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.

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.

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.

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	2011	2010
	£m	£m	£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.

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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.

Business review continued

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 customers	- UK	277,321	11,326	4.08	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 deposits	- UK	121,252	643	0.53	112,777	666	0.59
	- Overseas	35,087	210	0.60	43,177	483	1.12
Customer accounts: savings deposits	- UK	84,972	1,479	1.74	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 business	- UK	(21,140)	264	(1.25)	(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.

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)

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%

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	(Credit)/charge to income statement - continuing operations	Utilised during the year	At 31 December 2012
	£m	£m	£m	£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

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.

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 £m	2011 £m	2010 £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	2011	2010
	£bn	£bn	£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	2011	2010
	£m	£m	£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).

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	2011	2010	2012	2011	2010
	US$m	US$m	US$m	£m	£m	£m
Net interest income	3,087	3,048	2,940	1,948	1,900	1,902
Net fees and commissions	1,233	1,350	1,328	778	841	859
Other non-interest income	579	473	464	365	296	301
Non-interest income	1,812	1,823	1,792	1,143	1,137	1,160
Total income	4,899	4,871	4,732	3,091	3,037	3,062
Direct expenses						
- staff	(1,313)	(1,344)	(1,238)	(828)	(838)	(801)
- other	(833)	(893)	(897)	(526)	(557)	(580)
- litigation settlement	(138)	—	—	(88)	—	—
Indirect expenses	(1,274)	(1,250)	(1,255)	(804)	(779)	(813)
	(3,558)	(3,487)	(3,390)	(2,246)	(2,174)	(2,194)
Profit before impairment losses	1,341	1,384	1,342	845	863	868
Impairment losses	(145)	(524)	(802)	(91)	(326)	(519)
Operating profit	1,196	860	540	754	537	349
Average exchange rate - US$/£				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) .

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.

Markets

	2012	2011	2010
	£m	£m	£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.

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.

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

Direct Line Group continued

	2012	2011	2010
	£m	£m	£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.

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.

Business review continued

Consolidated balance sheet at 31 December 2012

	2012	2011	2010
	£m	£m	£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.

Cash flow

	2012 £m	2011 £m	2010 £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.

Business review continued

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

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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Business review Risk and balance sheet management continued

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:

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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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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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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

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

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

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
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.

Liquidity and funding risk: Analyses: Liquidity continued

	Liquidity value Period end			
	UK DLG (1)	CFG	Other	Total
2010	£m	£m	£m	£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.

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.

Encumbrance ratios	2012 %	2011 %
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			Total	Encumbered			
	Securitisations and conduits £bn	Covered bonds £bn	Derivatives £bn	Repos £bn	Secured borrowings £bn	encumbered assets £bn	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.

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.

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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.

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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.

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

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

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AQ10 credit risk assets by division	2012 AQ10 £m	2012 Divisional credit risk assets %	2011 AQ10 £m	2011 Divisional credit risk assets %	2010 AQ10 £m	2010 Divisional credit risk assets %
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		
Loan-to-value	Performing £m	Non-performing £m	Total £m	Performing £m	Non-performing £m	Total £m	Performing £m	Non-performing £m	Total £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	2011	2010
	£bn	£bn	£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)		
2011	Performing £m	Non-performing £m	Total £m	Performing £m	Non-performing £m	Total £m	Performing £m	Non-performing £m	Total £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.

2012	UK Retail £m	Ulster Bank £m	RBS Citizens (1) £m	Wealth (2) £m	Total (3) £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.

	UK Retail	Ulster Bank	RBS Citizens (1)	Wealth (2)	Total (3)
2012	£m	£m	£m	£m	
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

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

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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
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

Business review Risk and balance sheet management continued

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 £m	Impairment charge as a % of average loans and receivables %	Average loans and receivables £m	Impairment charge as a % of average loans and receivables %	Average loans and receivables £m	Impairment charge as a % of average loans and receivables %
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	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
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

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

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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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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.

2012	Gross exposure £m	IFRS offset (1) £m	Carrying value £m	Non-IFRS offset (2) £m	Exposure post offset £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.

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

2010	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	E
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,(
Hotels and restaurants	—	474	16	490	23	—	—	—	513	—	5
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

		Reverse	Lending			Securities				Balance sheet	Non-IFRS	Expo
		repos	Core	Non-Core	Total	Debt	Equity	Derivatives	Other	value	offset (1)	c
2011		£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	
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)	
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

2010		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	Exposure post offset £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	87,211	36,415	1,022	951	8,052	133,773	(100)	133,673
RFS Minority Interest		—	—	2	2	—	—	—	—	2	—	2
Total		122	63,890	23,323	87,213	36,415	1,022	951	8,052	133,775	(100)	133,675
RoW												
Government (2)		34	425	428	853	14,073	—	189	6	15,155	—	15,155
Financial institutions	- banks (3)	5,129	4,453	219	4,672	3,299	548	24,183	1,641	39,472	(22,063)	17,409
	- other (4)	2,088	6,751	93	6,844	145	160	3,354	1,792	14,383	(512)	13,871
Personal	- mortgages	—	410	203	613	—	—	—	—	613	—	613
	- unsecured	—	1,460	2	1,462	—	—	—	—	1,462	—	1,462
Property		—	735	1,205	1,940	303	15	68	—	2,326	—	2,326
Construction		—	183	91	274	12	4	22	—	312	—	312

Manufacturing	—	2,185	686	2,871	—	4	448	—	3,323	—	3,323
Finance leases (5)	—	47	—	47	—	—	—	—	47	—	47
Retail, wholesale and repairs	—	1,030	102	1,132	13	28	149	—	1,322	(1)	1,321
Transport and storage	—	430	403	833	398	27	199	—	1,457	—	1,457
Health, education and leisure	—	132	17	149	—	8	29	—	186	—	186
Hotels and restaurants	—	90	13	103	—	3	4	—	110	—	110
Utilities	—	1,468	480	1,948	33	34	97	—	2,112	—	2,112
Other	1	2,196	2,596	4,792	167	6	1,006	9	5,981	(1)	5,980
Total gross of provisions	7,252	21,995	6,538	28,533	18,443	837	29,748	3,448	88,261	(22,577)	65,684
Provisions	—	(121)	(549)	(670)	—	—	—	—	(670)	n/a	(670)
Total	7,252	21,874	5,989	27,863	18,443	837	29,748	3,448	87,591	(22,577)	65,014

Notes:

(1) 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.

(2) Includes central and local government.

(3) Includes £79.3 billion (2011 - £79.4 billion; 2010 - £57.2 billion) relating to cash and balances at central banks.

(4) Loans made by the Group's consolidated conduits to asset owning companies are included within Financal institutions - other.

(5) Includes instalment credit.

Business review Risk and balance sheet management continued

Asset quality

The asset quality analysis presented below is based on the Group's internal asset quality ratings which have ranges for the probability of default, as set out below. Customers are assigned credit grades, based on various credit grading models that reflect the key drivers of default for the 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. Debt securities are analysed by external ratings and are therefore excluded from the following table and are set out on pages 168 to 171.

Asset quality band	Probability of default range
AQ1	0% - 0.034%
AQ2	0.034% - 0.048%
AQ3	0.048% - 0.095%
AQ4	0.095% - 0.381%
AQ5	0.381% - 1.076%
AQ6	1.076% - 2.153%
AQ7	2.153% - 6.089%
AQ8	6.089% - 17.222%
AQ9	17.222% - 100%
AQ10	100%

		Loans and advances										
		Banks				Customers				Settlement		
	Cash and balances at central banks	Reverse repos	Derivative cash collateral	Other	Total	Reverse repos	Derivative cash collateral	Other	Total	balances and other financial assets	Derivatives	Commi
2012	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	
Total												
AQ1	78,039	17,806	3,713	10,913	32,432	42,963	15,022	39,734	97,719	2,671	100,652	
AQ2	12	3,556	4,566	526	8,648	710	704	13,101	14,515	185	108,733	
AQ3	1,156	5,703	2,241	2,757	10,701	2,886	3,917	25,252	32,055	539	152,810	
AQ4	100	6,251	1,761	2,734	10,746	14,079	2,144	104,060	120,283	1,202	58,705	
AQ5	—	1,183	469	787	2,439	8,163	679	92,147	100,989	659	13,244	
AQ6	—	282	39	357	678	86	50	40,096	40,232	73	2,175	
AQ7	—	2	—	236	238	1,133	12	36,223	37,368	191	3,205	
AQ8	—	—	—	68	68	4	2	12,812	12,818	8	262	
AQ9	1	—	—	93	93	23	7	17,431	17,461	137	1,360	
AQ10	—	—	—	—	—	—	—	807	807	1	772	
Past due	—	—	—	—	—	—	249	10,285	10,534	999	—	
Impaired	—	—	—	134	134	—	—	38,365	38,365	—	—	
Impairment provision	—	—	—	(114)	(114)	—	—	(21,148)	(21,148)	—	—	
Group	79,308	34,783	12,789	18,491	66,063	70,047	22,786	409,165	501,998	6,665	441,918	

Core												
AQ1	78,003	17,806	3,713	10,519	32,038	42,963	15,022	32,268	90,253	2,671	99,882	
AQ2	12	3,556	4,566	521	8,643	710	704	10,551	11,965	185	108,107	
AQ3	1,046	5,703	2,241	2,738	10,682	2,886	3,917	21,688	28,491	539	152,462	
AQ4	100	6,251	1,761	2,729	10,741	14,079	2,144	99,771	115,994	1,202	57,650	
AQ5	—	1,183	469	785	2,437	8,163	679	87,429	96,271	659	12,082	
AQ6	—	282	39	356	677	86	50	36,891	37,027	73	1,476	
AQ7	—	2	—	186	188	1,133	12	32,032	33,177	191	2,536	
AQ8	—	—	—	68	68	4	2	10,731	10,737	8	247	
AQ9	1	—	—	93	93	—	7	14,979	14,986	137	979	
AQ10	—	—	—	—	—	—	—	684	684	1	448	
Past due	—	—	—	—	—	—	249	9,528	9,777	991	—	
Impaired	—	—	—	133	133	—	—	17,418	17,418	—	—	
Impairment provision	—	—	—	(113)	(113)	—	—	(9,949)	(9,949)	—	—	
Group	79,162	34,783	12,789	18,015	65,587	70,024	22,786	364,021	456,831	6,657	435,869	2

Balance sheet analysis: Asset quality continued

		Loans and advances										
		Banks				Customers						
2012	Cash and balances at central banks £m	Reverse repos £m	Derivative cash collateral £m	Other £m	Total £m	Reverse repos £m	Derivative cash collateral £m	Other £m	Total £m	Settlement balances and other financial assets £m	Derivatives £m	Commitme
Non-Core												
AQ1	36	—	—	394	394	—	—	7,466	7,466	—	770	1,
AQ2	—	—	—	5	5	—	—	2,550	2,550	—	626	
AQ3	110	—	—	19	19	—	—	3,564	3,564	—	348	
AQ4	—	—	—	5	5	—	—	4,289	4,289	—	1,055	
AQ5	—	—	—	2	2	—	—	4,718	4,718	—	1,162	
AQ6	—	—	—	1	1	—	—	3,205	3,205	—	699	
AQ7	—	—	—	50	50	—	—	4,191	4,191	—	669	1,
AQ8	—	—	—	—	—	—	—	2,081	2,081	—	15	
AQ9	—	—	—	—	—	23	—	2,452	2,475	—	381	
AQ10	—	—	—	—	—	—	—	123	123	—	324	
Past due	—	—	—	—	—	—	—	757	757	8	—	
Impaired	—	—	—	1	1	—	—	20,947	20,947	—	—	
Impairment provision	—	—	—	(1)	(1)	—	—	(11,199)	(11,199)	—	—	
Group	146	—	—	476	476	23	—	45,144	45,167	8	6,049	5,

2011	Cash and balances at central banks £m	Loans and advances Banks (1) £m	Loans and advances Customers £m	Settlement balances and other financial assets £m	Derivatives £m	Commitments £m	Contingent liabilities £m	Total £m
Total								
AQ1	78,692	74,279	114,424	5,152	482,053	75,356	14,076	844,032
AQ2	342	1,881	15,810	93	8,177	24,269	3,154	53,726
AQ3	223	1,981	34,017	546	10,827	23,471	4,427	75,492
AQ4	19	1,612	108,262	760	14,421	40,071	5,847	170,992
AQ5	90	1,261	118,056	124	6,516	34,593	4,301	164,941
AQ6	9	188	50,428	46	2,221	17,153	1,662	71,707
AQ7	8	432	33,218	13	2,393	19,163	1,037	56,264
AQ8	7	30	12,622	19	1,252	4,159	276	18,365

AQ9	5	83	16,429	324	1,150	2,286	943	21,220
AQ10	1	164	784	6	1,047	2,354	221	4,577
Past due	—	2	11,591	1,623	—	—	—	13,216
Impaired	—	137	39,921	414	—	—	—	40,472
Impairment provision	—	(123)	(20,551)	(26)	—	—	—	(20,700)
Group	79,396	81,927	535,011	9,094	530,057	242,875	35,944	1,514,304
Core								
AQ1	78,634	73,689	95,691	5,034	478,177	69,220	13,249	813,694
AQ2	342	1,877	14,158	91	7,500	23,404	3,122	50,494
AQ3	56	1,967	30,546	546	10,360	22,319	4,354	70,148
AQ4	18	1,557	101,646	759	13,475	38,808	5,655	161,918
AQ5	90	1,256	110,911	124	5,087	33,226	4,092	154,786
AQ6	9	140	44,012	46	1,987	16,118	1,634	63,946
AQ7	8	432	28,953	13	796	17,514	949	48,665
AQ8	7	20	10,608	19	666	4,068	236	15,624
AQ9	5	83	11,938	276	592	1,769	898	15,561
AQ10	1	164	478	6	339	1,274	180	2,442
Past due	—	2	10,047	1,623	—	—	—	11,672
Impaired	—	136	16,457	413	—	—	—	17,006
Impairment provision	—	(122)	(9,065)	(25)	—	—	—	(9,212)
Group	79,170	81,201	466,380	8,925	518,979	227,720	34,369	1,416,744

For the note to these tables refer to page 167.

Business review Risk and balance sheet management continued

2011	Cash and balances at central banks £m	Loans and advances Banks (1) £m	Loans and advances Customers £m	Settlement balances and other financial assets £m	Derivatives £m	Commitments £m	Contingent liabilities £m	Total £m
Non-Core								
AQ1	58	590	18,733	118	3,876	6,136	827	30,338
AQ2	—	4	1,652	2	677	865	32	3,232
AQ3	167	14	3,471	—	467	1,152	73	5,344
AQ4	1	55	6,616	1	946	1,263	192	9,074
AQ5	—	5	7,145	—	1,429	1,367	209	10,155
AQ6	—	48	6,416	—	234	1,035	28	7,761
AQ7	—	—	4,265	—	1,597	1,649	88	7,599
AQ8	—	10	2,014	—	586	91	40	2,741
AQ9	—	—	4,491	48	558	517	45	5,659
AQ10	—	—	306	—	708	1,080	41	2,135
Past due	—	—	1,544	—	—	—	—	1,544
Impaired	—	1	23,464	1	—	—	—	23,466
Impairment provision	—	(1)	(11,486)	(1)	—	—	—	(11,488)
Group	226	726	68,631	169	11,078	15,155	1,575	97,560
2010								
Total								
AQ1	56,655	92,494	128,817	7,757	411,375	78,728	9,745	785,571
AQ2	14	598	13,282	1,411	3,704	26,128	1,980	47,117
AQ3	48	2,197	26,232	156	3,317	25,731	4,337	62,018
AQ4	372	748	95,777	577	3,391	41,027	6,522	148,414
AQ5	99	2,322	115,982	259	5,399	38,612	5,169	167,842
AQ6	3	159	66,683	34	1,070	25,991	2,230	96,170
AQ7	2	178	46,072	150	1,464	18,752	2,456	69,074
AQ8	—	15	16,573	14	403	9,289	9,545	35,839
AQ9	—	115	14,263	85	521	3,889	932	19,805
AQ10	5	355	5,644	2	1,581	2,829	407	10,823
Past due	—	10	13,430	2,675	—	—	—	16,115
Impaired	—	145	35,609	375	—	—	—	36,129
Impairment provision	—	(127)	(18,091)	(29)	—	—	—	(18,247)
Group before RFS MI	57,198	99,209	560,273	13,466	432,225	270,976	43,323	1,476,670
RFS MI	—	2	—	—	—	—	32	34
Group	57,198	99,211	560,273	13,466	432,225	270,976	43,355	1,476,704
Core								
AQ1	56,637	91,298	103,645	7,180	396,419	71,091	9,651	735,921
AQ2	14	550	10,534	1,274	2,243	24,923	1,728	41,266

AQ3	48	2,165	23,102	155	3,132	23,546	4,268	56,416
AQ4	10	539	85,779	577	3,017	36,909	5,070	131,901
AQ5	99	2,247	100,051	79	3,988	35,302	4,924	146,690
AQ6	3	138	53,498	34	805	24,050	2,140	80,668
AQ7	2	154	38,438	70	595	17,605	2,309	59,173
AQ8	—	15	13,290	14	257	8,617	9,434	31,627
AQ9	—	107	9,898	52	237	3,442	886	14,622
AQ10	5	300	2,777	2	368	1,500	250	5,202
Past due	—	3	10,744	2,629	—	—	—	13,376
Impaired	—	144	13,367	375	—	—	—	13,886
Impairment provision	—	(126)	(7,740)	(29)	—	—	—	(7,895)
Group	56,818	97,534	457,383	12,412	411,061	246,985	40,660	1,322,853

For the note to these tables refer to page 167.

Business review Risk and balance sheet management continued

Balance sheet analysis: Asset quality continued

2010	Cash and balances at central banks £m	Loans and advances Banks (1) £m	Customers £m	Settlement balances and other financial assets £m	Derivatives £m	Commitments £m	Contingent liabilities £m	Total £m
Non-Core								
AQ1	18	1,196	25,172	577	14,956	7,637	94	49,650
AQ2	—	48	2,748	137	1,461	1,205	252	5,851
AQ3	—	32	3,130	1	185	2,185	69	5,602
AQ4	362	209	9,998	—	374	4,118	1,452	16,513
AQ5	—	75	15,931	180	1,411	3,310	245	21,152
AQ6	—	21	13,185	—	265	1,941	90	15,502
AQ7	—	24	7,634	80	869	1,147	147	9,901
AQ8	—	—	3,283	—	146	672	111	4,212
AQ9	—	8	4,365	33	284	447	46	5,183
AQ10	—	55	2,867	—	1,213	1,329	157	5,621
Past due	—	7	2,686	46	—	—	—	2,739
Impaired	—	1	22,242	—	—	—	—	22,243
Impairment provision	—	(1)	(10,351)	—	—	—	—	(10,352)
Group before RFS MI	380	1,675	102,890	1,054	21,164	23,991	2,663	153,817
RFS MI	—	2	—	—	—	—	32	34
Group	380	1,677	102,890	1,054	21,164	23,991	2,695	153,851

Note:
(1) Excludes items in the course of collection from other banks (2011 - £1,470 million; 2010 - £1,958 million).

Key points
- In 2012, the Group implemented updates to certain models, including those used for sovereign and financial institution counterparties, to incorporate more recent data and reflect new regulatory requirements applicable to wholesale internal ratings based modelling. This has resulted in ratings migration from AQ1, primarily to AQ2-AQ5. However, it is not practicable to quantify the impact of model updates on individual asset quality bands. The Group had modified various risk frameworks, including risk appetite framework and latent loss assessment in anticipation of these changes. Further updates, primarily of models used for the corporate counterparties, are planned for 2013. The AQ composition of the corporate portfolio has not changed materially during the year.

- Loans and advances to banks: AQ1 balances decreased by £41.8 billion reflecting the balance sheet reduction, mainly in Markets and also the impact of model changes which resulted in certain counterparties moving to lower AQ bands, primarily to AQ2-AQ4, which increased by £6.8 billion, £8.7 billion and £9.1 billion respectively.

- Loans and advances to customers: Lower internal ratings due to model changes resulted in balances shifting from AQ1 to lower bands. The decrease in AQ5 and AQ6 balances is in line with the overall balance sheet reduction.

- Derivatives: Balance sheet reductions in Markets and model updates resulted in decrease in AQ1 balances. Increase in AQ2-AQ4 balances reflects the re-grading of counterparties previously included in AQ1.

- Impaired and past due assets, net of impairment provisions, comprise 37% of Non-Core balances. Continued weakness in commercial real estate market overall and difficult conditions in Ireland are significant contributors to this.

Debt securities

IFRS measurement classification and issuer

The table below analyses debt securities by issuer and IFRS measurement classifications. US central and local government includes US federal agencies; financial institutions includes US government sponsored agencies and securitisation entities.

	Central and local government				Other financial			Of which ABS
	UK	US	Other	Banks	institutions	Corporate	Total	(1)
2012	£m	£m	£m	£m	£m	£m	£m	£m
Held-for-trading (HFT)	7,692	17,349	27,195	2,243	21,876	2,015	78,370	18,619
Designated as at fair value	—	—	123	86	610	54	873	516
Available-for-sale	9,774	19,046	16,155	8,861	23,890	3,167	80,893	30,743
Loans and receivables	5	—	—	365	3,728	390	4,488	3,707
Long positions	17,471	36,395	43,473	11,555	50,104	5,626	164,624	53,585
Of which US agencies	—	5,380	—	—	21,566	—	26,946	24,828
Short positions (HFT)	(1,538)	(10,658)	(11,355)	(1,036)	(1,595)	(798)	(26,980)	(17)
Available-for-sale								
Gross unrealised gains	1,007	1,092	1,187	110	660	120	4,176	764
Gross unrealised losses	—	(1)	(14)	(509)	(1,319)	(4)	(1,847)	(1,817)
2011								
Held-for-trading	9,004	19,636	36,928	3,400	23,160	2,948	95,076	20,816
Designated as at fair value	1	—	127	53	457	9	647	558
Available-for-sale	13,436	20,848	25,552	13,175	31,752	2,535	107,298	40,735
Loans and receivables	10	—	1	312	5,259	477	6,059	5,200
Long positions	22,451	40,484	62,608	16,940	60,628	5,969	209,080	67,309
Of which US agencies	—	4,896	—	—	25,924	—	30,820	28,558
Short positions (HFT)	(3,098)	(10,661)	(19,136)	(2,556)	(2,854)	(754)	(39,059)	(352)
Available-for-sale								
Gross unrealised gains	1,428	1,311	1,180	52	913	94	4,978	1,001
Gross unrealised losses	—	—	(171)	(838)	(2,386)	(13)	(3,408)	(3,158)
2010								
Held-for-trading	5,097	15,648	42,828	5,486	23,711	6,099	98,869	21,988
Designated as at fair value	1	117	262	4	8	10	402	119
Available-for-sale	8,377	22,244	32,865	16,982	29,148	1,514	111,130	42,515
Loans and receivables	11	—	—	1	6,686	381	7,079	6,203
Long positions	13,486	38,009	75,955	22,473	59,553	8,004	217,480	70,825

Of which US agencies	—	6,811	—	—	21,686	—	28,497	25,375
Short positions (HFT)	(4,200)	(10,943)	(18,913)	(1,844)	(3,356)	(1,761)	(41,017)	(1,335)
Available-for-sale								
Gross unrealised gains	349	525	700	143	827	51	2,595	1,057
Gross unrealised losses	(10)	(2)	(618)	(786)	(2,626)	(55)	(4,097)	(3,396)

Note:

(1) Asset-backed securities.

Balance sheet analysis: Debt securities continued

Key points

Debt securities decreased by £44.5 billion or 21% during the year, principally due to a reduction of £26.4 billion in available-for-sale (AFS) across the Group and £16.7 billion of HFT positions within Markets reflecting a combination of de-risking strategies and active balance sheet management.

HFT

- The £16.7 billion decrease comprised £13.3 billion of central and local government, £1.3 billion financial institutions, £1.2 billion of banks and £0.9 billion of corporate:

- Decrease in UK and US government bonds of £1.3 billion and £2.3 billion respectively reflected maturities and disposals in line with Markets balance sheet management strategy and unwinding of positions.

- Reduction in other government bonds principally French, Italian, Swiss and Japanese, was partially offset by moves to German and Belgian bonds.

AFS

- Decreased by £26.4 billion, comprising £14.9 billion of central and local government, other financial institutions £7.9 billion, banks £4.3 billion offset by an increase in Corporate of £0.6 billion:

- UK and US government bonds fell by £3.7 billion and £1.8 billion respectively, primarily due to disposals.

- Group Treasury reduced its liquidity portfolio, reflecting smaller balance sheet resulting in lower government bonds primarily German and French (£6.0 billion)

- Japanese government bonds fell by £2.2 billion as lower collateral was required following a change in clearing status from direct (self- clearing) to agency.

- Reduction in ABS: US agency decrease reflected maturities and disposals in light of favourable market conditions in the US, Markets, and US Retail & Commercial; and Non-Core strategic reductions also contributed to the decrease in bonds issued by financial institutions.

- Bank bonds decreased by £4.3 billion of which £1.7 billion related to Spanish covered bonds reflecting disposals by Group Treasury, and lower positions in Australian and German securities reflected the close out of positions and maturities, respectively.

Ratings

The table below analyses debt securities by issuer and external ratings. Ratings are based on the lower of Standard and Poor's, Moody's and Fitch.

	Central and local government				Other financial				Of which
	UK	US	Other	Banks	institutions	Corporate	Total	Total	ABS (1)
2012	£m	£m	£m	£m	£m	£m	£m	%	£m
Total									
AAA	17,471	31	17,167	2,304	11,502	174	48,649	30	10,758

AA to AA+	—	36,357	7,424	1,144	26,403	750	72,078	44	28,775
A to AA-	—	6	11,707	2,930	3,338	1,976	19,957	12	2,897
BBB- to A-	—	—	6,245	4,430	4,217	1,643	16,535	10	7,394
Non-investment grade	—	—	928	439	3,103	614	5,084	3	2,674
Unrated	—	1	2	308	1,541	469	2,321	1	1,087
	17,471	36,395	43,473	11,555	50,104	5,626	164,624	100	53,585
Core									
AAA	17,471	31	17,161	2,296	10,023	172	47,154	30	9,319
AA to AA+	—	36,283	7,419	1,137	24,879	748	70,466	45	27,255
A to AA-	—	6	11,707	2,920	2,019	1,968	18,620	12	1,603
BBB- to A-	—	—	6,245	4,430	3,701	1,602	15,978	10	6,812
Non-investment grade	—	—	682	439	2,361	496	3,978	2	2,176
Unrated	—	1	2	294	1,297	338	1,932	1	859
	17,471	36,321	43,216	11,516	44,280	5,324	158,128	100	48,024
Non-Core									
AAA	—	—	6	8	1,479	2	1,495	23	1,439
AA to AA+	—	74	5	7	1,524	2	1,612	25	1,520
A to AA-	—	—	—	10	1,319	8	1,337	21	1,294
BBB- to A-	—	—	—	—	516	41	557	8	582
Non-investment grade	—	—	246	—	742	118	1,106	17	498
Unrated	—	—	—	14	244	131	389	6	228
	—	74	257	39	5,824	302	6,496	100	5,561

For the note to these tables refer to page 171.

	Central and local government								Of which
	UK	US	Other	Banks	Other financial institutions	Corporate	Total	Total	ABS (1)
2011	£m	£m	£m	£m	£m	£m	£m	%	£m
Total									
AAA	22,451	45	32,522	5,155	15,908	452	76,533	37	17,156
AA to AA+	—	40,435	2,000	2,497	30,403	639	75,974	36	33,615
A to AA-	—	1	24,966	6,387	4,979	1,746	38,079	18	6,331
BBB- to A-	—	—	2,194	2,287	2,916	1,446	8,843	4	4,480
Non-investment grade	—	—	924	575	5,042	1,275	7,816	4	4,492
Unrated	—	3	2	39	1,380	411	1,835	1	1,235
	22,451	40,484	62,608	16,940	60,628	5,969	209,080	100	67,309
Core									
AAA	22,112	45	32,489	4,601	13,245	448	72,940	37	14,534
AA to AA+	—	40,435	1,995	2,434	28,125	565	73,554	38	31,323
A to AA-	—	1	24,964	6,302	3,348	1,614	36,229	18	4,731
BBB- to A-	—	—	2,194	2,272	1,727	1,232	7,425	4	3,188
Non-investment grade	—	—	723	559	2,542	1,048	4,872	2	2,552
Unrated	—	3	1	25	821	260	1,110	1	785
	22,112	40,484	62,366	16,193	49,808	5,167	196,130	100	57,113
Non-Core									
AAA	339	—	33	554	2,663	4	3,593	28	2,622
AA to AA+	—	—	5	63	2,278	74	2,420	19	2,292
A to AA-	—	—	2	85	1,631	132	1,850	14	1,600
BBB- to A-	—	—	—	15	1,189	214	1,418	11	1,292
Non-investment grade	—	—	201	16	2,500	227	2,944	23	1,940
Unrated	—	—	1	14	559	151	725	5	450
	339	—	242	747	10,820	802	12,950	100	10,196

For the note to these tables refer to page 171.

