,401	335	37,842	(1,448)	36
Total gross of provisions		62,613	319,930	65,139	385,069	111,260	19,311	271,647	34,079	883,979	(272,006)	611
Provisions		—	(4,937)	(3,741)	(8,678)	(1,301)	(176)	—	(29)	(10,184)	n/a	(10
Total		62,613	314,993	61,398	376,391	109,959	19,135	271,647	34,050	873,795	(272,006)	601
US												
Government (2)		—	263	53	316	24,975	—	5	112	25,408	—	25
Financial institutions	- banks (3)	8,978	820	641	1,461	1,951	561	87,627	19,455	120,033	(80,128)	39
	- other (4)	16,023	9,522	656	10,178	21,958	525	34,090	5,505	88,279	(43,734)	44
Personal	- mortgages	—	20,548	3,653	24,201	—	—	—	—	24,201	—	24
	- unsecured	—	6,816	2,704	9,520	—	—	—	—	9,520	—	9
Property		—	1,611	3,318	4,929	95	4	23	—	5,051	—	5
Construction		—	442	78	520	5	—	16	—	541	—	
Manufacturing		—	5,459	209	5,668	412	22	583	—	6,685	—	6
Finance leases (5)		—	2,315	—	2,315	—	—	—	—	2,315	—	2
Retail, wholesale and repairs		—	4,264	237	4,501	132	—	68	—	4,701	—	4
Transport and storage		—	1,786	1,408	3,194	99	2	929	—	4,224	—	4
Health, education and leisure		—	2,380	313	2,693	1,308	3	292	—	4,296	—	4
Hotels and restaurants		—	486	136	622	104	—	3	—	729	—	
Utilities		—	1,117	326	1,443	567	2	272	—	2,284	—	2

Other	131	4,256	682	4,938	1,057	105	5,971	42	12,244	—	12
Total gross of provisions	25,132	62,085	14,414	76,499	52,663	1,224	129,879	25,114	310,511	(123,862)	186
Provisions	—	(824)	(819)	(1,643)	—	—	—	—	(1,643)	n/a	(1
Total	25,132	61,261	13,595	74,856	52,663	1,224	129,879	25,114	308,868	(123,862)	185

For the notes to these tables refer to page 163.

Business review Risk and balance sheet management continued

Balance sheet analysis: Financial assets: Sector and geographic concentration continued

		Reverse	Lending			Securities				Balance sheet	Non-IFRS	Exposure post
		repos	Core	Non-Core	Total	Debt	Equity	Derivatives	Other	value	offset (1)	offset
2010		£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Europe												
Government (2)		—	365	1,017	1,382	18,648	—	66	—	20,096	—	20,096
Financial institutions	- banks (3)	94	10,219	313	10,532	11,843	322	—	7,974	30,765	—	30,765
	- other (4)	—	2,642	1,019	3,661	4,886	64	746	53	9,410	(1)	9,409
Personal	- mortgages	—	19,473	621	20,094	—	—	—	—	20,094	(5)	20,089
	- unsecured	—	2,270	600	2,870	—	—	—	25	2,895	—	2,895
Property		—	5,139	12,636	17,775	—	43	—	—	17,818	(5)	17,813
Construction		—	1,014	873	1,887	—	27	1	—	1,915	(14)	1,901
Manufacturing		—	5,853	4,440	10,293	18	87	39	—	10,437	(6)	10,431
Finance leases (5)		—	370	744	1,114	—	—	—	—	1,114	—	1,114
Retail, wholesale and repairs		—	4,126	999	5,125	32	2	33	—	5,192	(15)	5,177
Transport and storage		—	5,625	1,369	6,994	141	22	2	—	7,159	(5)	7,154
Health, education and leisure		—	1,442	496	1,938	27	9	—	—	1,974	—	1,974
Hotels and restaurants		—	1,055	535	1,590	—	120	—	—	1,710	(4)	1,706
Utilities		—	1,412	683	2,095	74	188	10	—	2,367	—	2,367
Other		28	4,869	2,219	7,088	746	138	54	—	8,054	(45)	8,009
Total gross of provisions		122	65,874	28,564	94,438	36,415	1,022	951	8,052	141,000	(100)	140,900
Provisions		—	(1,984)	(5,243)	(7,227)	—	—	—	—	(7,227)	n/a	(7,227)
Total including disposal groups before RFS MI		122	63,890	23,321								