Business review Risk and balance sheet management continued

Balance sheet analysis: Debt securities continued

2010	Central and local government UK £m	US £m	Other £m	Banks £m	Other financial institutions £m	Corporate £m	Total £m	Total (2) %	Of which ABS (1) £m
Total									
AAA	13,486	38,009	44,123	10,704	39,388	878	146,588	67	51,235
AA to AA+	—	—	18,025	3,511	6,023	616	28,175	13	6,335
A to AA-	—	—	9,138	4,926	2,656	1,155	17,875	8	3,244
BBB- to A-	—	—	2,845	1,324	3,412	2,005	9,586	5	3,385
Non-investment grade	—	—	1,770	1,528	5,522	2,425	11,245	5	4,923
Unrated	—	—	54	480	2,552	925	4,011	2	1,703
	13,486	38,009	75,955	22,473	59,553	8,004	217,480	100	70,825
Core									
AAA	13,110	37,698	44,101	10,532	35,595	839	141,875	70	47,441
AA to AA+	—	—	18,025	3,485	3,242	612	25,364	13	3,656
A to AA-	—	—	9,138	4,420	1,605	1,089	16,252	8	1,879
BBB- to A-	—	—	2,845	1,050	1,412	1,903	7,210	4	1,108
Non-investment grade	—	—	1,464	1,444	3,658	2,014	8,580	4	3,052
Unrated	—	—	53	420	1,375	768	2,616	1	978
	13,110	37,698	75,626	21,351	46,887	7,225	201,897	100	58,114
Non-Core									
AAA	376	311	22	172	3,793	39	4,713	30	3,794
AA to AA+	—	—	—	26	2,781	4	2,811	18	2,679
A to AA-	—	—	—	506	1,051	66	1,623	11	1,365
BBB- to A-	—	—	—	274	2,000	102	2,376	15	2,277
Non-investment grade	—	—	306	84	1,864	411	2,665	17	1,871
Unrated	—	—	1	60	1,177	157	1,395	9	725
	376	311	329	1,122	12,666	779	15,583	100	12,711

Notes:

(1) Asset-backed securities.

(2) Percentage calculated on Group before RFS MI.

Key points

- AAA rated debt securities decreased as France and Austria were downgraded to AA+ in the first half of 2012 and also reflected the Group's reduced holdings of UK government bonds. Additionally, certain Spanish covered bonds were downgraded in the first half of 2012.

- The decrease in A to AA- debt securities related to downgrades of Italy and Spain to BBB+ and BBB- respectively, in the first half of 2012, along with a downgrade of selected banks.

- Non-investment grade and unrated debt securities decreased by £2.2 billion and accounted for 4% of the portfolio.

Asset-backed securities

Introduction

The Group structures, originates, distributes and trades debt in the form of loan, bond and derivative instruments in all major currencies and debt capital markets in North America, Western Europe, Asia and major emerging markets. The carrying value of the Group's debt securities is detailed below.

The Group's credit market activities gave rise to risk concentrations in asset-backed securities (ABS). The Group has exposures to ABS, which are predominantly debt securities, but can also be held in derivative form. ABS have an interest in an underlying pool of referenced assets. The risks and rewards of the referenced pool are passed onto investors by the issue of securities with varying seniority by a special purpose entity.

Debt securities include residential mortgage-backed securities (RMBS), commercial mortgage-backed securities (CMBS), collateralised debt obligations (CDOs), collateralised loan obligations (CLOs) and other ABS. In many cases, the risk associated with these assets is hedged by credit derivatives. The counterparties to some of these hedge transactions are monoline insurers.

The following tables summarise the gross and net exposures and carrying values of these securities by the location of the underlying assets at 31 December 2012, 2011 and 2010 and by IFRS measurement classification of held-for-trading (HFT), designated at fair value (DFV), available-for-sale (AFS) and loans and receivables (LAR). Gross exposures represent the principal amounts relating to ABS. Government sponsored or similar RMBS comprises securities that are: (a) guaranteed or effectively guaranteed by the US government, by way of its support for US federal agencies and government sponsored enterprises or (b) guaranteed by the Dutch government. Net exposures represent the carrying value after taking account of protection purchased from monoline insurers and other counterparties, but exclude the effect of counterparty credit valuation adjustments. The hedge provides credit protection of both principal and interest cash flows in the event of default by the counterparty. The value of this protection is based on the underlying instrument being protected.

Residential mortgage-backed securities

RMBS are securities that represent an interest in a portfolio of residential mortgages. Repayments made on the underlying mortgages are used to make payments to holders of the RMBS. The risk of the RMBS will vary primarily depending on the quality and geographic region in which the underlying mortgage assets are located and the credit enhancement of the securitisation structure. Several tranches of notes are issued, each secured against the same portfolio of mortgages, but providing differing levels of seniority to match the risk appetite of investors. The most junior (or equity) notes will suffer early capital and interest losses experienced by the referenced mortgage collateral, with each more senior note benefiting from the protection provided by the subordinated notes below. Additional credit enhancements may be provided to the holder of senior RMBS notes, including provided by monoline insurers.

The main categories of mortgages that serve as collateral to RMBS held by the Group with related vintages are set out below and described in the Glossary on pages 494 to 501. The US market has more established definitions of differing underlying mortgage quality and these are used as the basis for the Group's RMBS categorisation.

The Group RMBS classifications include sub-prime and non-conforming. Non-conforming RMBS include Alt-A RMBS. Classification as sub-prime or Alt-A is based on Fair Isaac Corporation scores (FICO), level of documentation and loan-to-value (LTV) ratios of the underlying mortgage loans. RMBS are classified as sub-prime if the mortgage portfolio comprises loans with FICO scores between 500 and 650 with full or limited documentation. Mortgages in Alt-A RMBS portfolios have FICO scores of 640 to 720, limited documentation and an original LTV of 70% to 100%.

Balance sheet analysis: Debt securities continued
Product, geography and IFRS measurement classification

2012	US £m	UK £m	Europe £m	RoW £m	Total £m	HFT £m	DFV £m	AFS £m	LAR £m
Gross exposure									
RMBS: government sponsored or similar	22,162	—	5,366	18	27,546	13,961	—	13,585	—
RMBS: prime	819	2,821	1,181	403	5,224	753	509	3,876	86
RMBS: non-conforming	595	2,077	58	—	2,730	202	—	1,235	1,293
RMBS: sub-prime	968	99	66	5	1,138	1,027	—	5	106
MBS: covered bond	46	172	6,129	—	6,347	—	—	6,347	—
CMBS	3,352	1,121	671	3	5,147	1,992	—	2,327	828
CDOs	4,002	42	404	—	4,448	3,111	—	1,307	30
CLOs	2,705	44	787	—	3,536	1,049	—	2,422	65
ABS covered bond	—	132	374	16	522	—	—	522	—
Other ABS	1,632	1,873	1,111	306	4,922	1,667	7	1,774	1,474
	36,281	8,381	16,147	751	61,560	23,762	516	33,400	3,882
Carrying value									
RMBS: government sponsored or similar	22,460	—	4,879	18	27,357	13,959	—	13,398	—
RMBS: prime	717	2,552	912	390	4,571	569	509	3,420	73
RMBS: non-conforming	477	1,918	58	—	2,453	150	—	1,009	1,294
RMBS: sub-prime	660	73	46	5	784	682	—	—	102
MBS: covered bond	48	204	5,478	—	5,730	—	—	5,730	—
CMBS	3,274	821	425	3	4,523	1,489	—	2,284	750
CDOs	480	22	218	—	720	104	—	589	27
CLOs	2,550	12	464	—	3,026	697	—	2,266	63
ABS covered bond	—	137	380	16	533	—	—	533	—
Other ABS	1,401	1,263	929	295	3,888	969	7	1,514	1,398
	32,067	7,002	13,789	727	53,585	18,619	516	30,743	3,707
Net exposure									
RMBS: government sponsored or similar	22,460	—	4,879	18	27,357	13,959	—	13,398	—
RMBS: prime	513	2,549	911	383	4,356	554	509	3,221	72
RMBS: non-conforming	277	1,908	58	—	2,243	110	—	839	1,294
RMBS: sub-prime	417	73	46	4	540	439	—	—	101
MBS: covered bond	48	204	5,478	—	5,730	—	—	5,730	—
CMBS	2,535	821	425	3	3,784	750	—	2,284	750
CDOs	162	22	212	1	397	79	—	290	28
CLOs	879	12	459	—	1,350	639	—	648	63

ABS covered bond	—	137	380	16	533	—	—	533	—
Other ABS	1,257	1,170	929	163	3,519	601	7	1,513	1,398
	28,548	6,896	13,777	588	49,809	17,131	516	28,456	3,706

Business review Risk and balance sheet management continued

2011	US £m	UK £m	Europe £m	RoW £m	Total £m	HFT £m	DFV £m	AFS £m	LAR £m
Gross exposure									
RMBS: government sponsored or similar	27,549	—	5,884	2	33,435	15,031	—	18,404	—
RMBS: prime	1,201	3,487	1,541	484	6,713	1,090	567	4,977	79
RMBS: non-conforming	1,220	2,197	74	—	3,491	717	—	1,402	1,372
RMBS: sub-prime	1,847	427	94	2	2,370	2,183	—	22	165
MBS: covered bond	133	203	8,256	—	8,592	—	—	8,592	—
CMBS	1,623	1,562	883	1	4,069	2,001	—	862	1,206
CDOs	7,889	72	469	—	8,430	4,455	—	3,885	90
CLOs	5,019	156	1,055	—	6,230	1,294	—	4,734	202
ABS covered bond	21	71	948	4	1,044	—	—	1,044	—
Other ABS	2,085	1,844	1,746	992	6,667	1,965	17	2,389	2,296
	48,587	10,019	20,950	1,485	81,041	28,736	584	46,311	5,410
Carrying value									
RMBS: government sponsored or similar	28,022	—	5,549	2	33,573	15,132	—	18,441	—
RMBS: prime	1,035	3,038	1,206	466	5,745	872	558	4,243	72
RMBS: non-conforming	708	1,897	74	—	2,679	327	—	980	1,372
RMBS: sub-prime	686	144	72	2	904	737	—	9	158
MBS: covered bond	136	209	7,175	—	7,520	—	—	7,520	—
CMBS	1,502	1,253	635	1	3,391	1,513	—	716	1,162
CDOs	1,632	31	294	—	1,957	315	—	1,555	87
CLOs	4,524	98	719	—	5,341	882	—	4,280	179
ABS covered bond	19	70	953	4	1,046	—	—	1,046	—
Other ABS	1,715	947	1,525	966	5,153	1,038	—	1,945	2,170
	39,979	7,687	18,202	1,441	67,309	20,816	558	40,735	5,200
Net exposure									
RMBS: government sponsored or similar	28,022	—	5,549	2	33,573	15,132	—	18,441	—
RMBS: prime	825	3,456	1,005	458	5,744	447	557	4,668	72
RMBS: non-conforming	677	2,225	74	—	2,976	284	—	1,320	1,372
RMBS: sub-prime	385	138	67	2	592	434	—	—	158
MBS: covered bond	136	209	7,175	—	7,520	—	—	7,520	—
CMBS	860	1,253	543	1	2,657	777	—	718	1,162
CDOs	1,030	31	294	—	1,355	304	—	964	87
CLOs	1,367	98	712	—	2,177	827	—	1,171	179
ABS covered bond	19	70	952	4	1,045	—	—	1,045	—
Other ABS	1,456	843	1,527	804	4,630	617	—	1,941	2,071
	34,777	8,323	17,898	1,271	62,269	18,822	557	37,788	5,101

Business review Risk and balance sheet management continued

Balance sheet analysis: Debt securities continued

2010	US £m	UK £m	Europe £m	RoW £m	Total £m	HFT £m	DFV £m	AFS £m	LAR £m
Gross exposure									
RMBS: government sponsored or similar	24,207	16	6,422	—	30,645	13,840	—	16,805	—
RMBS: prime	1,784	3,385	1,118	192	6,479	1,605	1	4,749	124
RMBS: non-conforming	1,249	2,107	92	—	3,448	708	—	1,313	1,427
RMBS: sub-prime	792	365	139	221	1,517	819	—	496	202
MBS: covered bond	138	208	8,525	—	8,871	—	—	8,871	—
CMBS	3,086	1,451	912	45	5,494	2,646	120	1,409	1,319
CDOs	12,156	128	453	—	12,737	7,951	—	4,687	99
CLOs	6,038	134	879	9	7,060	1,062	—	5,572	426
ABS covered bond	—	—	1,908	—	1,908	—	—	1,908	—
Other ABS	3,104	1,144	963	1,705	6,916	1,533	—	2,615	2,768
	52,554	8,938	21,411	2,172	85,075	30,164	121	48,425	6,365
Carrying value									
RMBS: government sponsored or similar	24,390	16	5,958	—	30,364	13,765	—	16,599	—
RMBS: prime	1,624	3,000	931	192	5,747	1,384	1	4,249	113
RMBS: non-conforming	1,084	1,959	92	—	3,135	605	—	1,102	1,428
RMBS: sub-prime	638	255	120	205	1,218	681	—	344	193
MBS: covered bond	142	208	7,522	—	7,872	—	—	7,872	—
CMBS	2,936	1,338	638	38	4,950	2,262	118	1,281	1,289
CDOs	3,135	69	254	—	3,458	1,341	—	2,021	96
CLOs	5,334	102	635	3	6,074	691	—	4,958	425
ABS covered bond	—	—	1,861	—	1,861	—	—	1,861	—
Other ABS	2,780	945	754	1,667	6,146	1,259	—	2,228	2,659
	42,063	7,892	18,765	2,105	70,825	21,988	119	42,515	6,203
Net exposure									
RMBS: government sponsored or similar	24,390	16	5,958	—	30,364	13,765	—	16,599	—
RMBS: prime	1,523	2,948	596	192	5,259	897	1	4,248	113
RMBS: non-conforming	1,081	1,959	92	—	3,132	602	—	1,102	1,428
RMBS: sub-prime	289	253	112	176	830	305	—	332	193
MBS: covered bond	142	208	7,522	—	7,872	—	—	7,872	—
CMBS	1,823	1,336	458	38	3,655	1,188	10	1,230	1,227
CDOs	1,085	39	245	—	1,369	743	—	530	96
CLOs	1,387	102	629	1	2,119	673	—	1,021	425
ABS covered bond	—	—	1,861	—	1,861	—	—	1,861	—

Other ABS	2,293	748	748	1,659	5,448	690	—	2,220	2,538
	34,013	7,609	18,221	2,066	61,909	18,863	11	37,015	6,020

Business review Risk and balance sheet management continued

Ratings
The table below summarises the rating levels of ABS carrying values.

	RMBS										
	Government sponsored or similar (1)	Prime	Non-conforming	Sub-prime	MBS covered bond	CMBS	CDOs	CLOs	ABS covered bond	Other ABS	Total
2012	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
AAA	2,454	2,854	1,487	11	639	396	92	1,181	165	1,479	10,758
AA to AA+	23,692	613	88	26	102	2,551	7	887	340	469	28,775
A to AA-	201	302	275	33	155	808	74	146	20	883	2,897
BBB- to A-	990	53	141	86	4,698	441	32	291	8	654	7,394
Non-investment grade (2)	20	641	454	330	136	304	421	133	—	235	2,674
Unrated (3)	—	108	8	298	—	23	94	388	—	168	1,087
	27,357	4,571	2,453	784	5,730	4,523	720	3,026	533	3,888	53,585
Of which in Non-Core	—	651	404	154	—	780	494	2,228	—	850	5,561
2011											
AAA	4,169	3,599	1,488	105	2,595	647	135	2,171	625	1,622	17,156
AA to AA+	29,252	669	106	60	379	710	35	1,533	321	550	33,615
A to AA-	131	506	110	104	2,567	1,230	161	697	100	725	6,331
BBB- to A-	—	39	288	93	1,979	333	86	341	—	1,321	4,480
Non-investment grade (2)	21	784	658	396	—	415	1,370	176	—	672	4,492
Unrated (3)	—	148	29	146	—	56	170	423	—	263	1,235
	33,573	5,745	2,679	904	7,520	3,391	1,957	5,341	1,046	5,153	67,309
Of which in Non-Core	—	837	477	308	—	830	1,656	4,227	—	1,861	10,196
2010											
AAA	28,835	4,355	1,754	317	7,107	2,789	444	2,490	988	2,156	51,235
AA to AA+	1,529	147	144	116	357	392	567	1,786	681	616	6,335
A to AA-	—	67	60	212	408	973	296	343	192	693	3,244
BBB- to A-	—	82	316	39	—	500	203	527	—	1,718	3,385
Non-investment grade (2)	—	900	809	458	—	296	1,863	332	—	265	4,923
Unrated (3)	—	196	52	76	—	—	85	596	—	698	1,703
	30,364	5,747	3,135	1,218	7,872	4,950	3,458	6,074	1,861	6,146	70,825
Of which in Non-Core	—	81	336	379	—	1,278	3,159	5,094	—	2,386	12,713

Notes:

(1) Includes US agency and Dutch government guaranteed securities.
(2) Includes HFT £1,177 million (2011 - £1,682 million; 2010 - £2,456 million), DFV £7 million (2011 and 2010 - nil), AFS £1,173 million (2011 - £2,056 million; 2010 - £2,160 million) and LAR £317 million (2011 - £754 million; 2010 - £307 million).
(3) Includes HFT £808 million (2011 - £804 million; 2010 - £867 million), AFS £149 million (2011 - £249 million; 2010 - £491 million) and LAR £130 million (2011 - £182 million; 2010 - £345 million).

Balance sheet analysis continued

Equity shares

The table below analyses holdings of equity shares for eurozone countries and other countries with balances more than £100 million by country, issuer and measurement classification. The HFT portfolios in Markets comprise positions in the Markets Derivative Products Solutions business primarily for economic hedging of liabilities including debt issuances and equity derivatives. The AFS portfolios include capital stock in the Federal Home Loans Bank (a government sponsored entity, included in Other financial institutions) and the Federal Reserve Bank together £0.7 billion, that US Retail & Commercial are required to hold and a number a number of individually small holdings in unlisted companies, mainly acquired through loan renegotiations in GRG.

	2012										
	HFT/DFV (1)				AFS						
Countries	Banks £m	Other financial institutions (2) £m	Corporate £m	Total HFT/DFV £m	Banks £m	Other financial institutions £m	Corporate £m	Total AFS £m	Total £m	AFS reserves £m	HFT short positions £m
Ireland	—	126	47	173	—	17	—	17	190	—	(3)
Spain	18	—	110	128	—	—	33	33	161	(41)	—
Italy	7	1	33	41	—	5	—	5	46	—	(15)
Greece	—	—	6	6	—	—	—	—	6	—	—
Portugal	—	—	5	5	—	—	—	—	5	—	—
Eurozone periphery	25	127	201	353	—	22	33	55	408	(41)	(18)
Netherlands	20	197	465	682	—	—	156	156	838	(19)	(21)
France	10	75	142	227	—	1	104	105	332	23	(10)
Luxembourg	14	196	77	287	—	6	3	9	296	1	(1)
Germany	33	1	106	140	—	—	—	—	140	—	(54)
Belgium	—	23	6	29	—	3	—	3	32	1	(1)
Other	18	3	110	131	—	—	—	—	131	—	(14)
Total eurozone	120	622	1,107	1,849	—	32	296	328	2,177	(35)	(119)
US	208	619	2,663	3,490	307	419	—	726	4,216	7	(132)
UK	372	163	2,648	3,183	35	51	155	241	3,424	73	(35)
Japan	24	67	973	1,064	—	2	—	2	1,066	—	(1)
South Korea	32	72	880	984	—	—	—	—	984	—	—
China	331	147	357	835	—	14	3	17	852	7	(3)
India	29	68	220	317	—	—	—	—	317	—	—
Taiwan	2	31	259	292	—	—	—	—	292	—	(11)
Australia	77	45	159	281	—	—	—	—	281	—	(17)
Canada	14	25	200	239	—	—	2	2	241	2	(277)
Hong Kong	2	81	97	180	—	—	4	4	184	2	—
Romania	16	4	158	178	—	—	—	—	178	—	—
Russia	—	123	—	123	—	—	—	—	123	—	—

MDB and supranationals (3)	—	—	156	156	—	—	—	—	156	—	—
Other	74	50	567	691	—	37	18	55	746	28	(16)
Total	1,301	2,117	10,444	13,862	342	555	478	1,375	15,237	84	(611)

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

Business review Risk and balance sheet management continued

	2011										
	HFT/DFV (1)				AFS						
Countries	Banks £m	Other financial institutions (2) £m	Corporate £m	Total HFT/DFV £m	Banks £m	Other financial institutions £m	Corporate £m	Total AFS £m	Total £m	AFS reserves £m	HFT short positions £m
Ireland	—	7	208	215	—	6	—	6	221	—	(4)
Spain	55	2	75	132	—	—	72	72	204	(4)	(16)
Italy	11	1	51	63	—	5	—	5	68	—	(4)
Greece	—	1	2	3	—	—	—	—	3	—	(22)
Portugal	—	—	—	—	—	—	5	5	5	—	(1)
Eurozone periphery	66	11	336	413	—	11	77	88	501	(4)	(47)
Netherlands	1	67	671	739	—	55	—	55	794	(76)	(82)
France	12	15	117	144	3	2	97	102	246	20	(62)
Luxembourg	—	201	90	291	383	3	—	386	677	17	—
Germany	23	4	114	141	—	—	—	—	141	—	(186)
Belgium	2	8	4	14	—	15	1	16	30	10	(10)
Other	18	15	102	135	—	—	—	—	135	—	(58)
Total eurozone	122	321	1,434	1,877	386	86	175	647	2,524	(33)	(445)
US	120	97	1,442	1,659	323	575	52	950	2,609	128	(544)
UK	420	217	2,785	3,422	33	215	64	312	3,734	40	(145)
Japan	43	82	1,289	1,414	—	1	—	1	1,415	—	(3)
South Korea	2	47	299	348	—	—	—	—	348	—	(3)
China	510	228	637	1,375	—	13	—	13	1,388	4	(6)
India	35	14	314	363	—	—	—	—	363	—	—
Taiwan	2	37	226	265	—	—	—	—	265	—	(4)
Australia	95	90	406	591	—	—	14	14	605	2	(219)
Canada	—	4	148	152	—	—	2	2	154	2	(449)
Hong Kong	10	45	100	155	—	—	3	3	158	(2)	(2)
Russia	30	—	215	245	—	—	—	—	245	—	(2)
Romania	1	45	—	46	—	—	—	—	46	—	—
MDB and supranationals (3)	—	—	233	233	—	—	—	—	233	—	—
Other	86	381	600	1,067	—	3	31	34	1,101	26	(158)
Total	1,476	1,608	10,128	13,212	742	893	341	1,976	15,188	167	(1,980)

Notes:

(1) Designated as at fair value through profit or loss (DFV) balances are £533 million (2011 - £774 million) of which nil banks (2011 - nil), £61 million other financial institutions (2011 - £81 million) and £472 million corporate (2011 - £693 million).

(2) Includes government sponsored entities (GSEs).
(3) MDB - Multilateral Development Banks.

Balance sheet analysis continued

Derivatives

Summary

The table below analyses the fair value of the Group’s derivatives by type of contract. Master netting arrangements in respect of mark-to-market (mtm) positions and collateral shown below do not result in a net presentation on the Group’s balance sheet under IFRS.

	2012							2011			2010		
	Notional (1)												
Contract type	GBP £bn	USD £bn	Euro £bn	Other £bn	Total £bn	Assets £m	Liabilities £m	Notional £bn	Assets £m	Liabilities £m	Notional £bn	Assets £m	Liab
Interest rate (2)	5,144	10,395	11,343	6,601	33,483	363,454	345,565	38,727	422,553	406,784	39,764	312,111	29
Exchange rate	370	1,987	716	1,625	4,698	63,067	70,481	4,482	74,526	81,022	4,854	83,253	8
Credit	4	320	202	27	553	11,005	10,353	1,054	26,836	26,743	1,357	26,872	2
Other (3)	18	50	27	16	111	4,392	7,941	123	6,142	9,560	384	9,989	1
						441,918	434,340		530,057	524,109		432,225	42
Counterparty mtm netting						(373,906)	(373,906)		(441,626)	(441,626)		(330,397)	(33
Cash collateral						(34,099)	(24,633)		(37,222)	(31,368)		(31,096)	(3
Securities collateral						(5,616)	(8,264)		(5,312)	(8,585)		(2,904)	(
						28,297	27,537		45,897	42,530		67,828	6

Notes:

(1) Exchange traded contracts were £2,497 billion, principally interest rate. Trades are generally closed out daily hence mark-to-market was insignificant (assets - £41 million; liabilities - £255 million).

(2) Interest rate notional includes £15,864 billion (2011 - £16,377 billion) relating to contracts with central clearing houses.

(3) Comprises equity and commodity derivatives.

Key points

- Net exposure, after taking account of position and collateral netting arrangements, decreased by 38% (liabilities decreased by 35%) due to lower derivative fair values, driven by market movements, including foreign exchange rates and increased use of compression cycles.

- Interest rate contracts decreased due to the increased use of compression cycles reflecting a greater number of market participants and hence trade-matching and the effect of exchange rate movements. This was partially offset by downward shifts in interest rate yields.

- The decrease in exchange rate contracts reflected the impact of exchange rate movements and trade maturities. This was partially offset by higher trade volumes, reflecting hedge funds taking advantage of market uncertainty.

- Credit derivatives decreased due to a managed risk reduction and an increase in trades compressed through compression cycles.

Derivative fair values are driven by complex factors such as changes in foreign exchange rates, interest rates, credit default swap spreads and other underlying rates. At 31 December 2012, derivative fair values were in a net asset position of £7.6 billion. More specifically:

- Group Treasury issues long term fixed rate debt that is hedged with floating rate interest rate swaps and also uses swaps to hedge fixed rate indefinite maturity liabilities such as equity and customer accounts. As interest rates have fallen over recent years the fair value of these swaps has increased. This net asset position mirrored by the net liability position relating to the difference between the fair value and carrying value on fixed rate loans and current accounts.

- Within Markets the hedging of issued notes, more exotic derivatives and long dated zero coupon inflation structures have led to a positive fair value which is not offset by other derivatives or hedges.

Business review Risk and balance sheet management continued

Credit derivatives
The Group trades credit derivatives as part of its client led business and to mitigate credit risk. The Group's credit derivative exposures relating to proprietary trading are minimal. The table below analyses the Group's bought and sold protection.

	2012				2011				2010			
	Notional		Fair value		Notional		Fair value		Notional		Fair value	
	Bought £bn	Sold £bn	Bought £bn	Sold £bn	Bought £bn	Sold £bn	Bought £bn	Sold £bn	Bought £bn	Sold £bn	Bought £bn	Sold £bn
Client-led trading and residual risk	250.7	240.7	3.4	3.1	401.0	390.5	17.0	16.5	386.7	362.5	8.4	6.7
Credit hedging - banking book (1)	5.4	0.4	0.1	—	15.6	4.7	0.1	0.1	16.3	21.8	—	0.1
Credit hedging - trading book												
- rates	9.4	5.8	0.1	0.1	21.2	17.1	0.9	1.7	21.9	10.4	(0.9)	0.2
- credit and mortgage markets	22.4	16.0	0.9	0.7	42.9	28.4	2.3	1.7	168.1	172.7	3.5	3.1
- other	1.4	0.6	—	—	0.9	0.1	—	—	0.7	0.1	—	—
Total excluding APS	289.3	263.5	4.5	3.9	481.6	440.8	20.3	20.0	593.7	567.5	11.0	10.1
APS	—	—	—	—	131.8	—	(0.2)	—	195.8	—	0.6	—
	289.3	263.5	4.5	3.9	613.4	440.8	20.1	20.0	789.5	567.5	11.6	10.1
Core												
Client-led trading	231.4	228.4	3.0	2.7	371.0	369.4	14.6	14.0	347.5	343.0	5.2	4.4
Credit hedging - banking book	1.7	—	—	—	2.2	1.0	—	0.1	1.1	1.0	(0.2)	—
Credit hedging - trading book												
- rates	7.8	4.6	0.1	0.1	19.9	16.2	0.9	1.7	21.7	10.3	(0.8)	0.2
- credit and mortgage markets	13.9	13.6	0.2	0.2	4.6	4.0	0.3	0.2	4.4	4.3	0.2	0.3
- other	1.3	0.5	—	—	0.7	0.1	—	—	0.6	0.1	—	—
	256.1	247.1	3.3	3.0	398.4	390.7	15.8	16.0	375.3	358.7	4.4	4.9
Non-Core												
Residual risk	19.3	12.3	0.4	0.4	30.0	21.1	2.4	2.5	39.2	19.5	3.2	2.3
Credit hedging - banking book (1)	3.7	0.4	0.1	—	13.4	3.7	0.1	—	15.2	20.8	0.2	0.1
Credit hedging - trading book												

- rates	1.6	1.2	—	—	1.3	0.9	—	—	0.2	0.1	(0.1)	—
- credit and mortgage markets	8.5	2.4	0.7	0.5	38.3	24.4	2.0	1.5	163.7	168.4	3.3	2.8
- other	0.1	0.1	—	—	0.2	—	—	—	0.1	—	—	—
	33.2	16.4	1.2	0.9	83.2	50.1	4.5	4.0	218.4	208.8	6.6	5.2
By counterparty												
Central government (APS)	—	—	—	—	131.8	—	(0.2)	—	195.8	—	0.6	—
Monoline insurers	4.6	—	0.4	—	8.6	—	0.6	—	14.9	—	1.5	—
CDPCs (2)	21.0	—	0.2	—	24.5	—	0.9	—	25.0	—	0.8	—
Banks	127.2	128.6	2.3	2.8	204.1	202.1	8.5	10.2	370.7	370.6	5.0	5.7
Other financial institutions	135.8	134.9	1.4	1.1	234.8	231.6	10.5	9.5	176.6	195.0	4.4	4.3
Corporates	0.7	—	0.2	—	9.6	7.1	(0.2)	0.3	6.5	1.9	(0.7)	0.1
	289.3	263.5	4.5	3.9	613.4	440.8	20.1	20.0	789.5	567.5	11.6	10.1

Notes:

(1) Credit hedging in the banking book principally relates to portfolio management in Non-Core.

(2) Credit derivative product companies.

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Business review Risk and balance sheet management continued

Balance sheet analysis: Derivatives continued

Monoline insurers

The table below summarises the Group's exposure to monolines, all of which are in Non-Core.

	2012 £m	2011 £m	2010 £m
Gross exposure to monolines	561	1,888	4,023
Hedges with financial institutions	(12)	(71)	(71)
Credit valuation adjustment	(192)	(1,198)	(2,443)
Net exposure to monolines	357	619	1,509
Credit valuation adjustment as a % of gross exposure	34%	63%	61%
Counterparty and credit risk RWAs*	£1.2bn	£3.6bn	£17.8bn

The table below summarises monoline exposures by rating. Credit ratings are based on those from rating agencies Standard and Poor’s and Moody's. Where the ratings differ, the lower of the two is taken.

	Notional: protected assets	Fair value: reference protected assets	Gross exposure	Credit valuation adjustment	Hedges	Net exposure
2012	£m	£m	£m	£m	£m	£m
A to AA-	3,388	2,944	444	128	—	316
Non-investment grade	1,194	1,077	117	64	12	41
	4,582	4,021	561	192	12	357
Of which:						
CMBS	183	170	13	3		
CLOs	2,777	2,563	214	47		
Other ABS	1,202	999	203	95		
Other	420	289	131	47		
	4,582	4,021	561	192		
2011						
A to AA-	4,939	4,243	696	252	—	444
Non-investment grade	3,623	2,431	1,192	946	71	175
	8,562	6,674	1,888	1,198	71	619
Of which:						
CMBS	946	674	272	247		
CDOs	500	57	443	351		
CLOs	4,616	4,166	450	177		
Other ABS	1,998	1,455	543	334		
Other	502	322	180	89		
	8,562	6,674	1,888	1,198		

2010						
A to AA-	6,336	5,503	833	272	—	561
Non-investment grade	8,555	5,365	3,190	2,171	71	948
	14,891	10,868	4,023	2,443	71	1,509
Of which:						
CMBS	4,149	2,424	1,725	1,253		
CDOs	1,133	256	877	593		
CLOs	6,724	6,121	603	210		
Other ABS	2,393	1,779	614	294		
Other	492	288	204	93		
	14,891	10,868	4,023	2,443		

Key points

- The exposure to monolines declined during the year primarily due to restructuring of certain exposures and an increase in underlying asset prices.

- The credit valuation adjustment decreased on a total basis reflecting reduction in exposure and on a relative basis due to restructurings and tighter credit spreads.

Business review Risk and balance sheet management continued

Credit derivative product companies (CDPCs)
A summary of the Group's exposure to CDPCs, all of which are in Non-Core, is detailed below.

	2012 £m	2011 £m	2010 £m
Gross exposure to CDPCs	554	1,896	1,244
Valuation adjustment	(314)	(1,034)	(490)
Net exposure to CDPCs	240	862	754
Valuation adjustment as a % of gross exposure	57%	55%	39%
Counterparty and credit risk RWAs*	£2.0bn	£8.4bn	£7.2bn
Capital deductions	—	£245m	£280m

The table below details CDPC exposures by rating.

	Notional: protected assets £m	Fair value: reference protected assets £m	Gross exposure £m	Valuation adjustment £m	Net exposure £m
2012					
AAA	43	43	—	—	—
A to AA-	619	612	7	7	—
Non-investment grade	16,254	15,841	413	173	240
Unrated	4,073	3,939	134	134	—
	20,989	20,435	554	314	240
2011					
AAA	213	212	1	—	1
A to AA-	646	632	14	3	11
Non-investment grade	19,671	18,151	1,520	788	732
Unrated	3,974	3,613	361	243	118
	24,504	22,608	1,896	1,034	862
2010					
AAA	213	212	1	—	1
BBB- to A-	644	629	15	4	11
Non-investment grade	20,066	19,050	1,016	401	615
Unrated	4,165	3,953	212	85	127
	25,088	23,844	1,244	490	754

Key points

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The exposure to CDPCs decreased during the year primarily driven by tighter credit spreads of the underlying reference loans and bonds together with a decrease in the relative value of senior tranches compared with the underlying reference portfolio and the impact of restructuring certain exposures in the first half of the year.

- The valuation adjustment decreased on an absolute basis in line with the decrease in exposure while remaining stable on a relative basis.

Business review Risk and balance sheet management continued

Balance sheet analysis: continued

REIL, provisions and AFS reserves

Risk elements in lending (REIL) comprises impaired loans and accruing loans past due 90 days or more as to principal or interest. Impaired loans are all loans (including renegotiated loans) for which an impairment provision has been established; for collectively assessed loans, impairment loss provisions are not allocated to individual loans and the entire portfolio is included in impaired loans. Accruing loans past due 90 days or more comprise loans past due 90 days where no impairment loss is expected and those awaiting individual assessment. A latent provision is established for the latter.

Divisional analysis

The following tables analyse gross loans and advances to banks and customers (excluding reverse repos) and the related debt management measures and ratios by division.

	Gross loans to				Credit metrics			
					REIL as a % of gross loans to	Provisions as a %	Impairment	Amounts
	Banks	Customers	REIL	Provisions	customers	of REIL	charge	written-off
2012	£m	£m	£m	£m	%	%	£m	£m
UK Retail	695	113,599	4,569	2,629	4.0	58	529	599
UK Corporate	746	107,025	5,452	2,432	5.1	45	836	514
Wealth	1,545	17,074	248	109	1.5	44	46	15
International Banking	4,827	42,342	422	391	1.0	93	111	445
Ulster Bank	632	32,652	7,533	3,910	23.1	52	1,364	72
US Retail & Commercial	435	51,271	1,146	285	2.2	25	83	391
Retail & Commercial	8,880	363,963	19,370	9,756	5.3	50	2,969	2,036
Markets	16,805	29,787	396	305	1.3	77	25	109
Direct Line Group and other	5,232	3,006	—	1	—	—	1	—
Core	30,917	396,756	19,766	10,062	5.0	51	2,995	2,145
Non-Core	477	56,343	21,374	11,200	37.9	52	2,320	2,121
Group	31,394	453,099	41,140	21,262	9.1	52	5,315	4,266
2011								
UK Retail	628	110,659	4,599	2,679	4.2	58	788	823
UK Corporate	806	110,729	5,001	2,061	4.5	41	790	658
Wealth	2,422	16,913	211	81	1.2	38	25	11
International Banking	3,411	57,729	1,632	851	2.8	52	168	125
Ulster Bank	2,079	34,052	5,523	2,749	16.2	50	1,384	124
US Retail & Commercial	208	51,562	1,007	455	2.0	45	248	373
Retail & Commercial	9,554	381,644	17,973	8,876	4.7	49	3,403	2,114
Markets	29,991	31,490	414	311	1.3	75	—	23
Direct Line Group and other	3,829	929	—	—	—	—	—	—
Core	43,374	414,063	18,387	9,187	4.4	50	3,403	2,137
Non-Core	706	80,005	24,007	11,487	30.0	48	3,838	2,390
Group	44,080	494,068	42,394	20,674	8.6	49	7,241	4,527

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Business review Risk and balance sheet management continued

	Gross loans to				Credit metrics			
					REIL as a % of gross loans to	Provisions as a %	Impairment	Amounts
	Banks	Customers	REIL	Provisions	customers	of REIL	charge	written-off
2010	£m	£m	£m	£m	%	%	£m	£m
UK Retail	408	108,405	4,620	2,741	4.3	59	1,160	1,135
UK Corporate	126	113,782	3,981	1,746	3.5	44	768	357
Wealth	2,220	16,130	223	66	1.4	30	18	9
International Banking	3,982	63,173	1,484	855	2.3	58	125	92
Ulster Bank	2,928	36,858	3,619	1,633	9.8	45	1,161	48
US Retail & Commercial	145	48,602	914	509	1.9	56	485	550
Retail & Commercial	9,809	386,950	14,841	7,550	3.8	51	3,717	2,191
Markets	45,084	25,300	366	316	1.4	86	20	33
Direct Line Group and other	2,140	601	—	—	—	—	—	—
Core	57,033	412,851	15,207	7,866	3.7	52	3,737	2,224
Non-Core	1,656	113,001	23,444	10,352	20.7	44	5,407	3,818
Group	58,689	525,852	38,651	18,218	7.4	47	9,144	6,042

Key points

- Total REIL decreased by £1.3 billion to £41.1 billion compared with December 2011 as improvements in International Banking and in Non-Core were partially offset by the continued increase in REIL in UK Corporate and Ulster Bank Core mortgage and corporate portfolios.

- Non-Core REIL decreased by £2.6 billion or 11% reflecting a mixture of repayments and write-offs within UK Corporate, Markets and International Banking corporate portfolios.

- Conditions in Ireland remain difficult and economic indicators continue to be weak, this is reflected in the Ulster Bank credit metrics with Core REIL increasing by £2.0 billion since 31 December 2011, primarily within mortgage and commercial real estate portfolios, to £7.5 billion and is now 23% of loans and advances to customers. Impairments continue to outpace write-offs.

- The provision coverage increased to 52% at 31 December 2012 from 49% at 31 December 2011 as the economic conditions remain challenging particularly in relation to Ulster Bank and commercial real estate portfolios.

- The impairment charge for 2012 of £5.3 billion was 26% lower than in 2011. The main drivers were lower impairment across Non-Core portfolios (down £1.5 billion or 40%) mainly as a result of lower impairments across Ulster Bank's commercial real estate portfolio (down £1.3 billion or 58%) and continued improvement across Core UK portfolios.

Commercial real estate lending metrics were as follows:

	Total		Non-Core (1)	
	2012	2011	2012	2011
Lending (gross)	£63.0bn	£74.8bn	£26.4bn	£34.3bn
Of which REIL	£22.1bn	£22.9bn	£17.1bn	£18.8bn
Provisions	£10.1bn	£9.5bn	£8.3bn	£8.2bn
REIL as a % of gross loans to customers	35.1%	30.6%	64.8%	54.8%
Provisions as a % of REIL	46%	41%	49%	44%

Note:
(1) Excludes property related lending to customers in other sectors managed by Real Estate Finance.

Ulster Bank is a significant contributor to Non-Core commercial real estate lending. For further information refer to the section on Ulster Bank Group (Core and Non-Core).

Business review Risk and balance sheet management continued

Balance sheet analysis: REIL, provisions and AFS reserves continued

Sector and geographical regional analyses: Group

The following tables analyse gross loans and advances to banks and customers (excluding reverse repos) and the related debt management measures and ratios by sector and geography (by location of lending office) for the Group, Core and Non-Core.

				Credit metrics				
2012	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
Government (1)	9,853	—	—	—	—	—	—	—
Finance	42,198	592	317	1.4	54	0.8	145	380
Personal - mortgages	149,625	6,549	1,824	4.4	28	1.2	948	461
- unsecured	32,212	2,903	2,409	9.0	83	7.5	631	793
Property	72,219	21,223	9,859	29.4	46	13.7	2,212	1,080
Construction	8,049	1,483	640	18.4	43	8.0	94	182
Manufacturing	23,787	755	357	3.2	47	1.5	134	203
Finance leases (2)	13,609	442	294	3.2	67	2.2	44	263
Retail, wholesale and repairs	21,936	1,143	644	5.2	56	2.9	230	176
Transport and storage	18,341	834	336	4.5	40	1.8	289	102
Health, education and leisure	16,705	1,190	521	7.1	44	3.1	144	100
Hotels and restaurants	7,877	1,597	726	20.3	45	9.2	176	102
Utilities	6,631	118	21	1.8	18	0.3	(4)	—
Other	30,057	2,177	1,240	7.2	57	4.1	322	395
Latent	—	—	1,960	—	—	—	(73)	—
	453,099	41,006	21,148	9.1	52	4.7	5,292	4,237
of which:								
UK								
- residential mortgages	109,530	2,440	457	2.2	19	0.4	122	32
- personal lending	20,498	2,477	2,152	12.1	87	10.5	479	610
- property	53,730	10,521	3,944	19.6	37	7.3	964	490
- construction	6,507	1,165	483	17.9	41	7.4	100	158
- other	122,029	3,729	2,611	3.1	70	2.1	674	823
Europe								
- residential mortgages	17,836	3,092	1,151	17.3	37	6.5	526	50
- personal lending	1,905	226	208	11.9	92	10.9	38	13
- property	14,634	10,347	5,766	70.7	56	39.4	1,264	441
- construction	1,132	289	146	25.5	51	12.9	(11)	12
- other	27,424	4,451	2,996	16.2	67	10.9	817	539
US								
- residential mortgages	21,929	990	208	4.5	21	0.9	298	377
- personal lending	8,748	199	48	2.3	24	0.5	109	162
- property	3,343	170	29	5.1	17	0.9	(11)	83

- construction	388	8	1	2.1	13	0.3	—	12
- other	29,354	352	630	1.2	179	2.1	(86)	149
RoW								
- residential mortgages	330	27	8	8.2	30	2.4	2	2
- personal lending	1,061	1	1	0.1	100	0.1	5	8
- property	512	185	120	36.1	65	23.4	(5)	66
- construction	22	21	10	95.5	48	45.5	5	—
- other	12,187	316	179	2.6	57	1.5	2	210
Group	453,099	41,006	21,148	9.1	52	4.7	5,292	4,237
Banks	31,394	134	114	0.4	85	0.4	23	29

For the notes to this table refer to page 193.

Business review Risk and balance sheet management continued

				Credit metrics				
2011	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
Government (1)	9,742	—	—	—	—	—	—	—
Finance	51,870	1,062	726	2.0	68	1.4	89	87
Personal - mortgages	149,273	5,270	1,396	3.5	26	0.9	1,076	516
- unsecured	34,424	3,070	2,456	8.9	80	7.1	782	1,286
Property	81,058	22,101	8,994	27.3	41	11.1	3,669	1,171
Construction	9,869	1,943	761	19.7	39	7.7	140	244
Manufacturing	28,639	913	525	3.2	58	1.8	227	215
Finance leases (2)	14,499	794	508	5.5	64	3.5	112	170
Retail, wholesale and repairs	24,378	1,067	549	4.4	51	2.3	180	172
Transport and storage	22,058	606	154	2.7	25	0.7	78	43
Health, education and leisure	17,492	1,192	502	6.8	42	2.9	304	98
Hotels and restaurants	8,870	1,490	675	16.8	45	7.6	334	131
Utilities	8,406	88	23	1.0	26	0.3	3	3
Other	33,490	2,661	1,217	7.9	46	3.6	792	391
Latent	—	—	2,065	—	—	—	(545)	—
	494,068	42,257	20,551	8.6	49	4.2	7,241	4,527
of which:								
UK								
- residential mortgages	106,388	2,262	431	2.1	19	0.4	180	25
- personal lending	22,008	2,717	2,209	12.3	81	10.0	645	1,007
- property	60,041	11,147	3,837	18.6	34	6.4	1,411	493
- construction	7,589	1,427	560	18.8	39	7.4	187	228
- other	132,548	4,635	2,943	3.5	63	2.2	514	655
Europe								
- residential mortgages	18,946	2,205	713	11.6	32	3.8	467	10
- personal lending	2,464	209	180	8.5	86	7.3	25	126
- property	16,384	10,314	4,947	63.0	48	30.2	2,296	504
- construction	1,754	362	185	20.6	51	10.5	(62)	—
- other	34,497	4,261	2,873	12.4	67	8.3	1,267	293
US								
- residential mortgages	23,237	770	240	3.3	31	1.0	426	481
- personal lending	8,441	143	66	1.7	46	0.8	112	153
- property	3,783	329	92	8.7	28	2.4	(2)	139
- construction	457	121	10	26.5	8	2.2	9	16
- other	37,015	517	895	1.4	173	2.4	(175)	180
RoW								
- residential mortgages	702	33	12	4.7	36	1.7	3	—
- personal lending	1,511	1	1	0.1	100	0.1	—	—

- property	850	311	118	36.6	38	13.9	(36)	35
- construction	69	33	6	47.8	18	8.7	6	—
- other	15,384	460	233	3.0	51	1.5	(32)	182
Group	494,068	42,257	20,551	8.6	49	4.2	7,241	4,527
Banks	44,080	137	123	0.3	90	0.3	—	—

For the notes to this table refer to page 193.

Business review Risk and balance sheet management continued

Balance sheet analysis: REIL, provisions and AFS reserves continued
Sector and geographical regional analyses: Group continued

				Credit metrics				
2010	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
Government (1)	8,452	—	—	—	—	—	—	—
Finance	54,952	1,129	595	2.1	53	1.1	198	141
Personal - mortgages	146,501	4,276	877	2.9	21	0.6	1,014	669
- unsecured	37,472	3,544	2,894	9.5	82	7.7	1,370	1,577
Property	90,403	19,584	6,736	21.7	34	7.5	4,682	1,009
Construction	12,105	2,464	875	20.4	36	7.2	530	146
Manufacturing	33,485	1,199	503	3.6	42	1.5	(92)	1,547
Finance leases (2)	16,850	847	554	5.0	65	3.3	252	113
Retail, wholesale and repairs	25,165	1,157	572	4.6	49	2.3	334	161
Transport and storage	24,141	248	118	1.0	48	0.5	87	39
Health, education and leisure	19,431	1,055	319	5.4	30	1.6	159	199
Hotels and restaurants	9,681	1,269	504	13.1	40	5.2	321	106
Utilities	10,046	91	23	0.9	25	0.2	14	7
Other	37,168	1,643	863	4.4	53	2.3	409	316
Latent	—	—	2,658	—	—	—	(121)	—
	525,852	38,506	18,091	7.3	47	3.4	9,157	6,030
of which:								
UK								
- residential mortgages	101,593	2,062	314	2.0	15	0.3	169	17
- personal lending	23,620	3,083	2,518	13.1	82	10.7	1,046	1,153
- property	65,759	7,986	2,219	12.1	28	3.4	1,546	397
- construction	9,424	1,747	605	18.5	35	6.4	371	110
- other	142,651	3,815	2,895	2.7	76	2.0	826	594
Europe								
- residential mortgages	20,094	1,551	301	7.7	19	1.5	221	6
- personal lending	2,870	401	316	14.0	79	11.0	66	24
- property	17,775	10,534	4,199	59.3	40	23.6	2,828	210
- construction	1,887	667	255	35.3	38	13.5	138	2
- other	41,280	3,229	2,156	7.8	67	5.2	633	1,414
US								
- residential mortgages	24,201	640	253	2.6	40	1.0	615	645
- personal lending	9,520	55	55	0.6	100	0.6	160	271
- property	4,929	765	202	15.5	26	4.1	321	220
- construction	520	50	15	9.6	30	2.9	26	34
- other	35,868	820	1,118	2.3	136	3.1	(102)	490
RoW								

- residential mortgages	613	23	9	3.8	39	1.5	9	1
- personal lending	1,462	5	5	0.3	100	0.3	98	129
- property	1,940	299	116	15.4	39	6.0	(13)	182
- construction	274	—	—	—	—	—	(5)	—
- other	19,572	774	540	4.0	70	2.8	204	131
Group	525,852	38,506	18,091	7.3	47	3.4	9,157	6,030
Banks	58,689	145	127	0.2	88	0.2	(13)	12

For the notes to this table refer to page 193.

Business review Risk and balance sheet management continued

Sector and geographical regional analyses: Core

				Credit metrics				
2012	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
Government (1)	8,485	—	—	—	—	—	—	—
Finance	39,658	185	149	0.5	81	0.4	54	338
Personal - mortgages	146,770	6,229	1,691	4.2	27	1.2	786	234
- unsecured	31,247	2,717	2,306	8.7	85	7.4	568	718
Property	43,602	4,672	1,674	10.7	36	3.8	748	214
Construction	6,020	757	350	12.6	46	5.8	119	60
Manufacturing	22,234	496	225	2.2	45	1.0	118	63
Finance leases (2)	9,201	159	107	1.7	67	1.2	35	41
Retail, wholesale and repairs	20,842	791	439	3.8	55	2.1	181	129
Transport and storage	14,590	440	112	3.0	25	0.8	72	21
Health, education and leisure	15,770	761	299	4.8	39	1.9	109	67
Hotels and restaurants	6,891	1,042	473	15.1	45	6.9	138	56
Utilities	5,131	10	5	0.2	50	0.1	—	—
Other	26,315	1,374	794	5.2	58	3.0	189	175
Latent	—	—	1,325	—	—	—	(145)	—
	396,756	19,633	9,949	4.9	51	2.5	2,972	2,116
of which:								
UK								
- residential mortgages	109,511	2,440	457	2.2	19	0.4	122	32
- personal lending	20,443	2,454	2,133	12.0	87	10.4	474	594
- property	35,532	2,777	896	7.8	32	2.5	395	181
- construction	5,101	671	301	13.2	45	5.9	109	47
- other	108,713	2,662	1,737	2.4	65	1.6	499	379
Europe								
- residential mortgages	17,446	3,060	1,124	17.5	37	6.4	521	24
- personal lending	1,540	143	138	9.3	97	9.0	29	11
- property	4,896	1,652	685	33.7	41	14.0	350	6
- construction	513	60	39	11.7	65	7.6	4	10
- other	22,218	2,280	1,711	10.3	75	7.7	362	267
US								
- residential mortgages	19,483	702	102	3.6	15	0.5	141	176
- personal lending	8,209	119	34	1.4	29	0.4	65	112
- property	2,847	112	13	3.9	12	0.5	3	27
- construction	384	5	—	1.3	—	—	1	3
- other	28,267	252	432	0.9	171	1.5	(111)	90
RoW								

- residential mortgages	330	27	8	8.2	30	2.4	2	2
- personal lending	1,055	1	1	0.1	100	0.1	—	1
- property	327	131	80	40.1	61	24.5	—	—
- construction	22	21	10	95.5	48	45.5	5	—
- other	9,919	64	48	0.6	75	0.5	1	154
Group	396,756	19,633	9,949	4.9	51	2.5	2,972	2,116
Banks	30,917	133	113	0.4	85	0.4	23	29

For the notes to this table refer to page 193.

Business review Risk and balance sheet management continued

Balance sheet analysis: REIL, provisions and AFS reserves continued
Sector and geographical regional analyses: Core continued

				Credit metrics				
2011	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
Government (1)	8,359	—	—	—	—	—	—	—
Finance	48,598	745	579	1.5	78	1.2	207	44
Personal - mortgages	144,171	4,890	1,216	3.4	25	0.8	776	198
- unsecured	32,868	2,960	2,364	9.0	80	7.2	715	935
Property	42,994	4,132	1,133	9.6	27	2.6	469	167
Construction	7,197	841	286	11.7	34	4.0	179	143
Manufacturing	23,708	490	242	2.1	49	1.0	106	125
Finance leases (2)	8,440	172	110	2.0	64	1.3	31	68
Retail, wholesale and repairs	22,039	679	345	3.1	51	1.6	208	119
Transport and storage	16,581	342	60	2.1	18	0.4	47	29
Health, education and leisure	16,073	691	257	4.3	37	1.6	170	55
Hotels and restaurants	7,709	1,005	386	13.0	38	5.0	209	60
Utilities	6,557	22	1	0.3	5	—	—	—
Other	28,769	1,282	668	4.5	52	2.3	538	194
Latent	—	—	1,418	—	—	—	(252)	—
	414,063	18,251	9,065	4.4	50	2.2	3,403	2,137
of which:								
UK								
- residential mortgages	104,965	2,210	420	2.1	19	0.4	174	24
- personal lending	21,881	2,680	2,179	12.2	81	10.0	657	828
- property	35,431	2,984	744	8.4	25	2.1	378	114
- construction	5,707	655	236	11.5	36	4.1	160	138
- other	114,878	2,571	1,648	2.2	64	1.4	366	398
Europe								
- residential mortgages	18,393	2,121	664	11.5	31	3.6	437	10
- personal lending	1,972	143	125	7.3	87	6.3	(8)	22
- property	4,846	1,037	365	21.4	35	7.5	162	10
- construction	1,019	72	43	7.1	60	4.2	13	—
- other	24,414	2,430	1,806	10.0	74	7.4	915	183
US								
- residential mortgages	20,311	526	120	2.6	23	0.6	162	164
- personal lending	7,505	136	59	1.8	43	0.8	66	85
- property	2,413	111	24	4.6	22	1.0	16	43
- construction	412	98	1	23.8	1	0.2	—	5
- other	34,971	345	583	1.0	169	1.7	26	96
RoW								

- residential mortgages	502	33	12	6.6	36	2.4	3	—
- personal lending	1,510	1	1	0.1	100	0.1	—	—
- property	304	—	—	—	—	—	(87)	—
- construction	59	16	6	27.1	38	10.2	6	—
- other	12,570	82	29	0.7	35	0.2	(43)	17
Group	414,063	18,251	9,065	4.4	50	2.2	3,403	2,137
Banks	43,374	136	122	0.3	90	0.3	—	—

For the notes to this table refer to page 193.

Business review Risk and balance sheet management continued

					Credit metrics				
2010		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
Government (1)		6,781	—	—	—	—	—	—	—
Finance		47,161	567	402	1.2	71	0.9	191	53
Personal	- mortgages	140,359	3,999	693	2.8	17	0.5	578	243
	- unsecured	33,581	3,131	2,545	9.3	81	7.6	1,157	1,271
Property		42,455	3,287	818	7.7	25	1.9	739	98
Construction		8,680	610	222	7.0	36	2.6	189	38
Manufacturing		25,797	555	266	2.2	48	1.0	119	124
Finance leases (2)		8,321	244	140	2.9	57	1.7	63	42
Retail, wholesale and repairs		21,974	611	259	2.8	42	1.2	199	103
Transport and storage		15,946	112	40	0.7	36	0.3	40	35
Health, education and leisure		17,456	507	134	2.9	26	0.8	145	64
Hotels and restaurants		8,189	741	236	9.0	32	2.9	165	49
Utilities		7,098	22	3	0.3	14	—	1	—
Other		29,053	677	329	2.3	49	1.1	161	103
Latent		—	—	1,653	—	—	—	(5)	—
		412,851	15,063	7,740	3.6	51	1.9	3,742	2,223
of which:									
UK									
- residential mortgages		99,928	2,010	307	2.0	15	0.3	164	16
- personal lending		23,035	2,888	2,341	12.5	81	10.2	1,033	1,142
- property		34,970	2,454	500	7.0	20	1.4	394	43
- construction		7,041	536	183	7.6	34	2.6	148	29
- other		113,415	2,031	1,480	1.8	73	1.3	541	289
Europe									
- residential mortgages		19,473	1,506	280	7.7	19	1.4	184	6
- personal lending		2,270	203	164	8.9	81	7.2	43	19
- property		5,139	631	240	12.3	38	4.7	241	1
- construction		1,014	67	32	6.6	48	3.2	35	(1)
- other		27,759	1,444	1,268	5.2	88	4.6	438	85
US									
- residential mortgages		20,548	460	97	2.2	21	0.5	225	221
- personal lending		6,816	35	35	0.5	100	0.5	81	110
- property		1,611	144	43	8.9	30	2.7	84	54
- construction		442	7	7	1.6	100	1.6	6	10
- other		31,848	381	642	1.2	169	2.0	29	161
RoW									
- residential mortgages		410	23	9	5.6	39	2.2	5	—
- personal lending		1,460	5	5	0.3	100	0.3	—	—

- property	735	58	35	7.9	60	4.8	20	—
- construction	183	—	—	—	—	—	—	—
- other	14,754	180	72	1.2	40	0.5	71	38
Group	412,851	15,063	7,740	3.6	51	1.9	3,742	2,223
Banks	57,033	144	126	0.3	88	0.2	(5)	1

For the notes to this table refer to page 193.

Business review Risk and balance sheet management continued

Balance sheet analysis: REIL, provisions and AFS reserves continued
Sector and geographical regional analyses: Non-Core

					Credit metrics			
2012	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
Government (1)	1,368	—	—	—	—	—	—	—
Finance	2,540	407	168	16.0	41	6.6	91	42
Personal - mortgages	2,855	320	133	11.2	42	4.7	162	227
- unsecured	965	186	103	19.3	55	10.7	63	75
Property	28,617	16,551	8,185	57.8	49	28.6	1,464	866
Construction	2,029	726	290	35.8	40	14.3	(25)	122
Manufacturing	1,553	259	132	16.7	51	8.5	16	140
Finance leases (2)	4,408	283	187	6.4	66	4.2	9	222
Retail, wholesale and repairs	1,094	352	205	32.2	58	18.7	49	47
Transport and storage	3,751	394	224	10.5	57	6.0	217	81
Health, education and leisure	935	429	222	45.9	52	23.7	35	33
Hotels and restaurants	986	555	253	56.3	46	25.7	38	46
Utilities	1,500	108	16	7.2	15	1.1	(4)	—
Other	3,742	803	446	21.5	56	11.9	133	220
Latent	—	—	635	—	—	—	72	—
	56,343	21,373	11,199	37.9	52	19.9	2,320	2,121
of which:								
UK								
- residential mortgages	19	—	—	—	—	—	—	—
- personal lending	55	23	19	41.8	83	34.5	5	16
- property	18,198	7,744	3,048	42.6	39	16.7	569	309
- construction	1,406	494	182	35.1	37	12.9	(9)	111
- other	13,316	1,067	874	8.0	82	6.6	175	444
Europe								
- residential mortgages	390	32	27	8.2	84	6.9	5	26
- personal lending	365	83	70	22.7	84	19.2	9	2
- property	9,738	8,695	5,081	89.3	58	52.2	914	435
- construction	619	229	107	37.0	47	17.3	(15)	2
- other	5,206	2,171	1,285	41.7	59	24.7	455	272
US								
- residential mortgages	2,446	288	106	11.8	37	4.3	157	201
- personal lending	539	80	14	14.8	18	2.6	44	50
- property	496	58	16	11.7	28	3.2	(14)	56
- construction	4	3	1	75.0	33	25.0	(1)	9
- other	1,087	100	198	9.2	198	18.2	25	59
RoW								

- residential mortgages	—	—	—	—	—	—	—	—
- personal lending	6	—	—	—	—	—	5	7
- property	185	54	40	29.2	74	21.6	(5)	66
- construction	—	—	—	—	—	—	—	—
- other	2,268	252	131	11.1	52	5.8	1	56
Group	56,343	21,373	11,199	37.9	52	19.9	2,320	2,121
Banks	477	1	1	0.2	100	0.2	—	—

For the notes to this table refer to page 193.

Business review Risk and balance sheet management continued

				Credit metrics				
2011	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
Government (1)	1,383	—	—	—	—	—	—	—
Finance	3,272	317	147	9.7	46	4.5	(118)	43
Personal - mortgages	5,102	380	180	7.4	47	3.5	300	318
- unsecured	1,556	110	92	7.1	84	5.9	67	351
Property	38,064	17,969	7,861	47.2	44	20.7	3,200	1,004
Construction	2,672	1,102	475	41.2	43	17.8	(39)	101
Manufacturing	4,931	423	283	8.6	67	5.7	121	90
Finance leases (2)	6,059	622	398	10.3	64	6.6	81	102
Retail, wholesale and repairs	2,339	388	204	16.6	53	8.7	(28)	53
Transport and storage	5,477	264	94	4.8	36	1.7	31	14
Health, education and leisure	1,419	501	245	35.3	49	17.3	134	43
Hotels and restaurants	1,161	485	289	41.8	60	24.9	125	71
Utilities	1,849	66	22	3.6	33	1.2	3	3
Other	4,721	1,379	549	29.2	40	11.6	254	197
Latent	—	—	647	—	—	—	(293)	—
	80,005	24,006	11,486	30.0	48	14.4	3,838	2,390
of which:								
UK								
- residential mortgages	1,423	52	11	3.7	21	0.8	6	1
- personal lending	127	37	30	29.1	81	23.6	(12)	179
- property	24,610	8,163	3,093	33.2	38	12.6	1,033	379
- construction	1,882	772	324	41.0	42	17.2	27	90
- other	17,670	2,064	1,295	11.7	63	7.3	148	257
Europe								
- residential mortgages	553	84	49	15.2	58	8.9	30	—
- personal lending	492	66	55	13.4	83	11.2	33	104
- property	11,538	9,277	4,582	80.4	49	39.7	2,134	494
- construction	735	290	142	39.5	49	19.3	(75)	—
- other	10,083	1,831	1,067	18.2	58	10.5	352	110
US								
- residential mortgages	2,926	244	120	8.3	49	4.1	264	317
- personal lending	936	7	7	0.7	100	0.7	46	68
- property	1,370	218	68	15.9	31	5.0	(18)	96
- construction	45	23	9	51.1	39	20.0	9	11
- other	2,044	172	312	8.4	181	15.3	(201)	84
RoW								
- residential mortgages	200	—	—	—	—	—	—	—
- personal lending	1	—	—	—	—	—	—	—

- property	546	311	118	57.0	38	21.6	51	35
- construction	10	17	—	170.0	—	—	—	—
- other	2,814	378	204	13.4	54	7.2	11	165
Group	80,005	24,006	11,486	30.0	48	14.4	3,838	2,390
Banks	706	1	1	0.1	100	0.1	—	—

For the notes to this table refer to page 193.

Business review Risk and balance sheet management continued

Balance sheet analysis: REIL, provisions and AFS reserves continued
Sector and geographical regional analyses: Non-Core continued

				Credit metrics				
2010	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
Government (1)	1,671	—	—	—	—	—	—	—
Finance	7,791	562	193	7.2	34	2.5	7	88
Personal - mortgages	6,142	277	184	4.5	66	3.0	436	426
- unsecured	3,891	413	349	10.6	85	9.0	213	306
Property	47,948	16,297	5,918	34.0	36	12.3	3,943	911
Construction	3,425	1,854	653	54.1	35	19.1	341	108
Manufacturing	7,688	644	237	8.4	37	3.1	(211)	1,423
Finance leases (2)	8,529	603	414	7.1	69	4.9	189	71
Retail, wholesale and repairs	3,191	546	313	17.1	57	9.8	135	58
Transport and storage	8,195	136	78	1.7	57	1.0	47	4
Health, education and leisure	1,975	548	185	27.7	34	9.4	14	135
Hotels and restaurants	1,492	528	268	35.4	51	18.0	156	57
Utilities	2,948	69	20	2.3	29	0.7	13	7
Other	8,115	966	534	11.9	55	6.6	248	213
Latent	—	—	1,005	—	—	—	(116)	—
	113,001	23,443	10,351	20.7	44	9.2	5,415	3,807
of which:								
UK								
- residential mortgages	1,665	52	7	3.1	13	0.4	5	1
- personal lending	585	195	177	33.3	91	30.3	13	11
- property	30,789	5,532	1,719	18.0	31	5.6	1,152	354
- construction	2,383	1,211	422	50.8	35	17.7	223	81
- other	29,236	1,784	1,415	6.1	79	4.8	285	305
Europe								
- residential mortgages	621	45	21	7.2	47	3.4	37	—
- personal lending	600	198	152	33.0	77	25.3	23	5
- property	12,636	9,903	3,959	78.4	40	31.3	2,587	209
- construction	873	600	223	68.7	37	25.5	103	3
- other	13,521	1,785	888	13.2	50	6.6	195	1,329
US								
- residential mortgages	3,653	180	156	4.9	87	4.3	390	424
- personal lending	2,704	20	20	0.7	100	0.7	79	161
- property	3,318	621	159	18.7	26	4.8	237	166
- construction	78	43	8	55.1	19	10.3	20	24
- other	4,020	439	476	10.9	108	11.8	(131)	329
RoW								

- residential mortgages	203	—	—	—	—	—	4	1
- personal lending	2	—	—	—	—	—	98	129
- property	1,205	241	81	20.0	34	6.7	(33)	182
- construction	91	—	—	—	—	—	(5)	—
- other	4,818	594	468	12.3	79	9.7	133	93
Group	113,001	23,443	10,351	20.7	44	9.2	5,415	3,807
Banks	1,654	1	1	0.1	100	0.1	(8)	11

Notes:

(1) Includes central and local government.

(2) Includes instalment credit.

Business review Risk and balance sheet management continued

Provisions and AFS reserves methodology
The Group's consumer portfolios, which consist of high volume, small value credits, have highly efficient largely automated processes for identifying problem credits and very short timescales, typically three months, before resolution or adoption of various recovery methods. Corporate portfolios consist of higher value, lower volume credits, which tend to be structured to meet individual customer requirements.

Provisions are assessed on a case by case basis by experienced specialists with input from professional valuers and accountants. The Group operates a transparent provisions governance framework, setting thresholds to trigger enhanced oversight and challenge.

Analyses of provisions are set out on pages 195 to 197.

Available-for-sale financial assets are initially recognised at fair value plus directly related transaction costs and are subsequently measured at fair value with changes in fair value reported in owners' equity until disposal, at which stage the cumulative gain or loss is recognised in profit or loss. When there is objective evidence that an available-for-sale financial asset is impaired, any decline in its fair value below original cost is removed from equity and recognised in profit or loss.

The Group reviews its portfolios of available-for-sale financial assets for evidence of impairment, which includes: default or delinquency in interest or principal payments; significant financial difficulty of the issuer or obligor; and it becoming probable that the issuer will enter bankruptcy or other financial reorganisation. However, the disappearance of an active market because an entity's financial instruments are no longer publicly traded is not evidence of impairment. Furthermore, a downgrade of an entity's credit rating is not, of itself, evidence of impairment, although it may be evidence of impairment when considered with other available information. A decline in the fair value of a financial asset below its cost or amortised cost is not necessarily evidence of impairment. Determining whether objective evidence of impairment exists requires the exercise of management judgement. The unrecognised losses on the Group's available-for-sale debt securities are concentrated in its portfolios of mortgage-backed securities. The losses reflect the widening of credit spreads as a result of the reduced market liquidity in these securities and the current uncertain macroeconomic outlook in the US and Europe. The underlying securities remain unimpaired.

Analyses of AFS debt securities and related AFS reserves are set out on page 199.

REIL flow statement
REIL are stated without giving effect to any security held that could reduce the eventual loss should it occur or to any provisions marked.

	UK Retail	UK Corporate	Wealth	International Banking	Ulster Bank	US Retail & Commercial	Markets	Core	Non-Core	Total
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
At 1 January 2012	4,599	5,001	211	1,632	5,523	1,007	414	18,387	24,007	42,394
Currency translation and other adjustments	53	(6)	(1)	(227)	(115)	(47)	184	(159)	(487)	(646)
Additions	1,771	4,362	111	286	3,299	660	56	10,545	5,800	16,345
Transfers (1)	(33)	7	—	(110)	—	—	6	(130)	70	(60)
	—	(133)	(8)	(624)	—	—	(75)	(840)	(1,035)	(1,875)

Transfer to performing book										
Repayments	(1,222)	(3,265)	(50)	(90)	(1,102)	(83)	(80)	(5,892)	(4,860)	(10,752)
Amounts written-off	(599)	(514)	(15)	(445)	(72)	(391)	(109)	(2,145)	(2,121)	(4,266)
At 31 December 2012	4,569	5,452	248	422	7,533	1,146	396	19,766	21,374	41,140

Non-Core (by donating divisions)	UK Corporate	International Banking	Ulster Bank	US Retail & Commercial	Other	Total
	£m	£m	£m	£m	£m	£m
At 1 January 2012	3,685	8,051	11,675	486	110	24,007
Currency translation and other adjustments	(57)	(104)	(231)	(20)	(75)	(487)
Additions	1,542	2,210	1,713	323	12	5,800
Transfers	11	59	—	—	—	70
Transfer to performing book	(171)	(863)	—	—	(1)	(1,035)
Repayments	(1,798)	(1,379)	(1,618)	(62)	(3)	(4,860)
Amounts written-off	(590)	(1,067)	(140)	(309)	(15)	(2,121)
At 31 December 2012	2,622	6,907	11,399	418	28	21,374

Note:

(1) Represents transfers to/from REIL from/to potential problem loans.

Business review Risk and balance sheet management continued

Balance sheet analysis: REIL, provisions and AFS reserves continued

REIL and PPLs summary

The table below analyses REIL between UK and overseas, based on the location of the lending office.

	2012			2011			2010		
	Core	Non-Core	Total	Core	Non-Core	Total	Core	Non-Core	Total
	£m	£m	£m	£m	£m	£m	£m	£m	£m
Impaired loans									
- UK	9,332	9,081	18,413	9,754	10,580	20,334	8,575	7,835	16,410
- overseas	8,219	11,867	20,086	6,839	12,885	19,724	4,936	14,408	19,344
	17,551	20,948	38,499	16,593	23,465	40,058	13,511	22,243	35,754
Accruing loans past due 90 days or more									
- UK	1,759	248	2,007	1,430	508	1,938	1,434	939	2,373
- overseas	456	178	634	364	34	398	262	262	524
	2,215	426	2,641	1,794	542	2,336	1,696	1,201	2,897
Total REIL	19,766	21,374	41,140	18,387	24,007	42,394	15,207	23,444	38,651
REIL as a % of gross loans and advances (1)	4.9%	38.2%	9.1%	4.4%	30.1%	8.6%	3.7%	20.8%	7.3%
Provisions as a % of REIL	51%	52%	52%	50%	48%	49%	52%	44%	47%

Note:

(1) Includes disposal groups but excludes reverse repos.

Past due analysis

The table below shows loans and advances to customers that were past due at the balance sheet date but are not considered impaired.

	2012			2011			2010		
	Core	Non-Core	Total	Core	Non-Core	Total	Core	Non-Core	Total
	£m	£m	£m	£m	£m	£m	£m	£m	£m
Past due 1-29 days	5,349	250	5,599	5,722	724	6,446	6,401	822	7,223
Past due 30-59 days	1,062	55	1,117	1,556	171	1,727	1,725	392	2,117
Past due 60-89 days	1,151	26	1,177	975	107	1,082	922	271	1,193
Past due 90 days or more	2,215	426	2,641	1,794	542	2,336	1,696	1,201	2,897
	9,777	757	10,534	10,047	1,544	11,591	10,744	2,686	13,430

Impairment provisions flow statement

The movement in loan impairment provisions by division is shown in the table below.

UK Retail	UK Corporate	Wealth	International Banking	Ulster Bank	US R&C (1)	Total R&C (1)	Markets	Central Items	Total Core	Non-Core	RFS MI	Group
£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
2,679	2,061	81	851	2,749	455	8,876	311	—	9,187	11,487	—	20,674

At 1 January 2012													
Currency translation and other adjustments	12	87	—	(131)	(54)	53	(33)	77	—	44	(369)	—	(325)
Disposal of subsidiaries	—	—	—	—	—	—	—	—	—	—	(1)	(4)	(5)
Amounts written-off	(599)	(514)	(15)	(445)	(72)	(391)	(2,036)	(109)	—	(2,145)	(2,121)	—	(4,266)
Recoveries of amounts previously written-off	96	18	—	9	2	85	210	1	—	211	130	—	341
Charged to income statement													
- continuing operations	529	836	46	111	1,364	83	2,969	25	1	2,995	2,320	—	5,315
- discontinued operations	—	—	—	—	—	—	—	—	—	—	—	4	4
Unwind of discount (2)	(88)	(56)	(3)	(4)	(79)	—	(230)	—	—	(230)	(246)	—	(476)
At 31 December 2012	2,629	2,432	109	391	3,910	285	9,756	305	1	10,062	11,200	—	21,262
Individually assessed													
- banks	—	—	—	6	—	—	6	107	—	113	1	—	114
- customers	—	1,024	96	270	1,213	46	2,649	189	1	2,839	9,805	—	12,644
Collectively assessed	2,439	1,111	—	—	2,110	125	5,785	—	—	5,785	757	—	6,542
Latent	190	297	13	115	587	114	1,316	9	—	1,325	637	—	1,962
	2,629	2,432	109	391	3,910	285	9,756	305	1	10,062	11,200	—	21,262

For the notes to these tables refer to page 197.

Business review Risk and balance sheet management continued

	Non-Core (by donating division)					
	UK Corporate	International Banking	Ulster Bank	US R&C (1)	Other	Total
	£m	£m	£m	£m	£m	£m
At 1 January 2012	1,633	3,027	6,363	416	48	11,487
Currency translation and other adjustments	(100)	(58)	(107)	(89)	(15)	(369)
Disposal of subsidiaries	—	—	—	(1)	—	(1)
Amounts written-off	(590)	(1,067)	(140)	(309)	(15)	(2,121)
Recoveries of amounts previously written-off	21	38	4	63	4	130
Charged to income statement						
- continuing operations	241	913	983	177	6	2,320
Unwind of discount (2)	(38)	(38)	(170)	—	—	(246)
At 31 December 2012	1,167	2,815	6,933	257	28	11,200
Individually assessed						
- banks	—	1	—	—	—	1
- customers	688	2,604	6,481	24	8	9,805
Collectively assessed	422	—	225	92	18	757
Latent	57	210	227	141	2	637
	1,167	2,815	6,933	257	28	11,200

	UK Retail	UK Corporate	Wealth	International Banking	Ulster Bank	US R&C (1)	Total R&C (1)	Markets	Total Core	Non-Core	RFS MI	Group
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
At 1 January 2011	2,741	1,746	66	855	1,633	509	7,550	316	7,866	10,352	—	18,218
Intra-group transfers	—	177	—	—	—	—	177	—	177	(177)	—	—
Currency translation and other adjustments	—	25	3	(37)	(79)	(5)	(93)	17	(76)	(225)	—	(301)
Disposal of subsidiaries	—	—	—	—	—	—	—	—	—	—	8	8
Amounts written-off	(823)	(658)	(11)	(125)	(124)	(373)	(2,114)	(23)	(2,137)	(2,390)	—	(4,527)
Recoveries of amounts previously written-off	69	17	—	3	1	76	166	1	167	360	—	527
Charged to income												

statement												
- continuing operations	788	790	25	168	1,384	248	3,403	—	3,403	3,838	—	7,241
- discontinued operations	—	—	—	—	—	—	—	—	—	—	(8)	(8)
Unwind of discount (2)	(96)	(36)	(2)	(13)	(66)	—	(213)	—	(213)	(271)	—	(484)
At 31 December 2011	2,679	2,061	81	851	2,749	455	8,876	311	9,187	11,487	—	20,674
Individually assessed												
- banks	—	—	2	44	—	—	46	76	122	1	—	123
- customers	—	838	70	637	991	73	2,609	224	2,833	9,965	—	12,798
Collectively assessed	2,474	894	—	2	1,282	162	4,814	—	4,814	874	—	5,688
Latent	205	329	9	168	476	220	1,407	11	1,418	647	—	2,065
	2,679	2,061	81	851	2,749	455	8,876	311	9,187	11,487	—	20,674

For the notes to these tables refer to page 197.

Business review Risk and balance sheet management continued

Balance sheet analysis: REIL, provisions and AFS reserves continued

	UK Retail £m	UK Corporate £m	Wealth £m	International Banking £m	Ulster Bank £m	US R&C (1) £m	Total R&C (1) £m	Markets £m	Total Core £m	Non-Core £m	RFS MI £m	Group £m
At 1 January 2010	2,677	1,287	55	1,139	962	482	6,602	319	6,921	8,553	2,110	17,584
Transfers to disposal groups	—	—	—	—	—	—	—	—	—	(72)	—	(72)
Intra-group transfers	—	—	—	(217)	(351)	—	(568)	—	(568)	568	—	—
Currency translation and other adjustments	—	71	4	(98)	(22)	20	(25)	9	(16)	(206)	—	(222)
Disposal of subsidiaries	—	—	—	—	—	—	—	—	—	(20)	(2,152)	(2,172)
Amounts written-off	(1,135)	(357)	(9)	(92)	(48)	(550)	(2,191)	(33)	(2,224)	(3,818)	—	(6,042)
Recoveries of amounts previously written-off	128	8	—	2	1	72	211	2	213	198	—	411
Charged to income statement												
- continuing operations	1,160	768	18	125	1,161	485	3,717	20	3,737	5,407	—	9,144
- discontinued operations	—	—	—	—	—	—	—	—	—	—	42	42
Unwind of discount (2)	(89)	(31)	(2)	(4)	(70)	—	(196)	(1)	(197)	(258)	—	(455)
At 31 December 2010	2,741	1,746	66	855	1,633	509	7,550	316	7,866	10,352	—	18,218
Individually assessed												
- banks	—	—	2	46	—	—	48	78	126	1	—	127
- customers	—	546	57	572	502	56	1,733	215	1,948	8,176	—	10,124
Collectively assessed	2,526	703	—	—	733	177	4,139	—	4,139	1,170	—	5,309
Latent	215	497	7	237	398	276	1,630	23	1,653	1,005	—	2,658
	2,741	1,746	66	855	1,633	509	7,550	316	7,866	10,352	—	18,218

Notes:
(1) Retail & Commercial.
(2) Recognised in interest income.

Impairment provisions
The table below analyses impairment provisions in respect of loans and advances to banks and customers.

	2012			2011			2010		
	Core	Non-Core	Total	Core	Non-Core	Total	Core	Non-Core	Total
	£m	£m	£m	£m	£m	£m	£m	£m	£m
Individually assessed	2,839	9,805	12,644	2,833	9,965	12,798	1,948	8,176	10,124
Collectively assessed	5,785	757	6,542	4,814	874	5,688	4,139	1,170	5,309
Latent loss	1,325	637	1,962	1,418	647	2,065	1,653	1,005	2,658
Loans and advances to customers	9,949	11,199	21,148	9,065	11,486	20,551	7,740	10,351	18,091
Loans and advances to banks	113	1	114	122	1	123	126	1	127
Total provisions	10,062	11,200	21,262	9,187	11,487	20,674	7,866	10,352	18,218
Provisions as a % of REIL	51%	52%	52%	50%	48%	49%	52%	44%	47%
Customer provisions as a % of customer loans (1)	2.5%	20.0%	4.7%	2.2%	14.4%	4.2%	1.9%	9.1%	3.4%

Note:
(1) Includes disposal groups and excludes reverse repos.

Key points
- Within Core, the increase in collectively assessed provisions related primarily to Ulster Bank's mortgage and corporate portfolio reflecting a continuation of difficult conditions in Ireland.

- Non-Core individually assessed provisions decreased by £0.2 billion, principally reflecting write-offs in Markets and UK Corporate.

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Business review Risk and balance sheet management continued

Impairment charge analysis

The table below analyses the impairment charge for loans and securities.

2012	UK Retail £m	UK Corporate £m	Wealth £m	International Banking £m	Ulster Bank £m	US R&C (1) £m	Total R&C (1) £m	Markets £m	Central Items £m	Total Core £m	Non-Core £m	Group £m
Individually assessed	—	554	42	136	457	15	1,205	28	1	1,233	1,936	3,169
Collectively assessed	544	317	—	(1)	787	237	1,884	—	—	1,884	312	2,196
Latent loss	(15)	(35)	4	(47)	120	(169)	(143)	(3)	—	(145)	72	(73)
Loans to customers	529	836	46	88	1,364	83	2,946	25	1	2,972	2,320	5,292
Loans to banks	—	—	—	23	—	—	23	—	—	23	—	23
Securities - other	—	2	—	—	—	8	10	12	39	61	(97)	(36)
Charge to income statement	529	838	46	111	1,364	91	2,979	37	40	3,056	2,223	5,279
2011												
Individually assessed	—	612	24	233	637	64	1,570	10	—	1,580	3,615	5,195
Collectively assessed	798	392	—	—	655	230	2,075	—	—	2,075	516	2,591
Latent loss	(10)	(213)	1	(65)	92	(46)	(241)	(11)	—	(252)	(293)	(545)
Loans to customers	788	791	25	168	1,384	248	3,404	(1)	—	3,403	3,838	7,241
Securities												
- sovereign debt (2)	—	—	—	—	—	—	—	—	1,268	1,268	—	1,268
- other	—	2	—	—	—	78	80	39	(2)	117	83	200
Charge to income statement	788	793	25	168	1,384	326	3,484	38	1,266	4,788	3,921	8,709

Notes:

(1) Retail & Commercial.

(2) Includes related interest rate hedge instruments.

	Non-Core (by donating division)					
2012	UK Corporate £m	International Banking £m	Ulster Bank £m	US R&C (1) £m	Other £m	Total £m
Individually assessed	206	913	842	(25)	—	1,936
Collectively assessed	71	—	25	208	8	312
Latent loss	(37)	1	116	(6)	(2)	72
Loans to customers	240	914	983	177	6	2,320
Securities	—	(97)	—	—	—	(97)
Charge to income statement	240	817	983	177	6	2,223

2011						
Individually assessed	512	679	2,426	(3)	1	3,615
Collectively assessed	129	—	29	372	(14)	516
Latent loss	(113)	—	(106)	(66)	(8)	(293)
Loans to customers	528	679	2,349	303	(21)	3,838
Securities	—	78	—	—	5	83
Charge to income statement	528	757	2,349	303	(16)	3,921

Notes:

(1) Retail & Commercial.

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Balance sheet analysis: REIL, provisions and AFS reserves continued

The tables below analyses the impairment charge for loans and securities.

		2012			2011			2010		
		Core	Non-Core	Total	Core	Non-Core	Total	Core	Non-Core	Total
		£m	£m	£m	£m	£m	£m	£m	£m	£m
Individually assessed		1,233	1,936	3,169	1,580	3,615	5,195	1,489	4,719	6,208
Collectively assessed		1,884	312	2,196	2,075	516	2,591	2,258	812	3,070
Latent loss		(145)	72	(73)	(252)	(293)	(545)	(5)	(116)	(121)
Loans to customers		2,972	2,320	5,292	3,403	3,838	7,241	3,742	5,415	9,157
Loans to banks		23	—	23	—	—	—	(5)	(8)	(13)
Securities	- sovereign debt (1)	—	—	—	1,268	—	1,268	—	—	—
	- other	61	(97)	(36)	117	83	200	44	68	112
Charge to income statement		3,056	2,223	5,279	4,788	3,921	8,709	3,781	5,475	9,256
Charge as a % of gross loans (1)		0.7%	4.2%	1.2%	0.8%	4.8%	1.5%	0.9%	4.8%	1.7%

Notes:

(1) Includes related interest rate hedge adjustments.

(2) Customer loan impairment charge as a percentage of gross loans and advances to customers including assets of disposal groups and excluding reverse repurchase agreements.

	2012			2011			2010		
	Core	Non-Core	Total	Core	Non-Core	Total	Core	Non-Core	Total
	£m	£m	£m	£m	£m	£m	£m	£m	£m
Loan impairment losses									
- customers	2,972	2,320	5,292	3,403	3,838	7,241	3,742	5,415	9,157
- banks	23	—	23	—	—	—	(5)	(8)	(13)
	2,995	2,320	5,315	3,403	3,838	7,241	3,737	5,407	9,144
Impairment losses on securities									
- debt securities	47	(114)	(67)	1,381	52	1,433	40	41	81
- equity securities	14	17	31	4	31	35	4	27	31
	61	(97)	(36)	1,385	83	1,468	44	68	112
Charge to income statement	3,056	2,223	5,279	4,788	3,921	8,709	3,781	5,475	9,256

Potential problem loans

Potential problem loans (PPL) are loans for which an impairment event has taken place but no impairment loss is expected. This category is used for advances which are not past due 90 days or revolving credit facilities where identification as 90 days overdue is not feasible.

2012	2011	2010
£m	£m	£m

Potential problem loans	807	739	633

Both REIL and PPL are reported gross and take no account of the value of any security held which could reduce the eventual loss should it occur, nor of any provision marked. Therefore impaired assets which are highly collateralised, such as mortgages, will have a low coverage ratio of provisions held against the reported impaired balance.

AFS reserves

The table below analyses available-for-sale debt securities and related reserves, gross of tax.

	2012				2011				2010			
	UK	US	Other (1)	Total	UK	US	Other (1)	Total	UK	US	Other (1)	Total
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Central and local government	9,774	19,046	16,155	44,975	13,436	20,848	25,552	59,836	8,377	22,244	32,865	63,486
Banks	1,085	357	7,419	8,861	1,391	376	11,408	13,175	4,297	704	11,981	16,982
Other financial institutions	2,861	10,613	10,416	23,890	3,100	17,453	11,199	31,752	1,662	15,973	11,513	29,148
Corporate	1,318	719	1,130	3,167	1,105	131	1,299	2,535	438	65	1,011	1,514
Total	15,038	30,735	35,120	80,893	19,032	38,808	49,458	107,298	14,774	38,986	57,370	111,130
Of which ABS	3,558	14,209	12,976	30,743	3,659	20,256	16,820	40,735	4,002	20,872	17,641	42,515
AFS reserves (gross)	667	763	(1,277)	153	845	486	(1,815)	(484)	158	(304)	(2,559)	(2,705)

Note:

(1) Includes eurozone countries as detailed in the Country risk section (page 246).

Refer to Country risk section for additional analysis on eurozone country by country AFS reserves.

Business review Risk and balance sheet management continued

AFS gross unrealised losses

The table below shows the fair value of available-for-sale debt securities that were in an unrealised loss position at 31 December and the related gross unrealised losses.

	Less than 12 months		More than 12 months		Total	
	Fair value	Gross unrealised losses	Fair value	Gross unrealised losses	Fair value	Gross unrealised losses
2012	£m	£m	£m	£m	£m	£m
Central and local government						
- US	59	1	—	—	59	1
- other	1,625	2	145	12	1,770	14
Banks	398	2	3,466	507	3,864	509
Other financial institutions	248	19	7,686	1,300	7,934	1,319
Corporate	346	4	4	—	350	4
Total	2,676	28	11,301	1,819	13,977	1,847
Of which ABS	398	20	10,999	1,797	11,397	1,817
2011						
Central and local government - other	2,878	65	778	106	3,656	171
Banks	3,924	49	5,676	789	9,600	838
Other financial institutions	472	41	6,504	2,345	6,976	2,386
Corporate	204	11	78	2	282	13
Total	7,478	166	13,036	3,242	20,514	3,408
Of which ABS	878	54	11,908	3,104	12,786	3,158
2010						
Central and local government						
- UK	716	10	—	—	716	10
- US	74	1	163	1	237	2
- Other	4,328	6	1,738	612	6,066	618
Banks	1,655	16	6,202	770	7,857	786
Other financial institutions	2,993	73	6,972	2,553	9,965	2,626
Corporate	163	32	114	23	277	55
Total	9,929	138	15,189	3,959	25,118	4,097
Of which ABS	2,519	101	12,867	3,296	15,386	3,397

Market risk

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Market risk

Introduction

Market risk arises from fluctuations in interest rates, foreign currency, credit spreads, equity prices, commodity prices and risk related factors such as market volatilities. The Group manages market risk within its trading and non-trading portfolios through a comprehensive market risk management framework. This control framework includes qualitative and quantitative guidance in the form of comprehensive policy statements, dealing authorities, limits based on, but not limited to, value-at-risk (VaR), stressed VaR (SVaR), stress testing and sensitivity analyses.

Governance

Business structure

The primary focus of the Group's trading activities is to provide an extensive range of financing, risk management and investment services to its customers, including major corporations and financial institutions around the world. The Group undertakes these activities organised within the principal business lines: money markets; rates flow trading; currencies and commodities; equities; credit markets; and portfolio management and origination.

Financial instruments held in the Group's trading portfolios include, but are not limited to: debt securities; loans; deposits; equities; securities sale and repurchase agreements and derivative financial instruments.

The Group undertakes transactions in financial instruments that are traded or cleared on an exchange, including interest rate swaps, futures and options. Holders of exchange traded instruments provide margin on a daily basis with cash or other security at the exchange.

The Group also undertakes transactions in financial instruments that are traded over-the-counter rather than on a recognised exchange. These instruments range from commoditised transactions in derivative markets, to trades where the specific terms are tailored to meet customer requirements.

In 2011, RBS Group announced plans to transfer a substantial part of its business from RBS N.V. to RBS plc, in an effort to simplify the structure and reduce risk. During 2012, a substantial part of the business was transferred to RBS plc. A key element of this was the Financial Services Authority (FSA) approval of the Netherlands trading branch location into the scope of the regulatory models.

Organisation structure

Independent oversight and support is provided to the divisions by the Global Head of Market & Insurance Risk, assisted by the Group and divisional market risk teams. The head of each division, assisted by a divisional market risk management team, is accountable for all market risks associated with its activities. The Global Market Risk Committee reviews and makes recommendations concerning the market risk profile across the Group, including risk appetite, risk policy, models, methodology and market risk development issues. The committee meets quarterly and is chaired by the Global Head of Market & Insurance Risk. Attendees include respective divisional market risk managers and Group Market Risk.

Regulatory Risk

Trading activities will indirectly be impacted by regulatory proposals that will change market participants behaviours. These are discussed in more detail in the Regulatory risk section (refer to page 244). Developments specific to market risk include the Fundamental Review of the Trading Book (FRTB) and the Fundamental Review of the Securitisation Treatments. The FRTB remains at a conceptual stage and there is currently insufficient practical detail available to provide a meaningful assessment of what may eventually be implemented. The Basel Committee's review of the

treatment of securitisation positions is further advanced and the Group is currently reviewing how it can participate to assess the impact on trading book activities.

Risk measurement

Key principles

The Group's qualitative market risk appetite is set out in policy statements, which outline the governance, responsibilities and requirements surrounding the identification, measurement, analysis, management and communication of market risk arising from the trading and non-trading investment activities of the Group. All teams involved in the management and control of market risk are required to fully comply with the policy statements to ensure the Group is not exposed to market risk beyond the qualitative and quantitative risk appetite. The control framework covers the following principles:

- Clearly defined responsibilities and authorities for the primary groups involved in market risk management in the Group;
- An independent market risk management process;
- Daily monitoring, analysis and reporting of market risk exposures against market risk limits;
- Clearly defined limit structure and escalation process in the event of a market risk limit excess;
- A market risk measurement methodology that captures correlation effects and allows aggregation of market risk across risk types, markets and business lines;
- Use of VaR as a measure of the one-day and SVaR as a measure of the ten-day market risk exposure of all trading positions;
- Use of non-VaR based limits and other controls;
- Use of stress testing and scenario analysis to support the market risk measurement and risk management process by assessing how portfolios and global business lines perform under extreme market conditions;
- Use of back-testing as a diagnostic tool to assess the accuracy of the VaR model and other risk management techniques;
- Adherence to the risks not in VaR framework to identify, quantify and capitalise risks not captured within the VaR model; and
- A product approval process that requires market risk teams to assess and quantify market risk associated with proposed new products.

Market risk: Risk measurement continued

Risk appetite*

The Executive Risk Forum (ERF) approves the quantitative market risk appetite for trading and non-trading activities. The Global Head of Market & Insurance Risk, under delegated authority from the ERF, sets and populates a limit framework, which is cascaded down through legal entity, division, business and desk level market risk limits.

At the Group level, the risk appetite is expressed in the form of a combination of VaR, SVaR, sensitivity and stress testing limits.

A daily report summarises the Group's market risk exposures against the agreed limits. This daily report is sent to the Head of Restructuring & Risk, Global Head of Market & Insurance Risk, divisional Chief Risk Officers and appropriate divisional market risk managers.

Legal entities, divisions and lower levels in the business also have an appropriate market risk framework of controls and limits in place to cover all material market risk exposures.

The specific market risk metrics that are appropriate for controlling the positions of a desk will be more granular than the Group level limits and tailored to the particular division and business.

The market risk control framework has been enhanced further during 2012 with the implementation of SVaR and portfolio gap risk limits. The portfolio gap risk takes into consideration the possibility of the joint occurrence of losses across different gap risk products.

In line with the overall business strategy to reduce risk exposures, the Group's market risk limits were adjusted down during 2012. The majority of the Group's market risk exposure were 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. These aspects are discussed in more detail in Non-traded interest rate risk on page 112 and Structural foreign currency exposures on page 114.

In 2012, a market risk economic capital model was developed. It is planned to use this model for performance measurement within Markets and to assess the risks of the group from a consolidated economic perspective. The results of the model will be consolidated with other risk types and reported during 2013. The model calculates the market and default risk in the trading book using an extended historic simulation approach with multiple liquidity horizons (differentiated by portfolio and asset class). The results are annualised to be consistent with the other Group economic capital models.

Risk models*

Risk models are developed both within divisional units and by Group functions. Risk models are also subject to independent review and sign-off to the same standard as pricing models. Meetings are held with the FSA every quarter to discuss the traded market risk, including changes in models, management, back-testing results, risks not included in the VaR framework and other model performance statistics.

VaR - is a technique that produces estimates of the potential change in the market value of a portfolio over a specified time horizon at a given confidence level. For internal risk management purposes, the Group's VaR assumes a time horizon of one trading day and a confidence level of 99%. The Group's VaR model is based on a historical simulation model, utilising data from the previous two years.

The VaR model has been approved by the FSA to calculate regulatory capital for the trading book for those legal entities under its jurisdiction. These legal entities are The Royal Bank of Scotland plc; National Westminster Bank Plc; RBS Financial Products Inc; and RBS Securities Inc. Regulatory VaR differs from the internal VaR as it is based on a ten-day holding period. The approval covers general market risk in interest rate, foreign exchange, equity and specified commodity products and specific risk in interest rate and equity products.

The VaR model is an important market risk measurement and control tool. It is used for determining a significant component of the market risk capital and, as such, it is regularly assessed. The main approach employed to asses the ongoing model performance is back-testing, which counts the number of days when a loss (as defined by the FSA) exceeds the corresponding daily VaR estimate, measured at a 99% confidence level. The FSA categorises a VaR model as green, amber or red. A green model status is consistent with a good working model and is achieved for models that have four or fewer back-testing exceptions in a 12-month period. For the Group's trading book, a green model status was maintained throughout 2012.

The Group's VaR should be interpreted in light of the limitations of the methodology used, as follows:

- Historical simulation VaR may not provide the best estimate of future market movements. It can only provide a forecast of portfolio losses based on events that occurred in the two-year time series. Therefore, events that are more severe than those in the historical data series are not represented.
- The use of a 99% confidence level does not reflect the extent of potential losses beyond that percentile.
- The use of a one-day time horizon will not fully capture the profit and loss implications of positions that cannot be liquidated or hedged within one day.
- The Group computes the VaR of trading portfolios at the close of business. Positions may change substantially during the course of the trading day and, if so, intra-day profit and losses will be incurred.

These limitations mean that the Group cannot guarantee that losses will not exceed the VaR.

During 2012, an improved methodology was implemented for interest rates, to more realistically represent the distribution of rate changes. The enhanced model introduces a level-dependent scaling methodology for interest rates, which removes the overestimation of rate fluctuations in regimes of declining rates and leads to a swifter adaptation to changing circumstances in times of increasing rates. At the point of implementation the impact on the trading VaR was a decrease of £3.9 million, while the interest rate VaR saw an increase of £1.4 million. The non-trading total and interest rate VaR decreased by £0.5 million and £1.9 million respectively.

SVaR - is applied to the trading portfolio and utilises data from a specific one year period of stress. As with VaR, the technique produces estimates of the potential change in the market value of a portfolio over a specified time horizon at given confidence level. For the purposes of calculating regulatory SVaR, a time horizon of ten trading days is assumed and a confidence level of 99%.

In December 2012, the FSA confirmed the European Banking Authority guidelines relating to SVaR. The FSA now requires the use of 'Dynamic' SVaR, where the worst one year period of stress is determined on a daily basis.

Risks not in VaR (RNIV) - The RNIV framework has been developed to quantify those market risks not adequately captured by VaR and SVaR methodologies. The RNIV approach is used for market risks that fall within the scope of VaR, but which are insufficiently captured by the model methodology, for example due to the lack of sufficient historical data. These risks are therefore assessed outside the VaR model.

The Group adopts two approaches to the quantification of risks not in VaR (RNIVs):

- Some RNIVs are quantified using a (standalone) VaR approach. For these RNIVs, two values are calculated: (i) the VaR RNIV; and (ii) the SVaR RNIV.

- Some RNIVs are quantified using a stress scenario approach. For these RNIVs, an assessment of ten-day extreme, but plausible, market moves is used in combination with position sensitivities to give a stress-type loss number - the stressed RNIV value.

For each legal entity covered by the FSA VaR model waiver, all RNIVs are aggregated to obtain the following three measures: (i) Total VaR RNIV; (ii) Total SVaR RNIV; and (iii) Total stressed RNIV.

In each case, no allowance is made for potential diversification in respect of material RNIVs.

Incremental risk charge (IRC) - The IRC model aims to quantify the impact of defaults and rating changes on the market value of bonds, credit derivatives, and other related positions held in the trading book. It is calculated over a one year horizon to a 99.9% confidence level, and therefore represents a 1-in-1,000 loss over the following year. The modelling framework differentiates between the liquidity of different underlying instruments, with a minimum liquidity horizon of three months. It also captures basis risks between different products referencing the same underlying credit (e.g. bonds and credit default swaps (CDS)), and between similar products with different contractual terms (e.g. CDS in different currencies). The portfolio impact of correlated defaults and rating changes is assessed with reference to the resulting market value change of positions, which is determined using stressed recovery rates and modelled credit spread changes. The average liquidity horizon at the year end was 4.6 months.

In 2012, the IRC model was enhanced further; i) to better capture the risk characteristics of sovereign exposure migrations and defaults; and ii) to align the recovery rates for sovereign exposures to the banking book internal ratings

based approach.

All price risk (APR) - The APR model is applied to the corporate credit correlation trading portfolio, subject to certain eligibility constraints (principally that the underlying names are liquid corporate CDS positions). The measure is calibrated to a 99.9% confidence level over a one year time horizon. All material price risks, including defaults and credit rating changes, are within the scope of the model. Of these, the most significant are credit spread risk, credit correlation risk, index basis risk, default risk, and recovery rate risk. In addition, losses due to both hedging costs and hedge slippage are modelled. The overall APR capital charge is floored at 8% of the corresponding standard rules charge for the same portfolio. The average liquidity horizon at the year end was 12 months.

Model validation - A model assessment is performed before a new or changed model element is implemented, and before a change is made to a market data mapping. Depending on the results, it may be necessary to notify the FSA before implementation. The form of internal validation depends on the type of model and the materiality of the change.

In the case of VaR models, the following steps are considered. In some cases, for example a minor change to a market data mapping, it will not be necessary to perform all of the steps. However, in all cases there will be an independent review and validation.

- Perform accuracy testing of the valuation methods used within VaR on appropriately chosen test portfolios. Ensure that tests capture the effect of using external data proxies where these are used.
- Back-test the approach using the relevant portfolio.
- Back-test the approach using hypothetical portfolio(s) where this is helpful for isolating the performance of specific areas of the model.
- Identify all risks not adequately captured in VaR, and ensure that such risks are captured via the risks not in VaR process.
- Identify any model weaknesses or scope limitations, their effect and how they have been addressed.
- Identify ongoing model testing designed to give early warning of market or portfolio weakness becoming significant.
- Perform impact assessment. Estimate the impact on total one-day and ten-day 99% VaR at the total legal entity level and the major business level, and individual risk factor level one-day and ten-day 99% VaR at the total legal entity level.

Market risk: Risk measurement continued
Additionally, Group Risk Analytics (GRA) assess the appropriateness of all new or amended models prior to their introduction. Existing approved models are re-assessed on a periodic basis to ensure they remain fit-for-purpose, for example, following significant market developments or portfolio changes. The models required to be reviewed by GRA (in relation to market risk) include VaR, SVaR, IRC, APR and economic capital. The independent validation review process will consider some or all of the following areas as appropriate:

- Test and challenge the logical and conceptual soundness of the methodology;
- The assumptions underlying the model will be tested, where feasible against actual behaviour. The validation report will judge the reasonableness and stability of the assumptions and specify which assumptions, if any, should be routinely monitored in production;
- Compare model results with independent model replication;
- Compare outcome with results from alternative methods;
- Test parameter selection and calibration;
- Ensure that model outputs are sufficiently conservative in areas where there is significant model uncertainty;
- Confirm applicability of tests for accuracy, and stability; recalculate; and ensure that results are robust; and
- Ensure appropriate factor sensitivity analysis has been performed and documented.

Stress testing*
The Group undertakes daily stress testing to identify the potential losses in excess of VaR. Stress testing is used to calculate a range of trading book exposures which result from severe and extreme market events. Stress testing measures the impact of exceptional changes in market rates and prices on the fair value of the Group's trading and available-for-sale portfolios. The Group calculates sensitivity analysis, historical stress tests and bottom-up stress testing.

Sensitivity analysis measures the sensitivity of the current portfolio of positions to defined market risk factor movements. These stresses are of a smaller magnitude compared to historical or bottom-up stress testing and are subject to the Group Market Risk limit framework.

Historical stress tests calculate the changes in the portfolio valuations that would be generated if the extreme market movements that occurred during significant historical market events were repeated. Historical stress tests also form part of the Group Market Risk limit framework.

Bottom-up stress testing requires analysis of the market risk exposures by risk factors and different liquidity horizons, to identify the key risks. Stresses for these risks are then designed following consultation with risk managers, economists and front office. The tests may be based on an economic scenario that is translated into risk factor shocks by an economist or by risk managers and front office as a means of assessing the vulnerabilities of their book.

The Global Market Risk Stress Testing Committee reviews and discusses all matters relating to market risk stress testing. Stress test exposures are discussed with senior management and relevant information is reported to the Group Risk Committee, the ERF and the Board. Breaches in the Group's market risk stress testing limits are monitored and reported.

Reverse stress testing is designed to assess the plausibility of scenarios derived by stressing market risk factors until the loss reaches a given threshold. Market Risk contributes to the firm wide, cross risk reverse stress tests.

In addition to VaR and stress testing, the Group calculates a wide range of sensitivity and position risk measures, for example interest rate ladders or option revaluation matrices. These measures provide valuable additional controls, often at individual desk or strategy level.

Pricing models*

Pricing models are developed and owned by the front office. Where pricing models are used as the basis of books and records valuations, they are subject to oversight and approval by asset level modelled product review committees. These committees prioritise models for independent validation by GRA taking into consideration both the materiality of risk booked against the model and an assessment of the degree of model risk (i.e. valuation uncertainty arising from choice of modelling assumptions). GRA review aims to quantify model risk by comparing model outputs against those of alternative independently developed models, the results of which are used by Market Risk to inform risk limits and by Finance to inform model reserves.

Marking-to-market

To ensure that the risks associated with trading activity are reflected in the financial and management statements, assets and liabilities in the trading book are measured at their fair value. Any profits or losses on the revaluation of positions are recognised in the income statement on a daily basis.

The fair value is the amount at which the instrument could be exchanged in a current transaction between willing parties. The fair values are determined following IAS 39 'Financial Instruments: Recognition and Measurement' guidance, which requires banks to use quoted market prices or valuation techniques (models) that make the maximum use of observable inputs.

When marking-to-market using a model, the valuation methodologies must be approved by all stakeholders (trading, finance, market risk, model development and model review) prior to use for profit and loss and risk management purposes.

Traders are responsible for marking-to-market their trading book positions on a daily basis. Traders can either:

- directly mark a position with a price (e.g. spot foreign exchange); or
- indirectly mark a position through the marking of inputs to an approved model, which will in turn generate a price.

Independent price verification

Independent price verification is a key additional control over front office marking of positions.

Key elements of the independent price verification framework include:

- Appropriate financial controls - business unit controllers are responsible for ensuring that independent price verification processes are in place covering all trading book positions held by their business. The independent pricing verification policy requires that daily independent price verification is performed for positions where prices/model inputs are readily available on a daily basis. For positions where prices/model inputs are available on a less regular basis, verification may occur on a frequency that is less than daily. Where practical, verification is performed to a frequency that matches the availability of this independent price information.

- Compliance statements - business unit control is required to prepare and maintain compliance statements that benchmark price verification procedures against the independent pricing policy. Each compliance statement requires review and sign-off from the relevant financial controller, market risk manager and front office management every six months at least.

For more information on independent price verification, refer to Valuation of financial instruments carried at fair value on page 353.

Market risk analyses

Trading revenues*

The graph below shows the daily distribution of trading and related revenues for Markets for the years ended 31 December 2012 and 31 December 2011.

Note:

(1) The effect of any month end adjustments, not attributable to a specific daily market move, is spread evenly over the trading days in that specific month.

Key points

- Both 2011 and 2012 benefited from market rallies, albeit weaker but more sustained during 2012 than 2011, primarily due to the supportive actions of the Federal Reserve and European Central Bank in the third quarter of 2012. By way of contrast, in the third quarter of 2011, heightened uncertainty in the Eurozone saw a sudden deterioration in credit markets. Hence a wider range of results in 2011 than 2012.

- The average daily revenue earned by Markets' trading activities in 2012 was £16 million, compared with £18 million in 2011. The standard deviation of the daily revenues decreased from £20 million to £15 million. The number of days with negative revenue decreased to 34 from 45. The most frequent daily revenue was between £5 million and £10 million, which occurred 36 times. In 2011, the most frequent daily revenue was between £25 million and £30 million, which occurred 31 times.

* unaudited

Market risk: Market risk analyses continued
Daily VaR graph*

Trading book
The table below analyses the VaR for the Group's trading portfolios, segregated by type of market risk exposure, and between Core, Non-Core, counterparty exposure management (CEM) and the Group's total trading VaR excluding CEM.

CEM manages the over-the-counter derivative counterparty credit and funding risk on behalf of Markets and Non-Core, by actively controlling risk concentrations and reducing unwanted risk exposures. The hedging transactions CEM enters into are booked in the trading book and therefore contribute to the market risk VaR exposure of the Group. The counterparty exposures themselves are not captured in VaR for regulatory capital. In the interest of transparency and to more properly represent the exposure, CEM trading book exposure and total trading VaR excluding CEM are disclosed separately.

	2012				2011				2010			
	Average	Period end	Maximum	Minimum	Average	Period end	Maximum	Minimum	Average	Period end	Maximum	Minim
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	
Interest rate	62.6	75.6	95.7	40.8	53.4	68.1	79.2	27.5	51.6	57.0	83.0	3
Credit spread	69.2	74.1	94.9	44.9	82.7	74.3	151.1	47.4	166.3	133.4	243.2	11
Currency	10.3	7.6	21.3	2.6	10.3	16.2	19.2	5.2	17.9	14.8	28.0	
Equity	6.0	3.9	12.5	1.7	9.4	8.0	17.3	4.6	9.5	10.9	17.9	
Commodity	2.0	1.5	6.0	0.9	1.4	2.3	7.0	—	9.5	0.5	18.1	
Diversification (1)		(55.4)				(52.3)				(75.6)		
Total	97.3	107.3	137.0	66.5	105.5	116.6	181.3	59.7	168.5	141.0	252.1	10
Core	74.6	88.1	118.0	47.4	75.8	89.1	133.9	41.7	103.6	101.2	153.4	5
Non-Core	30.1	22.8	41.9	22.0	64.4	34.6	128.6	30.0	105.7	101.4	169.4	6
CEM	78.5	84.9	86.0	71.7	50.1	75.8	78.8	30.3				
Total (excluding CEM)	47.1	57.6	76.4	32.2	75.5	49.9	150.0	41.6				

Note:
(1) The Group benefits from diversification, which reflects the risk reduction achieved by allocating investments across various financial instrument types, currencies and markets. The extent of diversification benefit depends on the correlation between the assets and risk factors in the portfolio at a particular time.

Key points
- The Group's average and maximum credit spread VaR for 2012 was lower than for 2011. This reflected the credit spread volatility experienced during the financial crisis dropping out of the time series window, combined with a reduction in the asset-backed securities trading inventory in Core and the sale of unencumbered asset-backed securities assets following the prior restructuring of some monoline hedges in the Non-Core banking book.

- The average and period end interest rate VaR for 2012 were higher than for 2011 due to pre-hedging and positioning activity ahead of government bond auctions and syndications, combined with an increase in exposure to “safe haven” assets in December 2012, as the US “Fiscal Cliff” negotiations continued without resolution.

- The Non-Core VaR was significantly lower in 2012, as Non-Core continued its de-risking strategy through the disposal of assets and unwinding of trades.

- Since late 2011, CEM started to centrally manage the funding risk on over-the-counter derivatives contracts, causing the VaR to be considerably higher in 2012 than 2011.

* unaudited

VaR non-trading portfolios

VaR

The table below details VaR for the Group's non-trading portfolios, excluding the structured credit portfolio and loans and receivables.

VaR is not always the most appropriate measure of risk for assets in the banking book and particularly for those in Non-Core, which will diminish over time as the asset inventory is sold down or run-off.

In order to better represent the risk of the non-trading portfolios, the table below analyses the VaR for the non-trading portfolios but excludes the Non-Core structured credit portfolio. These assets are shown separately on a drawn notional and fair value basis by maturity profile and asset class. The risk in this portfolio is managed on both a third party asset and RWA basis.

Also excluded from the non-trading VaR portfolios are the loans and receivable products that are managed within the credit risk management framework.

	2012				2011				2010			
	Average	Period end	Maximum	Minimum	Average	Period end	Maximum	Minimum	Average	Period end	Maximum	Minimu
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	[illegible]
Interest rate	6.9	4.5	10.7	4.1	8.8	9.9	11.1	5.7	8.7	10.4	20.5	[illegible]
Credit spread	10.5	8.8	15.4	7.3	18.2	13.6	39.3	12.1	32.0	16.1	101.2	[illegible]
Currency	3.0	1.3	4.5	1.3	2.1	4.0	5.9	0.1	2.1	3.0	7.6	[illegible]
Equity	1.7	0.3	1.9	0.3	2.1	1.9	3.1	1.6	1.2	3.1	4.6	[illegible]
Diversification (1)		(5.4)				(13.6)				(15.9)		
Total	11.8	9.5	18.3	8.5	19.7	15.8	41.6	13.4	30.9	16.7	98.0	[illegible]
Core	11.3	7.5	19.0	7.1	19.3	15.1	38.9	13.5	30.5	15.6	98.1	[illegible]
Non-Core	2.5	3.4	3.6	1.6	3.4	2.5	4.3	2.2	1.3	2.8	4.1	[illegible]
CEM	1.0	1.0	1.1	0.9	0.4	0.9	0.9	0.3				
Total (excluding CEM)	11.5	9.4	17.8	8.2	19.7	15.5	41.4	13.7				

Note:

(1) The Group benefits from diversification, which reflects the risk reduction achieved by allocating investments across various financial instrument types, currencies and markets. The extent of diversification benefit depends on the correlation between the assets and risk factors in the portfolio at a particular time.

Key points

- The average and period end total and credit spread VaR were lower in 2012, due to reduced volatility in the market data time series, position reductions and a decrease in the size of the collateral portfolio. The reduction in collateral was driven by the restructuring of certain Dutch residential mortgage-backed securities during the first half of 2012, enabling their eligibility as European Central Bank collateral. This allowed the disposal of additional collateral purchased during the corresponding period in 2011.

- The average and period end interest rate VaR were lower in 2012, due to the implementation of an enhanced rates re-scaling methodology.

- The Non-Core period end VaR was higher in 2012 than in 2011, due to improvements in the time series mapping on certain Australian bonds and the purchase of additional hedges.

Business review Risk and balance sheet management continued

Market risk: VaR non-trading portfolios continued

Structured credit portfolio

The structured credit portfolio is within Non-Core. The risk in this portfolio is not disclosed using VaR, as the Group believes this is not an appropriate tool for the banking book portfolio, which comprises illiquid debt securities. These assets are reported on a drawn notional and fair value basis, and managed on a third party asset and risk-weighted assets basis. The table below shows the open market risk in the structured credit portfolio.

	Drawn notional					Fair value				
	CDOs (1)	CLOs (2)	MBS (3)	Other ABS (4)	Total	CDOs (1)	CLOs (2)	MBS (3)	Other ABS (4)	Total
2012	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
1-2 years	—	—	—	80	80	—	—	—	74	74
3-4 years	—	—	27	82	109	—	—	24	76	100
4-5 years	—	—	95	—	95	—	—	86	—	86
5-10 years	—	310	92	—	402	—	295	44	—	339
>10 years	289	279	380	398	1,346	116	256	253	254	879
	289	589	594	560	2,032	116	551	407	404	1,478
2011										
1-2 years	—	—	—	27	27	—	—	—	22	22
2-3 years	—	—	10	196	206	—	—	9	182	191
4-5 years	—	37	37	95	169	—	34	30	88	152
5-10 years	32	503	270	268	1,073	30	455	184	229	898
>10 years	2,180	442	464	593	3,679	766	371	291	347	1,775
	2,212	982	781	1,179	5,154	796	860	514	868	3,038
2010										
1-2 years	—	—	—	47	47	—	—	—	42	42
2-3 years	85	19	44	98	246	81	18	37	91	227
3-4 years	—	41	20	205	266	—	37	19	191	247
4-5 years	16	—	—	—	16	15	—	—	—	15
5-10 years	98	466	311	437	1,312	87	422	220	384	1,113
>10 years	412	663	584	550	2,209	161	515	397	367	1,440
	611	1,189	959	1,337	4,096	344	992	673	1,075	3,084

Notes:

(1) Collateralised debt obligations.

(2) Collateralised loan obligations.

(3) Mortgage-backed securities.

(4) Asset-backed securities.

Key point

- The structured credit portfolio drawn notional and fair values declined across all asset classes from 31 December 2011 to 31 December 2012. Key drivers were: (i) during the first half of 2012, the liquidation of legacy trust preferred securities and commercial real estate CDOs and subsequent sale of the underlying assets; and (ii) during

the second half of 2012, the sale of underlying assets from CDO collateral pools and legacy conduits.

Market risk capital*

Minimum capital requirements

The following table analyses the market risk minimum capital requirement, calculated in accordance with Basel 2.5.

	2012 £m	2011 £m
Interest rate position risk requirement	254	1,107
Equity position risk requirement	1	3
Option position risk requirement	26	26
Commodity position risk requirement	2	2
Foreign currency position risk requirement	12	10
Specific interest rate risk of securitisation positions	156	250
Total (standard method)	451	1,398
Pillar 1 model based position risk requirement	2,959	3,725
Total position risk requirement	3,410	5,123

* unaudited

Business review Risk and balance sheet management continued

The principal contributors to the Pillar 1 model based position risk requirement (PRR) are:

	2012				
	Average (1)	Maximum (1)	Minimum (1)	Period end	2011
	£m	£m	£m	£m	£m
Value-at-risk (VaR) (1)	939	1,190	757	825	887
Stressed VaR (SVaR)	1,523	1,793	1,160	1,226	1,682
Incremental risk charge (IRC)	521	659	372	467	469
All price risk (APR)	149	290	12	12	297

Note:
(1) The average, maximum and minimum are based on the monthly Pillar 1 model based capital requirements.

Key points

- The FSA approved the inclusion of the Group's US trading subsidiary RBS Securities Inc. in the regulatory models in March 2012. This resulted in the model-based charges for VaR, SVaR and IRC increasing at that time and the standardised interest rate PRR decreasing significantly.

- SVaR decreased during the remainder of 2012, due to the disposal of assets in Non-Core and general de-risking in sovereign and agency positions in Markets.

- The APR decreased significantly due to the disposal of assets and unwinding of trades.

IRC by rating and product category

The following table analyses the IRC by rating and product.

	Internal ratings							
	AAA	AA	A	BBB	BB	B	CCC	Total (1)
2012	£m	£m	£m	£m	£m	£m	£m	£m
Product categories								
Cash - ABS	59.2	—	—	(0.1)	(0.9)	—	—	58.2
Cash - regular	39.5	146.9	9.8	59.9	8.6	16.9	12.7	294.3
Derivatives - credit	(0.3)	(14.0)	4.0	30.4	28.4	5.6	(2.7)	51.4
Derivatives - interest rate	(1.0)	—	1.5	0.1	(2.1)	(0.3)	—	(1.8)
Other	13.8	—	—	—	—	—	—	13.8
Total	111.2	132.9	15.3	90.3	34.0	22.2	10.0	415.9

Note:
(1) The figures presented are based on the spot IRC charge at 31 December 2012 and will therefore not agree with the IRC position risk requirement, as this is based on the 60 day average. The figures presented above are in capital terms.

Securitisation positions in the trading book

The following table analyses the trading book securitised exposures, by rating, subject to a market risk capital requirement.

2012	Ratings (1)								
	AAA	AA	A	BBB	BB	Below BB	Total (1,2)	STD PRR (3)	Capital deductions
	£m	£m	£m	£m	£m	£m	£m	%	£m
Trading book securitisation charge	15.5	7.4	15.2	35.3	75.8	6.2	155.4	36.6	1,369.6

Notes:

(1) Based on S&P ratings.

(2) Excludes the capital deductions.

(3) Percentage of total standardised position risk requirement.

Country risk

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Country risk

Introduction*

Country risk is the risk of material losses arising from significant country-specific events such as sovereign events (default or restructuring); economic events (contagion of sovereign default to other parts of the economy, cyclical economic shock); political events (transfer or convertibility restrictions, expropriation or nationalisation); and conflict. Such events have the potential to affect elements of the Group's credit portfolio that are directly or indirectly linked to the country in question and can also give rise to market, liquidity, operational and franchise risk-related losses.

External environment*

Country risk, notably in the eurozone, remained elevated in 2012, particularly in the first half of the year. Economic growth projections were lowered, predominantly for Europe, but also for a number of major emerging markets. However, important first steps towards achieving longer-term stabilisation in the eurozone led to some notable easing of crisis risks. Growth data from major non-European economies, such as China, were more encouraging towards the end of the year. The ability of policymakers to tackle fiscal challenges and restore confidence and growth in both the US and Europe will be a key factor in determining the pace of recovery.

Eurozone risks

Eurozone risks continued to dominate, as concerns about the impact of banking sector problems on government balance sheets led to further capital flight from periphery countries and a rise in sovereign bond yields until August, particularly for Spain. To break the feedback loop between banks and their sovereigns, eurozone leaders agreed at their June summit that the European Stability Mechanism (ESM), the eurozone's permanent crisis fund, could lend to banks directly once a single eurozone-wide banking regulator had been established. They also approved the provision by the ESM of significant financial support to Spain to recapitalise its banks.

In the second half of the year, the ESM became fully operational and the European Central Bank (ECB) announced a major new facility, Outright Monetary Transactions. This facility allows secondary market purchases by the ECB of bonds issued by eurozone sovereigns that are subject to a European Union (EU)/International Monetary Fund (IMF) support programme. Following these steps, sovereign bond yields fell markedly.

Meanwhile, in Greece, private sector claims on the government were restructured in early 2012, but political risks remained acute as two successive parliamentary elections eventually resulted in a narrow victory for the pro-bailout New Democracy party. As the electoral process delayed policy implementation and the recession, contrary to earlier expectations, deepened further, additional reforms became necessary and the European Commission, the IMF and the ECB (known collectively as the Troika) further eased Greece's targets.

Elsewhere, Ireland continued to make progress towards targets set out in its Troika programme, notably allowing the government to resume a degree of market financing. Talks with the European authorities on ways to relieve the government of some of the costs of past banking sector support continued, resulting in a favourable restructuring of the Anglo Irish promissory note in early 2013, reducing related fiscal costs somewhat. Notwithstanding these developments, Irish growth remained very weak and reliant on external demand. Portugal also made progress in a number of areas, though had greater structural constraints to address to boost longer-term growth prospects. Towards the end of the year, Cyprus also entered negotiations with the EU and IMF on a support programme. The eurozone as a whole entered recession in the second half of the year, although divergence within the currency union continued, with the core considerably stronger than the periphery.

Emerging markets

Emerging markets performed better on the whole. In developing Asia, the economies of China and India both continued to slow from a strong base, but risks remained held in check by healthy external balance sheets.

Emerging countries in Europe started to be affected by very weak growth in the eurozone, with the most export-focused economies being worst hit. However, countries that took significant action in the wake of the financial crisis to stabilise their banking sectors, saw an easing of risk. Turkey was upgraded by one rating agency to investment grade.

General political instability seen in the Middle East and North Africa in 2011 moderated in 2012 in most countries except Syria, although transition to democratic rule was only partial in some cases. Excluding Bahrain, Gulf Cooperation Council countries were generally more stable, underpinned by high oil prices.

Latin America continued to be characterised by greater stability, due to generally healthier sovereign balance sheets. However, growth prospects deteriorated because of weaker external demand, notably in the region’s largest economy, Brazil.

Outlook

Overall, the outlook for 2013 remains challenging with risks likely to remain elevated but divergent. Much will depend on the success of EU efforts to contain contagion from the sovereign crisis (where downside risks are high) and on whether growth headwinds in larger advanced economies, particularly the US and Japan, persist. Emerging market balance sheet risks remain lower, despite structural and political constraints, but it is expected that these economies will continue to be affected by events elsewhere through financial markets and trade channels.

*unaudited

Country risk continued

Governance, monitoring and management*

The Group's country risk framework is set by the Executive Risk Forum (ERF), which has delegated authority to the Group Country Risk Committee (GCRC) to manage exposures within the framework and deal with any limit breaches, with escalation where needed to ERF. Under this framework, exposures to all countries are monitored. Countries with material exposures are included in 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.

Limits on total exposure are set for individual countries based on a risk assessment taking into account the country's economic and political situation and outlook, as well as the Group's portfolio composition in that country. Sub-limits are set on medium-term (greater than one year) exposure since this exposure can, by nature, not be reduced as rapidly as short-term exposure in the event of deterioration of a country's creditworthiness.

During 2012, in addition to all emerging markets and the vulnerable eurozone countries, the Group brought nearly all advanced countries under country limits. The exceptions were the UK (and related European special territories of Guernsey, Jersey, the Isle of Man and Gibraltar) and the US, given their home country status.

Also in 2012, an enhanced country risk appetite framework was introduced. The Group's risk appetite for a particular country is now guided by global risk appetite, the country's internal rating and strategic importance to the Group, the portfolio composition by tenors and clients, an assessment of the potential for losses arising from a number of possible key country risk events, and other country-specific considerations such as funding profile, risk/return analysis, business opportunities and reputational risk. The actual country limits continue to be set by GCRC (or the ERF above certain benchmark levels).

Further enhancements included improved divisional country risk operating models and the implementation of a new sovereign rating model.

Eurozone crisis preparedness

A Group executive steering group is driving eurozone crisis preparedness. Its agenda in 2012 included operational preparations for possible sovereign defaults and/or eurozone exits. The steering group 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.

Redenomination risk

The overall impact of redenomination risk on the Group is difficult to determine with certainty, but would be shaped by: the scope and reach of any new legislation introduced by an exiting country; its applicability to the facility documentation; and whether there are any appropriate offsets to the exposures. For the purposes of estimating funding mismatches at risk of redenomination (detailed below), the Group takes, as its starting point balance sheet exposure as defined on page 214 and excludes exposures at low risk of redenomination. The latter are identified through consideration of the relevant documentation, particularly the currency of exposure, governing law, court of jurisdiction, precise definition of the contract currency (for euro facilities), and location of payment. The Group also deducts offsets for provisions taken and liabilities that would be expected to redenominate at the same time.

A redenomination event would also be accompanied by increased credit risk, for two reasons. First, capital controls would likely be introduced in the affected country, resulting in any non-redenominated assets, including non-euro assets, potentially becoming harder to service. Second, a sharp devaluation could imply payment difficulties for counterparties with large debts denominated in foreign currency and counterparties that are heavily dependent on imports.

The Group's focus continues to be on reducing its asset exposures and funding mismatches in the eurozone periphery countries. During 2012, total asset exposures to these countries decreased by 13% to £59.1 billion. The estimated funding mismatch at risk of redenomination was £9.0 billion for Ireland, £4.5 billion for Spain, and £1.0 billion for Italy at 31 December 2012. These mismatches can fluctuate due to volatility in trading book positions and changes in bond prices. The net positions for Greece, Portugal and Cyprus were all minimal.

Refer to pages 215 to 239 for discussion on the Group’s exposure to banks, financial institutions and other sectors in a number of eurozone countries.

Credit default swaps

The Group uses credit default swap (CDS) contracts to service customer activity as well as to manage counterparty and country exposure. The latter is done to hedge portfolios or specific exposures. This may give rise to maturity mismatches between the underlying exposure and the CDS contract, as well as between bought and sold CDS contracts on the same reference entity. CDS positions are monitored on a daily basis as part of regular market risk management.

The terms of the Group’s CDS contracts are covered by standard International Swaps and Derivatives Association (ISDA) documentation, which determines if a contract is triggered due to a credit event. Such events may include bankruptcy or restructuring of the reference entity or a failure of the reference entity to repay its debt or interest. Under the terms of a CDS contract, one of the regional Credit Derivatives Determinations Committees of the ISDA is empowered to decide whether or not a credit event has occurred.

The Group transacts CDS contracts primarily on a collateralised basis with investment-grade global financial institutions who are active participants in the CDS market. These transactions are subject to regular margining, which usually takes the form of cash collateral. For European peripheral sovereigns, credit protection has been purchased from a number of major European banks, predominantly outside the country of the reference entity. In a few cases where protection was bought from banks in the country of the reference entity, giving rise to wrong-way risk, this risk is mitigated through specific collateralisation and monitored on a weekly basis.

*unaudited

Country risk: Country risk exposure
All the data tables and related definitions in this section are audited.

The tables that follow show the Group's exposure by country of incorporation of the counterparty at 31 December 2012. Countries shown are those where the Group's balance sheet exposure (as defined in this section) to counterparties incorporated in the country exceeded £1 billion and the country had an external rating of A+ or below from Standard and Poor's, Moody's or Fitch at 31 December 2012, as well as selected eurozone countries. The exposures are stated before taking into account mitigants, such as collateral (with the exception of reverse repos), insurance or guarantees, which may have been taken to reduce or eliminate exposure to country risk events. Exposures relating to ocean-going vessels are not included due to their multinational nature.

Definitions
Lending - Comprises gross loans and advances to: central and local government (Govt); central banks, including cash balances; other banks and financial institutions (FI), incorporating overdraft and other short-term facilities; corporates, in large part loans and leases; and individuals, comprising mortgages, personal loans and credit card balances. Lending includes risk elements in lending.

Risk elements in lending (REIL) - Comprises impaired loans and accruing past due 90 days or more as to principal or interest. Impaired loans are all loans (including renegotiated) for which an impairment provision has been established. Accruing past due 90 days or more comprise loans past due 90 days where no impairment loss is expected and those awaiting individual assessment. A latent provision is established for the latter.

Debt securities - Comprise securities classified as available-for-sale (AFS), loans and receivables (LAR), held-for-trading (HFT) and designated as at fair value through profit or loss (DFV). All debt securities other than LAR securities are carried at fair value. LAR debt securities are carried at amortised cost less impairment. HFT debt securities are presented as gross long positions (including DFV securities) and short positions per country. Impairment losses and exchange differences relating to AFS debt securities, together with interest, are recognised in the income statement. Other changes in the fair value of AFS securities are reported within AFS reserves, which are presented gross of tax.

Derivatives (net) - Comprise the mark-to-market (mtm) value of such contracts after the effect of legally enforceable netting agreements but before the effect of collateral. Figures shown include the effect of counterparty netting used within the regulatory capital model.

Repos (net) - Comprises the mtm value of repo and reverse repo contracts after the effect of legally enforceable netting agreements and collateral. Counterparty netting is applied within the regulatory capital model used.

In addition and as a memorandum item, the mtm value of derivatives and repos gross of netting referred to above are disclosed.

Balance sheet - Comprises lending, debt securities, derivatives (net) and repo (net) exposures, as defined above.

Off-balance sheet - Comprises letters of credit, guarantees, other contingent obligations and committed undrawn facilities.

Credit default swaps (CDSs) - Under a CDS contract, the credit risk on the reference entity is transferred from the buyer to the seller. The fair value, or mtm value, represents the balance sheet carrying value. The mtm value of CDSs is included within derivatives against the counterparty of the trade, as opposed to the reference entity. The notional is the par value of the credit protection bought or sold and is included against the reference entity of the CDS contract.

The column CDS notional less fair value represents the instantaneous increase in exposure arising from sold positions netted against the decrease arising from bought positions should the CDS contracts be triggered by a credit event and assuming there is a zero recovery rate on the reference exposure. For a sold position, the change in exposure equals the notional less fair value amount and represents the amount the Group would owe to its CDS counterparties. Positive recovery rates would tend to reduce the gross components (increases and decreases) of those numbers.

Due to their bespoke nature, exposures relating to credit derivative product companies and related hedges have not been included, as they cannot be meaningfully attributed to a particular country or a reference entity. Nth-to-default basket swaps have also been excluded as they cannot be meaningfully attributed to a particular reference entity. Exposures to CDPCs are disclosed on page 182.

Government - Comprises central, regional and local government.

Asset quality (AQ) - For the probability of default range relating to each internal asset quality band, refer to page 164.

Eurozone periphery - Comprises Ireland, Spain, Italy, Portugal, Greece and Cyprus.

Other eurozone - Comprises Austria, Estonia, Finland, Malta, Slovakia and Slovenia.

Refer to page 177 for country analysis of equity shares.

*unaudited

Business review Risk and balance sheet management continued

Country risk: Country risk exposure continued
Summary

	Lending												
	Govt	Central banks	Other banks	Other FI	Corporate	Personal	Total lending	Of which Non-Core	Debt securities	Net Derivatives	Repos	Balance sheet	Off-balanc shee
2012	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£r
Eurozone													
Ireland	42	73	98	532	17,921	17,893	36,559	9,506	787	1,692	579	39,617	2,95
Spain	—	6	1	59	4,260	340	4,666	2,759	5,374	1,754	—	11,794	1,62
Italy	9	21	200	218	1,392	23	1,863	900	1,607	2,297	—	5,767	2,61
Portugal	—	—	—	—	336	7	343	251	215	514	—	1,072	25
Greece	—	7	—	1	179	14	201	68	1	360	—	562	2
Cyprus	—	—	—	2	274	15	291	121	4	35	—	330	4
Eurozone periphery	51	107	299	812	24,362	18,292	43,923	13,605	7,988	6,652	579	59,142	7,53
Germany	—	20,018	660	460	3,756	83	24,977	2,817	12,763	9,476	323	47,539	7,29
Netherlands	7	1,822	496	1,785	3,720	26	7,856	2,002	8,447	9,089	354	25,746	11,47
France	494	9	2,498	124	2,426	71	5,622	1,621	5,823	7,422	450	19,317	9,46
Belgium	—	—	186	249	414	22	871	368	1,408	3,140	50	5,469	1,30
Luxembourg	—	13	99	717	1,817	4	2,650	973	251	1,462	145	4,508	2,19
Other	126	—	19	90	856	14	1,105	88	1,242	1,737	11	4,095	1,26
Total eurozone	678	21,969	4,257	4,237	37,351	18,512	87,004	21,474	37,922	38,978	1,912	165,816	40,52
Other													
Japan	—	832	315	193	319	15	1,674	123	6,438	2,883	199	11,194	62
India	—	100	1,021	48	2,628	106	3,903	170	1,074	64	—	5,041	91
China	2	183	829	48	585	29	1,676	33	262	903	94	2,935	73
Russia	—	53	848	14	494	55	1,464	56	409	23	—	1,896	39
Brazil	—	—	950	—	125	3	1,078	60	596	73	—	1,747	18
South Korea	—	22	771	71	289	2	1,155	2	307	221	30	1,713	70
Turkey	115	163	82	94	928	12	1,394	258	181	93	—	1,668	48
Romania	20	65	9	2	347	331	774	773	315	3	—	1,092	8
Poland	—	164	—	16	536	6	722	26	289	36	—	1,047	80

*unaudited

Business review Risk and balance sheet management continued

	Lending												
2011	Govt £m	Central banks £m	Other banks £m	Other FI £m	Corporate £m	Personal £m	Total lending £m	Of which Non-Core £m	Debt securities £m	Net Derivatives £m	Repos £m	Balance sheet £m	Off-balanc shee £r
Eurozone													
Ireland	45	1,467	136	333	18,994	18,858	39,833	10,156	886	2,273	551	43,543	2,92
Spain	9	3	130	154	5,775	362	6,433	3,735	6,155	2,391	2	14,981	2,63
Italy	—	73	233	299	2,444	23	3,072	1,155	1,258	2,314	—	6,644	3,15
Portugal	—	—	10	—	495	5	510	341	113	519	—	1,142	26
Greece	7	6	—	31	427	14	485	94	409	355	—	1,249	5
Cyprus	—	—	—	38	250	14	302	133	2	56	—	360	6
Eurozone periphery	61	1,549	509	855	28,385	19,276	50,635	15,614	8,823	7,908	553	67,919	9,09
Germany	—	18,068	653	305	6,608	155	25,789	5,402	15,767	10,169	166	51,891	7,52
Netherlands	8	7,654	623	1,557	4,827	20	14,689	2,498	9,893	10,010	275	34,867	13,56
France	481	3	1,273	282	3,761	79	5,879	2,317	7,794	8,701	345	22,719	10,21
Belgium	—	8	287	354	588	20	1,257	480	652	2,959	51	4,919	1,35
Luxembourg	—	—	101	925	2,228	2	3,256	1,497	130	2,884	805	7,075	2,00
Other	121	—	28	77	1,125	12	1,363	191	708	1,894	—	3,965	1,29
Total eurozone	671	27,282	3,474	4,355	47,522	19,564	102,868	27,999	43,767	44,525	2,195	193,355	45,06
Other													
Japan	—	2,085	688	96	433	26	3,328	338	12,456	2,443	191	18,418	45
India	—	275	610	35	2,949	127	3,996	350	1,530	218	—	5,744	1,28
China	9	178	1,237	16	654	30	2,124	50	597	410	3	3,134	1,55
Russia	—	36	970	8	659	62	1,735	76	186	47	—	1,968	35
Brazil	—	—	936	—	227	4	1,167	70	790	24	—	1,981	31
South Korea	—	5	812	2	576	1	1,396	3	845	251	153	2,645	62
Turkey	215	193	252	66	1,072	16	1,814	423	361	94	—	2,269	43
Romania	66	145	30	8	413	392	1,054	1,054	220	6	—	1,280	16
Poland	35	208	3	9	624	6	885	45	116	56	—	1,057	70

*unaudited

Business review Risk and balance sheet management continued

Country risk: Country risk exposure: Summary continued

	Lending												
2010	Govt £m	Central banks £m	Other banks £m	Other FI £m	Corporate £m	Personal £m	Total lending £m	Of which Non-Core £m	Debt securities £m	Net Derivatives £m	Repos £m	Balance sheet £m	Off-balance sheet £m
Eurozone													
Ireland	61	2,119	87	813	19,886	20,228	43,194	10,758	1,323	2,542	398	47,457	4,316
Spain	19	5	166	92	6,991	407	7,680	4,538	7,107	2,045	2	16,834	3,061
Italy	45	78	668	418	2,483	27	3,719	1,901	3,836	2,031	1	9,587	3,853
Portugal	86	—	63	—	611	6	766	316	242	394	—	1,402	734
Greece	14	36	18	31	191	16	306	130	974	227	—	1,507	164
Cyprus	—	—	1	38	285	13	337	142	—	55	14	406	38
Eurozone periphery	225	2,238	1,003	1,392	30,447	20,697	56,002	17,785	13,482	7,294	415	77,193	12,166
Germany	—	10,894	1,060	422	7,519	162	20,057	6,471	14,747	8,600	6,666	50,070	8,917
Netherlands	914	6,484	554	1,801	6,170	81	16,004	3,205	12,523	8,684	374	37,585	18,141
France	511	3	1,095	470	4,376	102	6,557	2,787	14,041	7,949	658	29,205	11,640
Belgium	102	14	441	32	893	327	1,809	501	803	2,238	—	4,850	1,492
Luxembourg	—	25	26	734	2,503	3	3,291	1,517	378	1,469	1,076	6,214	2,383
Other	124	1	141	81	1,220	11	1,578	190	535	1,293	8	3,414	1,999
Total eurozone	1,876	19,659	4,320	4,932	53,128	21,383	105,298	32,456	56,509	37,527	9,197	208,531	56,738
Other													
Japan	—	1,379	369	316	809	24	2,897	792	12,169	1,794	73	16,933	576
India	—	—	1,307	307	2,665	273	4,552	653	1,686	178	—	6,416	1,281
China	17	298	1,223	16	753	64	2,371	236	573	250	2	3,196	1,589
Russia	—	110	244	7	1,181	58	1,600	125	124	27	24	1,775	596
Brazil	—	—	825	—	315	5	1,145	120	687	8	7	1,847	190
South Korea	—	276	1,033	5	558	2	1,874	53	1,353	490	3	3,720	1,143
Turkey	282	68	448	37	1,386	12	2,233	692	550	111	—	2,894	686
Romania	36	178	21	21	426	446	1,128	1,123	310	8	—	1,446	319
Poland	—	168	7	7	655	6	843	108	271	69	—	1,183	1,020

*unaudited

Business review Risk and balance sheet management continued

Reported exposures are affected by currency movements. Over 2012, sterling appreciated 4.4% against the US dollar and 2.6% against the euro, resulting in exposures denominated in these currencies (and in other currencies linked to the same) decreasing in sterling terms.

Key points*

- Balance sheet and off-balance sheet exposures to nearly all countries shown in the table declined during 2012, as the Group maintained a cautious stance and many clients reduced debt levels. The reductions were seen in all broad product categories and in all client groups. Non-Core lending exposure declined as the strategy for disposal progressed, particularly in Germany, Spain and Ireland. Most of the Group's country risk exposure was in International Banking (primarily lending and off-balance sheet exposure to corporates), Markets (mostly derivatives and repos with financial institutions), Ulster Bank (mostly lending exposure to corporates and consumers in Ireland) and Group Treasury (largely AFS debt securities and liquidity with central banks).

- Total eurozone - Balance sheet exposure declined by £27.5 billion or 14% during 2012 to £165.8 billion, with reductions seen primarily in periphery countries but also in the Netherlands, Germany, France and Luxembourg. This reflected exchange rate movements, sales of Greek, Spanish and Portuguese AFS bonds, write-offs, active exposure management and debt reduction efforts by bank clients.

- Eurozone periphery - Balance sheet exposure decreased across all countries to a combined £59.1 billion, a reduction of £8.8 billion or 13%, caused in part by reductions in AFS bonds in Spain, Italy and Greece. Most of the Group's exposure arises from the activities of Markets, International Banking, Group Treasury and Ulster Bank (with respect to Ireland). Group Treasury has a portfolio of Spanish bank and financial institution securities. International Banking provides trade finance facilities to clients across Europe, including the eurozone periphery. Balance sheet exposure to Cyprus amounted to £0.3 billion at 31 December 2012, comprising mainly lending exposure to special purpose vehicles incorporated in Cyprus, but with assets and cash flows largely elsewhere.

- Japan - Exposure decreased during 2012, principally in the first half of the year, reflecting a reduction in International Banking's cash management business and a change in Japanese yen clearing status from direct (self-clearing) membership to agency. The Group no longer needs to hold positions resulting in a £2.2 billion reduction in AFS Japanese government bonds.

- China - Lending exposure and off-balance sheet exposure to banks decreased by £0.4 billion and £0.8 billion respectively, as a result of a slowdown in economic growth, changes in local regulations and risk/return considerations. Derivatives exposure to public sector entities increased by £0.7 billion, reflecting fluctuations in short-term hedging by bank clients.

CDS protection bought and sold

- The Group uses CDS contracts to service customer activity as well as manage counterparty and country exposure. During 2012, eurozone gross notional CDS contracts, bought and sold, decreased significantly. This was caused by maturing contracts and by efforts to reduce counterparty credit exposures and risk-weighted assets mainly through derivative compression trades. The fair value of bought and sold CDS contracts also decreased due to the reduction in gross notional CDS positions and a narrowing of CDS spreads over the year for a number of eurozone countries, including Portugal and Ireland. All in all, net bought CDS protection referencing entities in eurozone countries taken by the Group in terms of CDS notional less fair value, decreased to £6.8 billion, from £8.4 billion at 31 December 2011.

- Greek sovereign CDS positions were fully closed out in April 2012, as the use of the collective action clause in the Greek debt swap resulted in a credit event occurring, which triggered Greek sovereign CDS contracts.

- Outside the eurozone, the Group also has net bought CDS protection on most countries shown in the table. A £0.4 billion net sold CDS position on Brazil was primarily hedging bought nth-to-default CDS contracts with Brazilian reference entities (these latter contracts are not included in the reported numbers by country - refer to the Definitions section on page 214).

- During 2012 the credit quality of CDS bought protection counterparties shown in the individual country tables, deteriorated primarily reflecting rating model changes in the fourth quarter of the year resulting in more conservative internal ratings (refer to Changes to wholesale credit risk models on page 121). There was also a downgrading of some of these counterparties during the year.

For more specific analysis and commentary on the Group's exposure to Ireland, Spain, Italy, Portugal and Greece, refer to pages 221 to 230. For commentary on the Group's exposure to eurozone non-periphery countries, refer to page 239.

*unaudited

Business review Risk and balance sheet management continued

Country risk: Country risk exposure continued
Total eurozone

	Lending	REIL	Provisions	AFS and LAR debt securities	AFS reserves	HFT debt securities Long	HFT debt securities Short	Total debt securities	Net Derivatives	Repos	Balance sheet	O balan sheet
2012	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£
Government	678	—	—	11,487	267	17,430	8,469	20,448	1,797	—	22,923	7
Central bank	21,969	—	—	—	—	—	—	—	35	—	22,004	
Other banks	4,257	—	—	5,588	(509)	1,021	611	5,998	25,956	1,161	37,372	4,4
Other FI	4,237	—	—	9,367	(1,081)	1,261	142	10,486	7,595	727	23,045	5,5
Corporate	37,351	14,253	7,451	794	33	311	115	990	3,594	24	41,959	29,0
Personal	18,512	3,351	1,733	—	—	—	—	—	1	—	18,513	7
	87,004	17,604	9,184	27,236	(1,290)	20,023	9,337	37,922	38,978	1,912	165,816	40,5
2011												
Government	671	—	—	18,406	81	19,597	15,049	22,954	1,924	—	25,549	1,0
Central bank	27,282	—	—	20	—	6	—	26	35	—	27,343	
Other banks	3,474	—	—	8,423	(752)	1,272	1,502	8,193	28,595	1,090	41,352	4,4
Other FI	4,355	—	—	10,494	(1,129)	1,138	471	11,161	9,854	1,102	26,472	8,1
Corporate	47,522	14,152	7,267	964	24	528	59	1,433	4,116	3	53,074	30,5
Personal	19,564	2,280	1,069	—	—	—	—	—	1	—	19,565	7
	102,868	16,432	8,336	38,307	(1,776)	22,541	17,081	43,767	44,525	2,195	193,355	45,0
2010												
Government	1,876	—	—	23,201	(893)	25,041	14,256	33,986	1,537	—	37,399	3
Central bank	19,659	—	—	—	—	7	—	7	13	6,369	26,048	
Other banks	4,320	—	—	9,192	(916)	1,719	1,187	9,724	24,193	1,447	39,684	5,4
Other FI	4,932	—	—	10,583	(737)	908	83	11,408	7,648	1,377	25,365	10,1
Corporate	53,128	12,404	5,393	813	45	831	260	1,384	4,136	4	58,652	39,9
Personal	21,383	1,642	537	—	—	—	—	—	—	—	21,383	7
	105,298	14,046	5,930	43,789	(2,501)	28,506	15,786	56,509	37,527	9,197	208,531	56,7

CDS by reference entity

	2012				2011				2010			
	Notional		Fair value		Notional		Fair value		Notional		Fair value	
	Bought	Sold	Bought	Sold	Bought	Sold	Bought	Sold	Bought	Sold	Bought	Sold
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Government	40,154	38,580	1,407	(1,405)	37,080	36,759	6,488	(6,376)	28,825	29,075	2,899	(2,843)
Other banks	13,249	13,014	266	(217)	19,736	19,232	2,303	(2,225)	16,616	16,256	1,042	(1,032)

Other FI	11,015	9,704	104	(92)	17,949	16,608	693	(620)	12,921	12,170	173	(182)
Corporate	39,639	35,851	(455)	465	76,966	70,119	2,241	(1,917)	70,354	63,790	(267)	461
	104,057	97,149	1,322	(1,249)	151,731	142,718	11,725	(11,138)	128,716	121,291	3,847	(3,596)

CDS bought protection: counterparty analysis by internal asset quality band

	AQ1		AQ2-AQ3		AQ4-AQ9		AQ10		Total	
	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value
2012	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Banks	8,828	126	34,862	597	8,056	204	—	—	51,746	927
Other FI	23,912	88	23,356	319	4,111	(17)	932	5	52,311	395
	32,740	214	58,218	916	12,167	187	932	5	104,057	1,322
2011										
Banks	67,624	5,585	1,085	131	198	23	—	—	68,907	5,739
Other FI	79,824	5,605	759	89	2,094	278	147	14	82,824	5,986
	147,448	11,190	1,844	220	2,292	301	147	14	151,731	11,725

*unaudited

Business review Risk and balance sheet management continued

Eurozone periphery

	Lending	REIL	Provisions	AFS and LAR debt securities	AFS reserves	HFT debt securities Long	HFT debt securities Short	Total debt securities	Net Derivatives	Repos	Balance sheet	Off-balance sheet
2012	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Government	51	—	—	644	(132)	3,686	2,698	1,632	134	—	1,817	16
Central bank	107	—	—	—	—	—	—	—	—	—	107	—
Other banks	299	—	—	3,551	(660)	165	131	3,585	4,093	476	8,453	75
Other FI	812	—	—	2,065	(541)	466	40	2,491	746	103	4,152	1,414
Corporate	24,362	12,146	6,757	192	2	128	40	280	1,678	—	26,320	5,414
Personal	18,292	3,347	1,713	—	—	—	—	—	1	—	18,293	611
	43,923	15,493	8,470	6,452	(1,331)	4,445	2,909	7,988	6,652	579	59,142	7,530
2011												
Government	61	—	—	1,207	(339)	4,854	5,652	409	236	—	706	118
Central bank	1,549	—	—	—	—	—	—	—	—	—	1,549	—
Other banks	509	—	—	5,279	(956)	436	318	5,397	4,350	480	10,736	67
Other FI	855	—	—	2,331	(654)	228	56	2,503	1,783	73	5,214	1,862
Corporate	28,385	12,272	6,567	274	4	240	—	514	1,538	—	30,437	6,412
Personal	19,276	2,258	1,048	—	—	—	—	—	1	—	19,277	637
	50,635	14,530	7,615	9,091	(1,945)	5,758	6,026	8,823	7,908	553	67,919	9,096
2010												
Government	225	—	—	2,085	(871)	6,564	4,672	3,977	180	—	4,382	226
Central bank	2,238	—	—	—	—	7	—	7	1	125	2,371	1
Other banks	1,003	—	—	6,003	(920)	356	181	6,178	4,013	261	11,455	293
Other FI	1,392	—	—	2,708	(480)	295	7	2,996	1,618	25	6,031	2,558
Corporate	30,447	10,726	4,899	120	37	226	22	324	1,482	4	32,257	8,441
Personal	20,697	1,639	534	—	—	—	—	—	—	—	20,697	647
	56,002	12,365	5,433	10,916	(2,234)	7,448	4,882	13,482	7,294	415	77,193	12,166

CDS by reference entity

	2012				2011				2010			
	Notional		Fair value		Notional		Fair value		Notional		Fair value	
	Bought	Sold	Bought	Sold	Bought	Sold	Bought	Sold	Bought	Sold	Bought	Sold
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Government	24,785	24,600	1,452	(1,459)	25,883	26,174	5,979	(5,926)	20,494	20,440	2,762	(2,705)
Other banks	6,023	5,996	230	(202)	9,372	9,159	1,657	(1,623)	7,927	8,055	891	(890)
Other FI	2,592	2,350	76	(67)	3,854	3,635	290	(262)	2,981	2,723	148	(153)
Corporate	5,824	5,141	52	(47)	10,798	9,329	999	(860)	11,273	9,657	453	(317)

39,224	38,087	1,810	(1,775)	49,907	48,297	8,925	(8,671)	42,675	40,875	4,254	(4,065)

CDS bought protection: counterparty analysis by internal asset quality band

	AQ1		AQ2-AQ3		AQ4-AQ9		AQ10		Total	
	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value
2012	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Banks	3,517	153	14,725	780	5,153	214	—	—	23,395	1,147
Other FI	5,647	240	9,021	401	896	22	265	—	15,829	663
	9,164	393	23,746	1,181	6,049	236	265	—	39,224	1,810
2011										
Banks	26,008	4,606	604	112	93	14	—	—	26,705	4,732
Other FI	22,082	3,980	394	51	726	162	—	—	23,202	4,193
	48,090	8,586	998	163	819	176	—	—	49,907	8,925

*unaudited

Business review Risk and balance sheet management continued

Country risk: Country risk exposure continued
Ireland

	Lending	REIL	Provisions	AFS and LAR debt securities	AFS reserves	HFT debt securities Long	HFT debt securities Short	Total debt securities	Net Derivatives	Repos	Balance sheet	Off-balance sheet
2012	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Government	42	—	—	127	(23)	79	56	150	2	—	194	2
Central bank	73	—	—	—	—	—	—	—	—	—	73	—
Other banks	98	—	—	191	(6)	18	1	208	695	476	1,477	—
Other FI	532	—	—	46	—	325	2	369	583	103	1,587	601
Corporate	17,921	11,058	6,226	60	—	—	—	60	411	—	18,392	1,840
Personal	17,893	3,286	1,686	—	—	—	—	—	1	—	17,894	515
	36,559	14,344	7,912	424	(29)	422	59	787	1,692	579	39,617	2,958
2011												
Government	45	—	—	102	(46)	20	19	103	92	—	240	2
Central bank	1,467	—	—	—	—	—	—	—	—	—	1,467	—
Other banks	136	—	—	177	(39)	195	14	358	981	478	1,953	—
Other FI	333	—	—	61	—	116	35	142	782	73	1,330	546
Corporate	18,994	10,269	5,689	148	3	135	—	283	417	—	19,694	1,841
Personal	18,858	2,258	1,048	—	—	—	—	—	1	—	18,859	539
	39,833	12,527	6,737	488	(82)	466	68	886	2,273	551	43,543	2,928
2010												
Government	61	—	—	104	(45)	93	88	109	20	—	190	1
Central bank	2,119	—	—	—	—	7	—	7	1	125	2,252	—
Other banks	87	—	—	435	(51)	96	45	486	1,265	258	2,096	83
Other FI	813	—	—	291	(1)	205	—	496	826	11	2,146	1,050
Corporate	19,886	8,291	4,072	91	(2)	140	6	225	430	4	20,545	2,638
Personal	20,228	1,638	534	—	—	—	—	—	—	—	20,228	544
	43,194	9,929	4,606	921	(99)	541	139	1,323	2,542	398	47,457	4,316

CDS by reference entity

	2012				2011				2010			
	Notional		Fair value		Notional		Fair value		Notional		Fair value	
	Bought	Sold	Bought	Sold	Bought	Sold	Bought	Sold	Bought	Sold	Bought	Sold
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Government	2,486	2,525	72	(71)	2,145	2,223	466	(481)	1,872	2,014	360	(387)
Other banks	43	32	1	(2)	110	107	21	(21)	317	312	103	(95)
Other FI	759	677	21	(33)	523	630	64	(74)	566	597	45	(84)
Corporate	236	165	(17)	17	425	322	(11)	10	483	344	(20)	17
	3,524	3,399	77	(89)	3,203	3,282	540	(566)	3,238	3,267	488	(549)

CDS bought protection: counterparty analysis by internal asset quality band

	AQ1		AQ2-AQ3		AQ4-AQ9		AQ10		Total	
	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value
2012	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Banks	214	6	1,461	41	32	(1)	—	—	1,707	46
Other FI	528	16	970	7	319	8	—	—	1,817	31
	742	22	2,431	48	351	7	—	—	3,524	77
2011										
Banks	1,586	300	2	—	—	—	—	—	1,588	300
Other FI	1,325	232	161	1	129	7	—	—	1,615	240
	2,911	532	163	1	129	7	—	—	3,203	540

*unaudited

Key points*

- Ulster Bank Group's (UBG) Irish exposure comprises personal lending (largely mortgages) and corporate lending and commitments, plus some lending to financial institutions (refer to the Ulster Bank Group (Core and Non-Core) section on page 149 for further details). In addition, International Banking has lending exposure and commitments, and Markets has derivative and repo exposure to financial institutions and large international clients with funding subsidiaries based in Ireland.

- Group exposure decreased further during 2012, principally lending, which fell £3.3 billion as a result of de-risking of the portfolio and currency movements.

Government and central bank

- Exposure to the central bank fluctuates, driven by regulatory requirements and deposits of excess liquidity. It was reduced as part of asset and liability management.

Financial institutions

- Markets, International Banking and UBG account for the large majority of the Group's exposure to financial institutions, the main categories being derivatives and repos, where exposure is affected predominantly by market movements and much of it is collateralised.

Corporate

- Lending exposure fell by £1.1 billion during 2012, driven by exchange rate movements and write-offs. Commercial real estate lending amounted to £10.4 billion at 31 December 2012, down £0.5 billion from 31 December 2011 amid continuing adverse market conditions. The commercial real estate lending exposure was nearly all in UBG (£7.7 billion of this in Non-Core) and included REIL of £8.0 billion which were 55% covered by provisions.

Personal

- Overall lending exposure fell by £1.0 billion as a result of exchange rate movements, amortisation, maturities, a small amount of write-offs, low new business volumes and active risk management. Residential mortgage loans amounted to £16.9 billion at 31 December 2012, including REIL of £3.0 billion and loan provisions of £1.5 billion. The housing market continues to suffer from weak domestic demand, with house prices that stabilised in the course of 2012 at approximately 50% below their 2007 peak.

Non-Core (included above)

- Non-Core lending exposure was £9.5 billion at 31 December 2012, down £0.7 billion since 31 December 2011. The lending portfolio largely consisted of exposures to commercial real estate (82%), retail (4%) and leisure (4%).

*unaudited

Business review Risk and balance sheet management continued

Country risk: Country risk exposure continued
Spain

	Lending	REIL	Provisions	AFS and LAR debt securities	AFS reserves	HFT debt securities Long	HFT debt securities Short	Total debt securities	Net Derivatives	Repos	Balance sheet	Off-balance sheet
2012	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Government	—	—	—	37	(10)	786	403	420	18	—	438	14
Central bank	6	—	—	—	—	—	—	—	—	—	6	—
Other banks	1	—	—	3,169	(634)	100	76	3,193	1,254	—	4,448	42
Other FI	59	—	—	1,661	(540)	96	18	1,739	26	—	1,824	139
Corporate	4,260	601	246	4	—	36	18	22	456	—	4,738	1,373
Personal	340	61	27	—	—	—	—	—	—	—	340	56
	4,666	662	273	4,871	(1,184)	1,018	515	5,374	1,754	—	11,794	1,624
2011												
Government	9	—	—	33	(15)	360	751	(358)	35	—	(314)	116
Central bank	3	—	—	—	—	—	—	—	—	—	3	—
Other banks	130	—	—	4,892	(867)	162	214	4,840	1,620	2	6,592	41
Other FI	154	—	—	1,580	(639)	65	8	1,637	282	—	2,073	169
Corporate	5,775	1,190	442	9	—	27	—	36	454	—	6,265	2,247
Personal	362	—	—	—	—	—	—	—	—	—	362	57
	6,433	1,190	442	6,514	(1,521)	614	973	6,155	2,391	2	14,981	2,630
2010												
Government	19	—	—	88	(7)	1,172	1,248	12	53	—	84	1
Central bank	5	—	—	—	—	—	—	—	—	—	5	—
Other banks	166	—	—	5,264	(834)	147	118	5,293	1,480	2	6,941	41
Other FI	92	—	—	1,724	(474)	34	7	1,751	22	—	1,865	285
Corporate	6,991	1,871	572	9	38	50	8	51	490	—	7,532	2,672
Personal	407	1	—	—	—	—	—	—	—	—	407	62
	7,680	1,872	572	7,085	(1,277)	1,403	1,381	7,107	2,045	2	16,834	3,061

CDS by reference entity

	2012				2011				2010			
	Notional		Fair value		Notional		Fair value		Notional		Fair value	
	Bought	Sold	Bought	Sold	Bought	Sold	Bought	Sold	Bought	Sold	Bought	Sold
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Government	5,934	5,905	361	(359)	5,151	5,155	538	(522)	3,820	3,923	436	(435)
Other banks	1,583	1,609	34	(30)	1,965	1,937	154	(152)	2,087	2,159	133	(135)
Other FI	1,209	1,061	47	(28)	2,417	2,204	157	(128)	1,648	1,388	72	(45)
Corporate	2,263	2,011	7	(4)	4,831	3,959	448	(399)	5,192	4,224	231	(168)
	10,989	10,586	449	(421)	14,364	13,255	1,297	(1,201)	12,747	11,694	872	(783)

CDS bought protection: counterparty analysis by internal asset quality band

	AQ1		AQ2-AQ3		AQ4-AQ9		AQ10		Total	
	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value
2012	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Banks	646	27	3,648	168	1,409	65	—	—	5,703	260
Other FI	2,335	72	2,539	109	324	8	88	—	5,286	189
	2,981	99	6,187	277	1,733	73	88	—	10,989	449
2011										
Banks	6,595	499	68	5	32	4	—	—	6,695	508
Other FI	7,238	736	162	3	269	50	—	—	7,669	789
	13,833	1,235	230	8	301	54	—	—	14,364	1,297

*unaudited

Key points*

- The Group maintains good relationships with multinational banks, other financial institutions and large corporate clients.

- Exposure to Spain is driven by corporate lending and a sizeable mortgage-backed securities covered bond portfolio. Exposure fell further in most categories during 2012, driven by the sale of part of the covered bond portfolio and a decline in corporate lending, as a result of steps taken to de-risk the portfolio.

Government

- The Group has an active portfolio of Spanish government debt and CDS exposures that can result in fluctuations between long and short positions for HFT debt securities.

Financial institutions

- The Group's largest exposure was AFS debt securities (mainly the covered bond portfolio) of £4.8 billion at 31 December 2012, which decreased by £1.6 billion during 2012, largely as a result of sales in the first half of the year. The portfolio continued to perform satisfactorily. However, the Group is monitoring the situation closely, including undertaking stress analyses.

- Derivative exposure, mostly to Spanish international banks and a few of the large regional banks, declined to £1.3 billion at 31 December 2012 from £1.9 billion at 31 December 2011. The majority of this exposure was collateralised.

- Lending to financial institutions decreased to less than £0.1 billion at 31 December 2012 from £0.3 billion at 31 December 2011.

Corporate

- Lending decreased by £1.5 billion and off-balance sheet exposure by £0.9 billion, due to reductions primarily in the commercial real estate and electricity sectors. Commercial real estate lending amounted to £1.6 billion at 31 December 2012, predominantly in Non-Core. The majority of REIL and loan provisions relates to commercial real estate lending and further decreased during 2012, reflecting disposals and restructurings.

Non-Core (included above)

- At 31 December 2012, Non-Core had lending exposure to Spain of £2.8 billion, a reduction of £1.0 billion or 26% since 31 December 2011. Commercial real estate (63%), construction (14%) and electricity (9%) sectors accounted for the majority of the lending exposure.

*unaudited

Business review Risk and balance sheet management continued

Country risk: Country risk exposure continued

Italy

2012	Lending £m	REIL £m	Provisions £m	AFS and LAR debt securities £m	AFS reserves £m	HFT debt securities Long £m	HFT debt securities Short £m	Total debt securities £m	Net Derivatives £m	Repos £m	Balance sheet £m	Off-balance sheet £m
Government	9	—	—	408	(81)	2,781	2,224	965	80	—	1,054	—
Central bank	21	—	—	—	—	—	—	—	—	—	21	—
Other banks	200	—	—	125	(8)	42	54	113	1,454	—	1,767	33
Other FI	218	—	—	357	(1)	23	1	379	99	—	696	671
Corporate	1,392	34	5	87	2	85	22	150	664	—	2,206	1,900
Personal	23	—	—	—	—	—	—	—	—	—	23	12
	1,863	34	5	977	(88)	2,931	2,301	1,607	2,297	—	5,767	2,616
2011												
Government	—	—	—	704	(220)	4,336	4,725	315	90	—	405	—
Central bank	73	—	—	—	—	—	—	—	—	—	73	—
Other banks	233	—	—	119	(14)	67	88	98	1,064	—	1,395	23
Other FI	299	—	—	685	(15)	40	13	712	686	—	1,697	1,146
Corporate	2,444	361	113	75	—	58	—	133	474	—	3,051	1,968
Personal	23	—	—	—	—	—	—	—	—	—	23	13
	3,072	361	113	1,583	(249)	4,501	4,826	1,258	2,314	—	6,644	3,150
2010												
Government	45	—	—	906	(99)	5,113	3,175	2,844	71	—	2,960	6
Central bank	78	—	—	—	—	—	—	—	—	—	78	—
Other banks	668	—	—	198	(11)	67	16	249	781	1	1,699	161
Other FI	418	—	—	646	(5)	49	—	695	759	—	1,872	1,218
Corporate	2,483	314	141	20	—	36	8	48	420	—	2,951	2,456
Personal	27	—	—	—	—	—	—	—	—	—	27	12
	3,719	314	141	1,770	(115)	5,265	3,199	3,836	2,031	1	9,587	3,853

CDS by reference entity

	2012				2011				2010			
	Notional		Fair value		Notional		Fair value		Notional		Fair value	
	Bought £m	Sold £m	Bought £m	Sold £m	Bought £m	Sold £m	Bought £m	Sold £m	Bought £m	Sold £m	Bought £m	Sold £m
Government	13,181	13,034	717	(754)	12,125	12,218	1,750	(1,708)	8,998	8,519	641	(552)
Other banks	3,537	3,488	163	(139)	6,078	5,938	1,215	(1,187)	4,417	4,458	421	(414)
Other FI	616	607	8	(5)	872	762	60	(51)	723	697	21	(13)
Corporate	2,580	2,295	28	(20)	4,742	4,299	350	(281)	4,506	3,966	150	(88)
	19,914	19,424	916	(918)	23,817	23,217	3,375	(3,227)	18,644	17,640	1,233	(1,067)

CDS bought protection: counterparty analysis by internal asset quality band

	AQ1		AQ2-AQ3		AQ4-AQ9		AQ10		Total	
	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value
2012	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Banks	2,113	81	7,755	432	3,252	105	—	—	13,120	618
Other FI	2,120	96	4,344	194	218	8	112	—	6,794	298
	4,233	177	12,099	626	3,470	113	112	—	19,914	916
2011										
Banks	12,904	1,676	487	94	61	10	—	—	13,452	1,780
Other FI	10,138	1,550	8	2	219	43	—	—	10,365	1,595
	23,042	3,226	495	96	280	53	—	—	23,817	3,375

*unaudited

Business review Risk and balance sheet management continued

Key points*

- The Group maintains good relationships with Italian government entities, banks, other financial institutions and large corporate clients. Since the start of 2011, the Group has taken steps to reduce and mitigate its risk through strategic exits where appropriate and through increased collateral requirements, in line with its evolving appetite for Italian risk. Lending exposure to Italian counterparties was reduced by a further £1.2 billion during 2012, to £1.9 billion.

Government and central bank

- The Group is an active market-maker in Italian government bonds and has an active CDS portfolio, resulting in large and fluctuating gross long and short positions in HFT debt securities.

Financial institutions

- The majority of the Group's exposure relates to the top five banks. The Group's product offering consists largely of collateralised trading products and to a lesser extent, short-term uncommitted lending lines for liquidity purposes. During 2012, derivative exposure decreased by £0.2 billion due to market movements. Risk is mitigated since most facilities are fully collateralised. Lending declined by £0.1 billion to £0.4 billion.

- The AFS bond exposure was reduced by £0.3 billion due to sales.

Corporate

- Lending declined by £1.1 billion, particularly to industrials.

Non-Core (included above)

- Non-Core lending exposure was £0.9 billion at 31 December 2012, a £0.3 billion or 22% reduction since 31 December 2011, primarily due to a fall in exposure to investment funds and industrials. The remaining lending exposure was mainly to the commercial real estate (29%), leisure (25%) and electricity (16%) sectors.

*unaudited

Business review Risk and balance sheet management continued

Country risk: Country risk exposure continued
Portugal

2012	Lending £m	REIL £m	Provisions £m	AFS and LAR debt securities £m	AFS reserves £m	HFT debt securities Long £m	HFT debt securities Short £m	Total debt securities £m	Net Derivatives £m	Repos £m	Balance sheet £m	Off-balance sheet £m	T
Government	—	—	—	72	(18)	28	15	85	17	—	102	—	
Other banks	—	—	—	66	(12)	5	—	71	380	—	451	—	
Other FI	—	—	—	1	—	21	11	11	38	—	49	3	
Corporate	336	253	188	41	—	7	—	48	79	—	463	247	
Personal	7	—	—	—	—	—	—	—	—	—	7	8	
	343	253	188	180	(30)	61	26	215	514	—	1,072	258	1
2011													
Government	—	—	—	56	(58)	36	152	(60)	19	—	(41)	—	
Other banks	10	—	—	91	(36)	12	2	101	389	—	500	2	
Other FI	—	—	—	5	—	7	—	12	30	—	42	—	
Corporate	495	27	27	42	1	18	—	60	81	—	636	258	
Personal	5	—	—	—	—	—	—	—	—	—	5	8	
	510	27	27	194	(93)	73	154	113	519	—	1,142	268	1
2010													
Government	86	—	—	92	(26)	68	122	38	29	—	153	211	
Other banks	63	—	—	106	(24)	46	2	150	307	—	520	2	
Other FI	—	—	—	47	—	7	—	54	7	—	61	1	
Corporate	611	27	21	—	1	—	—	—	51	—	662	512	1
Personal	6	—	—	—	—	—	—	—	—	—	6	8	
	766	27	21	245	(49)	121	124	242	394	—	1,402	734	2

CDS by reference entity

	2012				2011				2010			
	Notional		Fair value		Notional		Fair value		Notional		Fair value	
	Bought £m	Sold £m	Bought £m	Sold £m	Bought £m	Sold £m	Bought £m	Sold £m	Bought £m	Sold £m	Bought £m	Sold £m
Government	3,182	3,134	302	(275)	3,304	3,413	997	(985)	2,844	2,923	471	(460)
Other banks	856	863	31	(30)	1,197	1,155	264	(260)	1,085	1,107	231	(243)
Other FI	8	5	—	(1)	8	5	1	(1)	9	6	(1)	—
Corporate	426	353	3	(7)	366	321	68	(48)	581	507	48	(29)
	4,472	4,355	336	(313)	4,875	4,894	1,330	(1,294)	4,519	4,543	749	(732)

CDS bought protection: counterparty analysis by internal asset quality band

AQ1		AQ2-AQ3		AQ4-AQ9		AQ10		Total	
Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value

2012	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Banks	480	34	1,805	133	460	45	—	—	2,745	212
Other FI	534	38	1,126	88	35	(2)	32	—	1,727	124
	1,014	72	2,931	221	495	43	32	—	4,472	336
2011										
Banks	2,922	786	46	12	—	—	—	—	2,968	798
Other FI	1,874	517	—	—	33	15	—	—	1,907	532
	4,796	1,303	46	12	33	15	—	—	4,875	1,330

*unaudited

Key points*

- The Portuguese portfolio, which is managed out of Spain, mainly consists of corporate lending and derivative trading with the largest local banks. Medium-term activity has ceased with the exception of collateralised business.

- Exposure declined further during 2012, with continued reductions in lending and off-balance sheet exposure, and sales of Group Treasury's AFS bonds.

Government and central bank

- The Group's exposure to the Portuguese government at 31 December 2012 was £102 million, comprising a very small derivative exposure and a small net long debt securities position, an increase from the net short debt securities position at 31 December 2011.

Financial institutions

- The remaining exposure is largely focused on the top four systemically important banks. Exposures generally consist of collateralised trading products.

Corporate

- The largest exposure is to the land transport and logistics, electricity and telecommunications sectors, concentrated on a few large, highly creditworthy clients.

Non-Core (included above)

- Non-Core lending exposure to Portugal decreased by £0.1 billion during 2012, to £0.3 billion. The portfolio largely comprised lending exposure to the land transport and logistics (40%), electricity (37%) and commercial real estate (18%) sectors.

*unaudited

Business review Risk and balance sheet management continued

Country risk: Country risk exposure continued
Greece

2012	Lending £m	REIL £m	Provisions £m	AFS and LAR debt securities £m	AFS reserves £m	HFT debt securities Long £m	HFT debt securities Short £m	Total debt securities £m	Net Derivatives £m	Repos £m	Balance sheet £m	Off-balance sheet £m	T
Government	—	—	—	—	—	9	—	9	17	—	26	—	
Central bank	7	—	—	—	—	—	—	—	—	—	7	—	
Other banks	—	—	—	—	—	—	—	—	299	—	299	—	
Other FI	1	—	—	—	—	—	8	(8)	—	—	(7)	—	
Corporate	179	38	38	—	—	—	—	—	44	—	223	18	
Personal	14	—	—	—	—	—	—	—	—	—	14	9	
	201	38	38	—	—	9	8	1	360	—	562	27	
2011													
Government	7	—	—	312	—	102	5	409	—	—	416	—	
Central bank	6	—	—	—	—	—	—	—	—	—	6	—	
Other banks	—	—	—	—	—	—	—	—	290	—	290	—	
Other FI	31	—	—	—	—	—	—	—	2	—	33	—	
Corporate	427	256	256	—	—	—	—	—	63	—	490	42	
Personal	14	—	—	—	—	—	—	—	—	—	14	10	
	485	256	256	312	—	102	5	409	355	—	1,249	52	1
2010													
Government	14	—	—	895	(694)	118	39	974	7	—	995	7	1
Central bank	36	—	—	—	—	—	—	—	—	—	36	—	
Other banks	18	—	—	—	—	—	—	—	167	—	185	1	
Other FI	31	—	—	—	—	—	—	—	3	—	34	3	
Corporate	191	48	48	—	—	—	—	—	50	—	241	143	
Personal	16	—	—	—	—	—	—	—	—	—	16	10	
	306	48	48	895	(694)	118	39	974	227	—	1,507	164	1

CDS by reference entity

	2012				2011				2010			
	Notional		Fair value		Notional		Fair value		Notional		Fair value	
	Bought £m	Sold £m	Bought £m	Sold £m	Bought £m	Sold £m	Bought £m	Sold £m	Bought £m	Sold £m	Bought £m	Sold £m
Government	—	—	—	—	3,158	3,165	2,228	(2,230)	2,960	3,061	854	(871)
Other banks	4	4	1	(1)	22	22	3	(3)	21	19	3	(3)
Other FI	—	—	—	—	34	34	8	(8)	35	35	11	(11)
Corporate	319	317	31	(33)	434	428	144	(142)	511	616	44	(49)
	323	321	32	(34)	3,648	3,649	2,383	(2,383)	3,527	3,731	912	(934)

CDS bought protection: counterparty analysis by internal asset quality band

	AQ1		AQ2-AQ3		AQ4-AQ9		AQ10		Total	
	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value
2012	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Banks	64	5	54	6	—	—	—	—	118	11
Other FI	130	18	42	3	—	—	33	—	205	21
	194	23	96	9	—	—	33	—	323	32
2011										
Banks	2,001	1,345	1	1	—	—	—	—	2,002	1,346
Other FI	1,507	945	63	45	76	47	—	—	1,646	1,037
	3,508	2,290	64	46	76	47	—	—	3,648	2,383

*unaudited

Key points*

- The Group's exposure to Greece decreased further in 2012, largely as a result of the restructuring and sale of Greek government debt and a corporate write-off. The remainder of the exposure is actively managed, in line with the Group's de-risking strategy that has been in place since early 2010. Much of the remaining exposure is collateralised or guaranteed. The remaining Greek exposure at 31 December 2012 was £0.6 billion. The majority of this was derivative exposure to banks (itself in part collateralised). The rest was mostly corporate lending including exposure to local subsidiaries of international companies.

Government and central bank

- The Group participated in the restructuring of Greek government debt in March 2012, which resulted in the issuance of new bonds that were sold in March and April, and £0.3 billion of AFS bonds issued by the European Financial Stability Facility incorporated in Luxembourg. The Group no longer holds any AFS bonds issued by the Greek government. A small HFT position, resulting from the sovereign debt restructuring in March, has been retained to enable the Group to quote prices and stay relevant to key clients.

Financial institutions

- Activity with Greek financial institutions is largely collateralised derivative and repo exposure, and remains under close scrutiny.

Corporate

- Lending exposure fell by £0.2 billion to £0.2 billion, largely due to a single name write-off in the first half of 2012.

- The Group's focus is on short-term trade facilities to the domestic subsidiaries of international clients, increasingly supported by parental guarantees.

Non-Core (included above)

- Non-Core lending exposure to Greece was £0.1 billion at 31 December 2012, a slight reduction from 31 December 2011. The remaining lending portfolio primarily consisted of the following sectors: commercial real estate (44%), construction (26%) and other services (12%).

*unaudited

Business review Risk and balance sheet management continued

Country risk: Country risk exposure continued
Cyprus

2012	Lending £m	REIL £m	Provisions £m	AFS and LAR debt securities £m	AFS reserves £m	HFT debt securities Long £m	HFT debt securities Short £m	Total debt securities £m	Net Derivatives £m	Repos £m	Balance sheet £m	Off-balance sheet £m	T
Government	—	—	—	—	—	3	—	3	—	—	3	—	
Other banks	—	—	—	—	—	—	—	—	11	—	11	—	
Other FI	2	—	—	—	—	1	—	1	—	—	3	—	
Corporate	274	162	54	—	—	—	—	—	24	—	298	36	
Personal	15	—	—	—	—	—	—	—	—	—	15	11	
	291	162	54	—	—	4	—	4	35	—	330	47	
2011													
Other banks	—	—	—	—	—	—	—	—	6	—	6	1	
Other FI	38	—	—	—	—	—	—	—	1	—	39	1	
Corporate	250	169	40	—	—	2	—	2	49	—	301	56	
Personal	14	—	—	—	—	—	—	—	—	—	14	10	
	302	169	40	—	—	2	—	2	56	—	360	68	
2010													
Central bank	—	—	—	—	—	—	—	—	—	—	—	1	
Other banks	1	—	—	—	—	—	—	—	13	—	14	5	
Other FI	38	—	—	—	—	—	—	—	1	14	53	1	
Corporate	285	175	45	—	—	—	—	—	41	—	326	20	
Personal	13	—	—	—	—	—	—	—	—	—	13	11	
	337	175	45	—	—	—	—	—	55	14	406	38	

*unaudited

Business review Risk and balance sheet management continued

Eurozone non-periphery

2012	Lending £m	REIL £m	Provisions £m	AFS and LAR debt securities £m	AFS reserves £m	HFT debt securities Long £m	HFT debt securities Short £m	Total debt securities £m	Net Derivatives £m	Repos £m	Balance sheet £m	Of balanc sheet £
Government	627	—	—	10,843	399	13,744	5,771	18,816	1,663	—	21,106	7
Central bank	21,862	—	—	—	—	—	—	—	35	—	21,897	
Other banks	3,958	—	—	2,037	151	856	480	2,413	21,863	685	28,919	4,3
Other FI	3,425	—	—	7,302	(540)	795	102	7,995	6,849	624	18,893	4,1
Corporate	12,989	2,107	694	602	31	183	75	710	1,916	24	15,639	23,6
Personal	220	4	20	—	—	—	—	—	—	—	220	1
	43,081	2,111	714	20,784	41	15,578	6,428	29,934	32,326	1,333	106,674	32,9
2011												
Government	610	—	—	17,199	420	14,743	9,397	22,545	1,688	—	24,843	9
Central bank	25,733	—	—	20	—	6	—	26	35	—	25,794	
Other banks	2,965	—	—	3,144	204	836	1,184	2,796	24,245	610	30,616	4,4
Other FI	3,500	—	—	8,163	(475)	910	415	8,658	8,071	1,029	21,258	6,3
Corporate	19,137	1,880	700	690	20	288	59	919	2,578	3	22,637	24,1
Personal	288	22	21	—	—	—	—	—	—	—	288	1
	52,233	1,902	721	29,216	169	16,783	11,055	34,944	36,617	1,642	125,436	35,9
2010												
Government	1,651	—	—	21,116	(22)	18,477	9,584	30,009	1,357	—	33,017	8
Central bank	17,421	—	—	—	—	—	—	—	12	6,244	23,677	
Other banks	3,317	—	—	3,189	4	1,363	1,006	3,546	20,180	1,186	28,229	5,1
Other FI	3,540	—	—	7,875	(257)	613	76	8,412	6,030	1,352	19,334	7,6
Corporate	22,681	1,678	494	693	8	605	238	1,060	2,654	—	26,395	31,5
Personal	686	3	3	—	—	—	—	—	—	—	686	1
	49,296	1,681	497	32,873	(267)	21,058	10,904	43,027	30,233	8,782	131,338	44,5

CDS by reference entity

	2012				2011				2010			
	Notional		Fair value		Notional		Fair value		Notional		Fair value	
	Bought £m	Sold £m	Bought £m	Sold £m	Bought £m	Sold £m	Bought £m	Sold £m	Bought £m	Sold £m	Bought £m	Sold £m
Government	15,369	13,980	(45)	54	11,197	10,585	509	(450)	8,331	8,635	137	(138)
Other banks	7,226	7,018	36	(15)	10,364	10,073	646	(602)	8,689	8,201	151	(142)
Other FI	8,423	7,354	28	(25)	14,095	12,973	403	(358)	9,940	9,447	25	(29)
Corporate	33,815	30,710	(507)	512	66,168	60,790	1,242	(1,057)	59,081	54,133	(720)	778
	64,833	59,062	(488)	526	101,824	94,421	2,800	(2,467)	86,041	80,416	(407)	469

CDS bought protection: counterparty analysis by internal asset quality band

	AQ1		AQ2-AQ3		AQ4-AQ9		AQ10		Total	
	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value
2012	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Banks	5,311	(27)	20,137	(183)	2,903	(10)	—	—	28,351	(220)
Other FI	18,265	(152)	14,335	(82)	3,215	(39)	667	5	36,482	(268)
	23,576	(179)	34,472	(265)	6,118	(49)	667	5	64,833	(488)
2011										
Banks	41,616	979	481	19	105	9	—	—	42,202	1,007
Other FI	57,742	1,625	365	38	1,368	116	147	14	59,622	1,793
	99,358	2,604	846	57	1,473	125	147	14	101,824	2,800

*unaudited

Business review Risk and balance sheet management continued

Country risk: Country risk exposure continued

Germany

	Lending	REIL	Provisions	AFS and LAR debt securities	AFS reserves	HFT debt securities Long	HFT debt securities Short	Total debt securities	Net Derivatives	Repos	Balance sheet	Off-balance sheet
2012	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Government	—	—	—	8,103	453	5,070	1,592	11,581	533	—	12,114	735
Central bank	20,018	—	—	—	—	—	—	—	—	—	20,018	—
Other banks	660	—	—	668	10	280	332	616	5,558	183	7,017	139
Other FI	460	—	—	285	(23)	95	30	350	3,046	116	3,972	933
Corporate	3,756	460	152	207	14	11	2	216	339	24	4,335	5,462
Personal	83	1	—	—	—	—	—	—	—	—	83	25
	24,977	461	152	9,263	454	5,456	1,956	12,763	9,476	323	47,539	7,294
2011												
Government	—	—	—	12,035	523	4,136	2,084	14,087	423	—	14,510	2
Central bank	18,068	—	—	—	—	—	—	—	2	—	18,070	—
Other banks	653	—	—	1,376	5	294	761	909	5,886	117	7,565	284
Other FI	305	—	—	563	(33)	187	95	655	3,272	49	4,281	1,116
Corporate	6,608	191	80	109	9	14	7	116	586	—	7,310	6,103
Personal	155	19	19	—	—	—	—	—	—	—	155	22
	25,789	210	99	14,083	504	4,631	2,947	15,767	10,169	166	51,891	7,527
2010												
Government	—	—	—	10,648	1	5,964	4,124	12,488	160	—	12,648	—
Central bank	10,894	—	—	—	—	—	—	—	4	6,229	17,127	—
Other banks	1,060	—	—	1,291	3	567	481	1,377	5,943	346	8,726	250
Other FI	422	—	—	494	(47)	195	17	672	1,860	91	3,045	740
Corporate	7,519	163	44	219	4	44	53	210	633	—	8,362	7,905
Personal	162	—	—	—	—	—	—	—	—	—	162	22
	20,057	163	44	12,652	(39)	6,770	4,675	14,747	8,600	6,666	50,070	8,917

CDS by reference entity

	2012				2011				2010			
	Notional		Fair value		Notional		Fair value		Notional		Fair value	
	Bought	Sold	Bought	Sold	Bought	Sold	Bought	Sold	Bought	Sold	Bought	Sold
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Government	4,288	4,191	4	—	2,631	2,640	76	(67)	2,056	2,173	25	(19)
Other banks	2,849	2,696	13	(11)	4,765	4,694	307	(310)	3,848	3,933	73	(88)
Other FI	2,385	2,172	(16)	18	3,653	3,403	7	(2)	2,712	2,633	(18)	18
Corporate	10,526	9,644	(257)	261	20,433	18,311	148	(126)	20,731	19,076	(382)	372
	20,048	18,703	(256)	268	31,482	29,048	538	(505)	29,347	27,815	(302)	283

CDS bought protection: counterparty analysis by internal asset quality band

	AQ1		AQ2-AQ3		AQ4-AQ9		AQ10		Total	
	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value
2012	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Banks	1,968	(22)	6,263	(87)	940	(7)	—	—	9,171	(116)
Other FI	5,047	(70)	5,103	(55)	727	(15)	—	—	10,877	(140)
	7,015	(92)	11,366	(142)	1,667	(22)	—	—	20,048	(256)
2011										
Banks	14,644	171	163	4	8	—	—	—	14,815	175
Other FI	16,315	357	18	—	334	6	—	—	16,667	363
	30,959	528	181	4	342	6	—	—	31,482	538

*unaudited

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Business review Risk and balance sheet management continued

Netherlands

	Lending	REIL	Provisions	AFS and LAR debt securities	AFS reserves	HFT debt securities Long	HFT debt securities Short	Total debt securities	Net Derivatives	Repos	Balance sheet	Off-balance sheet	
2012	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	
Government	7	—	—	1,052	57	1,248	993	1,307	36	—	1,350	29	
Central bank	1,822	—	—	—	—	—	—	—	2	—	1,824	—	
Other banks	496	—	—	575	136	252	86	741	6,667	309	8,213	3,471	1
Other FI	1,785	—	—	6,107	(508)	242	17	6,332	1,908	45	10,070	1,311	1
Corporate	3,720	508	156	66	2	29	28	67	476	—	4,263	6,650	1
Personal	26	—	—	—	—	—	—	—	—	—	26	12	
	7,856	508	156	7,800	(313)	1,771	1,124	8,447	9,089	354	25,746	11,473	3
2011													
Government	8	—	—	1,447	74	849	591	1,705	40	—	1,753	—	
Central bank	7,654	—	—	—	—	6	—	6	7	—	7,667	—	
Other banks	623	—	—	802	217	365	278	889	7,410	164	9,086	3,566	1
Other FI	1,557	—	—	6,804	(386)	290	108	6,986	1,806	108	10,457	3,388	1
Corporate	4,827	621	209	199	6	113	5	307	747	3	5,884	6,596	1
Personal	20	3	2	—	—	—	—	—	—	—	20	11	
	14,689	624	211	9,252	(89)	1,623	982	9,893	10,010	275	34,867	13,561	4
2010													
Government	914	—	—	3,469	16	1,426	607	4,288	46	—	5,248	46	
Central bank	6,484	—	—	—	—	—	—	—	—	—	6,484	—	
Other banks	554	—	—	984	2	223	275	932	4,819	202	6,507	3,813	1
Other FI	1,801	—	—	6,612	(185)	344	12	6,944	2,944	172	11,861	4,734	1
Corporate	6,170	388	149	264	3	152	57	359	875	—	7,404	9,537	1
Personal	81	3	3	—	—	—	—	—	—	—	81	11	
	16,004	391	152	11,329	(164)	2,145	951	12,523	8,684	374	37,585	18,141	5

CDS by reference entity

	2012				2011				2010			
	Notional		Fair value		Notional		Fair value		Notional		Fair value	
	Bought	Sold	Bought	Sold	Bought	Sold	Bought	Sold	Bought	Sold	Bought	Sold
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Government	1,352	1,227	(12)	11	1,206	1,189	31	(31)	1,195	999	(2)	(4)
Other banks	659	695	(1)	2	965	995	41	(42)	784	789	12	(10)
Other FI	3,080	2,799	20	(23)	5,772	5,541	142	(131)	4,210	3,985	48	(46)
Corporate	7,943	6,852	(93)	87	15,416	14,238	257	(166)	12,330	11,113	(72)	177
	13,034	11,573	(86)	77	23,359	21,963	471	(370)	18,519	16,886	(14)	117

CDS bought protection: counterparty analysis by internal asset quality band

	AQ1		AQ2-AQ3		AQ4-AQ9		AQ10		Total	
	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value
2012	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Banks	763	(17)	3,112	(32)	539	(3)	—	—	4,414	(52)
Other FI	4,990	(33)	2,046	7	917	(13)	667	5	8,620	(34)
	5,753	(50)	5,158	(25)	1,456	(16)	667	5	13,034	(86)
2011										
Banks	7,605	107	88	1	6	—	—	—	7,699	108
Other FI	14,529	231	308	37	676	81	147	14	15,660	363
	22,134	338	396	38	682	81	147	14	23,359	471

*unaudited

Business review Risk and balance sheet management continued

Country risk: Country risk exposure continued
France

	Lending	REIL	Provisions	AFS and LAR debt securities	AFS reserves	HFT debt securities Long	HFT debt securities Short	Total debt securities	Net Derivatives	Repos	Balance sheet	Off-balance sheet
2012	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Government	494	—	—	537	(41)	5,186	2,064	3,659	257	—	4,410	3
Central bank	9	—	—	—	—	—	—	—	—	—	9	—
Other banks	2,498	—	—	730	5	184	27	887	5,608	58	9,051	591
Other FI	124	—	—	757	(4)	252	51	958	833	392	2,307	1,106
Corporate	2,426	116	71	218	16	116	15	319	724	—	3,469	7,685
Personal	71	—	—	—	—	—	—	—	—	—	71	75
	5,622	116	71	2,242	(24)	5,738	2,157	5,823	7,422	450	19,317	9,460
2011												
Government	481	—	—	2,648	(14)	8,705	5,669	5,684	357	—	6,522	911
Central bank	3	—	—	20	—	—	—	20	—	—	23	—
Other banks	1,273	—	—	889	(17)	157	75	971	7,009	262	9,515	474
Other FI	282	—	—	642	(40)	325	126	841	592	83	1,798	928
Corporate	3,761	128	74	240	9	72	34	278	743	—	4,782	7,829
Personal	79	—	—	—	—	—	—	—	—	—	79	75
	5,879	128	74	4,439	(62)	9,259	5,904	7,794	8,701	345	22,719	10,217
2010												
Government	511	—	—	5,912	40	10,266	3,968	12,210	362	—	13,083	15
Central bank	3	—	—	—	—	—	—	—	—	15	18	—
Other banks	1,095	—	—	774	—	410	204	980	6,554	629	9,258	954
Other FI	470	—	—	666	(22)	42	23	685	361	14	1,530	1,310
Corporate	4,376	230	46	71	1	185	90	166	672	—	5,214	9,285
Personal	102	—	—	—	—	—	—	—	—	—	102	76
	6,557	230	46	7,423	19	10,903	4,285	14,041	7,949	658	29,205	11,640

CDS by reference entity

	2012				2011				2010			
	Notional		Fair value		Notional		Fair value		Notional		Fair value	
	Bought	Sold	Bought	Sold	Bought	Sold	Bought	Sold	Bought	Sold	Bought	Sold
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Government	4,989	4,095	76	(66)	3,467	2,901	228	(195)	2,225	2,287	87	(92)
Other banks	3,443	3,337	23	(5)	4,232	3,995	282	(236)	3,631	3,071	63	(43)
Other FI	1,789	1,374	(8)	9	2,590	2,053	136	(117)	1,722	1,609	—	(2)
Corporate	11,435	10,618	(106)	112	23,224	21,589	609	(578)	19,771	18,466	(181)	159
	21,656	19,424	(15)	50	33,513	30,538	1,255	(1,126)	27,349	25,433	(31)	22

CDS bought protection: counterparty analysis by internal asset quality band

	AQ1		AQ2-AQ3		AQ4-AQ9		AQ10		Total	
	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value
2012	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Banks	1,779	14	7,102	(15)	921	6	—	—	9,802	5
Other FI	5,995	(12)	4,798	(5)	1,061	(3)	—	—	11,854	(20)
	7,774	2	11,900	(20)	1,982	3	—	—	21,656	(15)
2011										
Banks	13,353	453	162	13	79	8	—	—	13,594	474
Other FI	19,641	758	24	1	254	22	—	—	19,919	781
	32,994	1,211	186	14	333	30	—	—	33,513	1,255

*unaudited

Business review Risk and balance sheet management continued

Belgium

	Lending	REIL	Provisions	AFS and LAR debt securities	AFS reserves	HFT debt securities Long	HFT debt securities Short	Total debt securities	Net Derivatives	Repos	Balance sheet	Off-balance sheet	T
2012	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	
Government	—	—	—	828	(44)	1,269	711	1,386	103	—	1,489	—	1
Other banks	186	—	—	2	—	2	2	2	2,618	50	2,856	7	2
Other FI	249	—	—	—	—	—	—	—	239	—	488	30	
Corporate	414	50	15	14	—	6	—	20	180	—	614	1,263	1
Personal	22	3	20	—	—	—	—	—	—	—	22	8	
	871	53	35	844	(44)	1,277	713	1,408	3,140	50	5,469	1,308	6
2011													
Government	—	—	—	742	(116)	608	722	628	89	—	717	—	
Central bank	8	—	—	—	—	—	—	—	3	—	11	—	
Other banks	287	—	—	4	—	—	—	4	2,399	51	2,741	8	2
Other FI	354	—	—	—	—	1	4	(3)	191	—	542	64	
Corporate	588	31	21	3	—	20	—	23	277	—	888	1,279	2
Personal	20	—	—	—	—	—	—	—	—	—	20	8	
	1,257	31	21	749	(116)	629	726	652	2,959	51	4,919	1,359	6
2010													
Government	102	—	—	763	(54)	529	602	690	92	—	884	—	
Central bank	14	—	—	—	—	—	—	—	7	—	21	—	
Other banks	441	—	—	39	1	66	2	103	1,822	—	2,366	3	2
Other FI	32	—	—	—	—	—	—	—	126	—	158	81	
Corporate	893	27	27	1	—	11	2	10	191	—	1,094	1,400	2
Personal	327	—	—	—	—	—	—	—	—	—	327	8	
	1,809	27	27	803	(53)	606	606	803	2,238	—	4,850	1,492	6

CDS by reference entity

	2012				2011				2010			
	Notional		Fair value		Notional		Fair value		Notional		Fair value	
	Bought	Sold	Bought	Sold	Bought	Sold	Bought	Sold	Bought	Sold	Bought	Sold
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Government	1,890	1,674	(31)	29	1,612	1,505	120	(110)	880	986	53	(57)
Other banks	212	222	1	(1)	312	302	14	(13)	278	266	2	(1)
Corporate	301	276	(1)	1	563	570	12	(12)	628	594	(6)	6
	2,403	2,172	(31)	29	2,487	2,377	146	(135)	1,786	1,846	49	(52)

CDS bought protection: counterparty analysis by internal asset quality band

AQ1	AQ2-AQ3	AQ4-AQ9	AQ10	Total
Notional	Notional	Notional	Notional	Notional

		Fair value		Fair value		Fair value		Fair value		Fair value
2012	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Banks	244	(2)	1,156	(17)	281	(3)	—	—	1,681	(22)
Other FI	178	—	505	(9)	39	—	—	—	722	(9)
	422	(2)	1,661	(26)	320	(3)	—	—	2,403	(31)
2011										
Banks	1,602	97	2	—	12	1	—	—	1,616	98
Other FI	866	48	1	—	4	—	—	—	871	48
	2,468	145	3	—	16	1	—	—	2,487	146

*unaudited

Business review Risk and balance sheet management continued

Country risk: Country risk exposure continued
Luxembourg

	Lending	REIL	Provisions	AFS and LAR debt securities	AFS reserves	HFT debt securities Long	HFT debt securities Short	Total debt securities	Net Derivatives	Repos	Balance sheet	Off-balance sheet	T
2012	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	
Central bank	13	—	—	—	—	—	—	—	—	—	13	—	
Other banks	99	—	—	8	—	8	6	10	485	77	671	—	
Other FI	717	—	—	51	(1)	198	4	245	821	68	1,851	719	2,
Corporate	1,817	940	287	—	—	19	23	(4)	156	—	1,969	1,469	3,
Personal	4	—	—	—	—	—	—	—	—	—	4	2	
	2,650	940	287	59	(1)	225	33	251	1,462	145	4,508	2,190	6,
2011													
Other banks	101	—	—	10	—	7	—	17	530	16	664	—	
Other FI	925	—	—	54	(7)	82	80	56	2,174	789	3,944	711	4,
Corporate	2,228	897	301	5	—	58	6	57	180	—	2,465	1,294	3,
Personal	2	—	—	—	—	—	—	—	—	—	2	2	
	3,256	897	301	69	(7)	147	86	130	2,884	805	7,075	2,007	9,
2010													
Government	—	—	—	—	—	24	—	24	—	—	24	—	
Central bank	25	—	—	—	—	—	—	—	—	—	25	—	
Other banks	26	—	—	30	(1)	45	—	75	492	7	600	1	
Other FI	734	—	—	99	(3)	32	19	112	731	1,069	2,646	696	3,
Corporate	2,503	807	206	5	1	183	21	167	246	—	2,916	1,684	4,
Personal	3	—	—	—	—	—	—	—	—	—	3	2	
	3,291	807	206	134	(3)	284	40	378	1,469	1,076	6,214	2,383	8,

CDS by reference entity

	2012				2011				2010			
	Notional		Fair value		Notional		Fair value		Notional		Fair value	
	Bought	Sold	Bought	Sold	Bought	Sold	Bought	Sold	Bought	Sold	Bought	Sold
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Other FI	1,169	1,009	32	(29)	2,080	1,976	118	(108)	1,296	1,220	(5)	1
Corporate	1,388	1,238	(9)	10	2,478	2,138	146	(116)	2,367	1,918	(16)	13
	2,557	2,247	23	(19)	4,558	4,114	264	(224)	3,663	3,138	(21)	14

CDS bought protection: counterparty analysis by internal asset quality band

AQ1		AQ2-AQ3		AQ4-AQ9		AQ10		Total	
Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value

2012	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Banks	96	4	611	23	63	(1)	—	—	770	26
Other FI	1,111	(12)	361	12	315	(3)	—	—	1,787	(3)
	1,207	(8)	972	35	378	(4)	—	—	2,557	23
2011										
Banks	1,535	93	16	—	—	—	—	—	1,551	93
Other FI	2,927	164	10	—	70	7	—	—	3,007	171
	4,462	257	26	—	70	7	—	—	4,558	264

*unaudited

Business review Risk and balance sheet management continued

Other eurozone(1)

	Lending	REIL	Provisions	AFS and LAR debt securities	AFS reserves	HFT debt securities Long	HFT debt securities Short	Total debt securities	Net Derivatives	Repos	Balance sheet	Off-balance sheet	T
2012	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	
Government	126	—	—	323	(26)	971	411	883	734	—	1,743	—	1
Central bank	—	—	—	—	—	—	—	—	33	—	33	—	
Other banks	19	—	—	54	—	130	27	157	927	8	1,111	117	1
Other FI	90	—	—	102	(4)	8	—	110	2	3	205	24	
Corporate	856	33	13	97	(1)	2	7	92	41	—	989	1,118	2
Personal	14	—	—	—	—	—	—	—	—	—	14	10	
	1,105	33	13	576	(31)	1,111	445	1,242	1,737	11	4,095	1,269	5
2011													
Government	121	—	—	327	(47)	445	331	441	779	—	1,341	25	1
Central bank	—	—	—	—	—	—	—	—	23	—	23	—	
Other banks	28	—	—	63	(1)	13	70	6	1,011	—	1,045	94	1
Other FI	77	—	—	100	(9)	25	2	123	36	—	236	130	
Corporate	1,125	12	15	134	(4)	11	7	138	45	—	1,308	1,038	2
Personal	12	—	—	—	—	—	—	—	—	—	12	10	
	1,363	12	15	624	(61)	494	410	708	1,894	—	3,965	1,297	5
2010													
Government	124	—	—	324	(25)	268	283	309	697	—	1,130	26	1
Central bank	1	—	—	—	—	—	—	—	1	—	2	—	
Other banks	141	—	—	71	(1)	52	44	79	550	2	772	149	
Other FI	81	—	—	4	—	—	5	(1)	8	6	94	70	
Corporate	1,220	63	22	133	(1)	30	15	148	37	—	1,405	1,745	3
Personal	11	—	—	—	—	—	—	—	—	—	11	9	
	1,578	63	22	532	(27)	350	347	535	1,293	8	3,414	1,999	5

CDS by reference entity

	2012				2011				2010			
	Notional		Fair value		Notional		Fair value		Notional		Fair value	
	Bought	Sold	Bought	Sold	Bought	Sold	Bought	Sold	Bought	Sold	Bought	Sold
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Government	2,850	2,793	(82)	80	2,281	2,350	54	(47)	1,975	2,190	(26)	34
Other banks	63	68	—	—	90	87	2	(1)	148	142	1	—
Corporate	2,222	2,082	(41)	41	4,054	3,944	70	(59)	3,254	2,966	(63)	51
	5,135	4,943	(123)	121	6,425	6,381	126	(107)	5,377	5,298	(88)	85

CDS bought protection: counterparty analysis by internal asset quality band

	AQ1		AQ2-AQ3		AQ4-AQ9		AQ10		Total	
	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value	Notional	Fair value
2012	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Banks	461	(4)	1,893	(55)	159	(2)	—	—	2,513	(61)
Other FI	944	(25)	1,522	(32)	156	(5)	—	—	2,622	(62)
	1,405	(29)	3,415	(87)	315	(7)	—	—	5,135	(123)
2011										
Banks	2,877	58	50	1	—	—	—	—	2,927	59
Other FI	3,464	67	4	—	30	—	—	—	3,498	67
	6,341	125	54	1	30	—	—	—	6,425	126

Note:

(1) Comprises Austria, Estonia, Finland, Malta, Slovakia and Slovenia.

*unaudited

Country risk: Country risk exposure continued
Eurozone non-periphery

Key points*
- The Group holds a major and diversified portfolio in eurozone non-periphery countries with significant exposures to financial institutions and corporates, notably in Germany, the Netherlands and France, and a sizeable liquidity portfolio with the German central bank.

- Exposure decreased in most product categories and to most client groups during 2012, particularly in lending to corporates, contingent liabilities and commitments, as a result of currency movements and de-risking of the portfolio.

Government and central bank
- The Group holds significant short-term surplus liquidity with central banks for liquidity, credit risk and capital considerations as well as due to limited alternative investment opportunities. This exposure also fluctuates as part of the Group's asset and liability management. In the third quarter of 2012 the Group transferred part of its euro payment activity from the RBS N.V. account with the Dutch central bank to the RBS plc account with the German central bank, as part of strategic plans to migrate most of the RBS N.V. balance sheet, activities and exposures to RBS plc.

- Germany - Net long HFT positions in German bonds in Markets increased during 2012, driven by market opportunities. Concurrently, German AFS bond positions in Group Treasury were reduced in the first half of the year, in line with internal liquidity management strategies.

- France - The Group reduced its long and short HFT positions in Markets throughout 2012 while reducing its net long HFT position in the first half of the year and increasing it again in the second half of the year, in anticipation of changes in credit spreads. AFS bond positions in Group Treasury were gradually reduced as part of general risk management and in line with internal liquidity management strategies.

- Belgium - Net HFT government debt exposure increased by £0.7 billion on balance over 2012, as part of regular fluctuations in the Markets business. AFS debt securities exposures increased by £0.1 billion and the negative AFS reserve declined by the same amount as a result of recovery in bond prices.

Financial institutions
- France - Lending exposure to banks increased as a result of a transfer of bank account services for Group Treasury secured funding transactions from in-house to an external bank, for £1.7 billion. Derivatives exposure to banks decreased by £1.4 billion, spread over a number of banks.

Corporate
- Germany - Lending to corporate clients fell by £2.9 billion, largely as a result of reductions in Non-Core exposure to the transport, commercial real estate, electricity and media sectors.

- The Netherlands - Lending to corporate clients decreased by £1.1 billion due to reductions in the commercial real estate and telecommunications sectors, with half of this reduction in the Non-Core portfolio.

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France - Lending to corporate clients decreased by £1.3 billion due to reductions in the telecommunications, commercial real estate and construction sectors, half of this reduction is in the Non-Core portfolio.

Non-Core (included above)

- Germany - Non-Core lending exposure was £2.8 billion at 31 December 2012, down £2.6 billion since 31 December 2011. Most of the lending was in the commercial real estate (64%) and natural resources (12%) sectors.

- The Netherlands - Non-Core lending exposure was £2.0 billion at 31 December 2012, down £0.5 billion since 31 December 2011. Most of the lending was in the commercial real estate (56%) and securitisations (21%) sectors.

- France - Non-Core lending exposure was £1.6 billion at 31 December 2012, a decline of £0.7 billion since 31 December 2011. The lending portfolio mainly comprised public sector (30%), commercial real estate (23%) and construction (13%) exposures.

Other risks

241	Operational risk
244	Regulatory risk
249	Conduct risk
250	Reputational risk
250	Business risk
251	Pension risk

Other risks
Operational risk*
Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. It is an integral and unavoidable part of the Group's business as it is inherent in the processes it operates to provide services to customers and meet strategic objectives.

Operational risk management
The objective of operational risk management is not to remove operational risk altogether, but to manage it to an acceptable level, taking into account the cost of minimising the risk against the resultant reduction in exposure. Strategies to manage operational risk include avoidance, transfer, acceptance and mitigation by controls.

In 2012, the Group continued to make good progress in enhancing its operational risk framework and risk management capabilities. Details of developments undertaken and planned are set out below along with the key processes through which the Group manages operational risk.

In 2013, through further embedding the enhanced operational risk framework and tools and improving framework linkages, operational risk will be managed on a more forward-looking basis.

Governance, structure and risk appetite
Governance and structure
Group Operational Risk is an independent function reporting to the Head of Restructuring & Risk. It is responsible for the design and maintenance of the operational risk policy standards.

The standards, which are incorporated in the Group Policy Framework (GPF), provide the direction for delivering effective operational risk management and are designed to allow the consistent identification, assessment, management, monitoring and reporting of operational risk across the Group.

The Operational Risk Executive Committee acts upon all operational risk matters, and reviews and monitors the operational risk profile across the Group, in line with risk appetite. It oversees, manages and monitors operational risk strategies and frameworks, and reviews operational risk policy. It escalates and reports necessary items to the Group Risk Committee.

Operational risk appetite, policy and frameworks are reviewed regularly at the Executive Risk Forum to satisfy oversight responsibilities and, as appropriate, other senior committees.

Risk appetite
The Group's operational risk appetite statement is agreed by the Group Board. It comprises a number of specific measures of risk, such as:

- The maximum operational risk losses the Group is prepared to accept. For 2012, this was expressed as a percentage of the Group's estimated gross income but will transition to a more forward-looking expected loss measure during 2013 following the development of the operational risk model; and

- Aggregate loss targets at specific confidence levels.

To confirm that the Group operates within the set risk appetite, the high-level statement is supplemented by specific tolerances for different types of operational risk. The GPF sets out how to manage risk within acceptable limits, which in turn enables the Group to operate within the overall risk appetite and the specific tolerances.

Operational risk cycle and key management tools
The operational risk cycle comprises four stages:

- identification of risks;
- assessment or measurement of the scale of risks;
- management or control of risks to prevent their recurrence or minimise the potential impact; and
- monitoring and reporting of risks.

Although the operational risk tools encompass all stages of the risk cycle, they can be broadly categorised as follows:

Identification and assessment
Risk and control assessments
Risk and control assessments are used to identify and assess material operational risks and key controls across all business areas. To provide a consistent categorisation of risks and controls across the Group and to support identification of risk concentrations, all risks and controls are mapped to the Group-wide risk taxonomy and the newly developed control catalogue.

The process is designed to confirm that risks are effectively managed in line with stated risk appetite, prioritised and documented. Controls are tested frequently to verify and validate that they remain fit for purpose and operate effectively.

Risk assessments are often conducted in a workshop environment, bringing together subject matter experts and key stakeholders from across the division and key functions. This approach has led to a more complete view of the risk profile and more informed decisions.

During 2013, the focus will be on the continued implementation and embedding of risk assessments across the Group. This includes the strengthening of links between risk assessments and other elements of the Group operational risk framework. In addition, risk assessments will increasingly be utilised to identify single points of failure.

New product risk assessment process
The Group's new product risk assessment process is designed to identify, assess and approve the risks associated with new products prior to launch.

Several process enhancements were made during 2012, which strengthened the interaction between business, risk and specialist areas. Reporting has been established and work has started to enhance the inventory of products provided by the Group.

* unaudited

Scenario analysis

Scenario analysis is used to assess the possible impact of extreme but plausible operational risk loss events. It provides a forward-looking basis for managing exposures beyond the Group's risk appetite. The methodology provides a structured and consistent approach to scenario scoping and measurement. During 2012, the portfolio of scenarios was further enhanced to increase coverage of the material risks to which the Group is exposed.

Scenario analysis is an important component in the operational risk framework, providing senior management with valuable insight into systemic risk that could significantly impact the Group's financial performance or reputation if these events were to occur. Using its forward-looking nature, senior management cross-examines various risk topics against a range of circumstances and assumptions, including consideration of single points of failure.

Scenarios are run in a workshop environment, bringing business, risk and control experts together, thereby ensuring that risk management is approached holistically. They include Group-wide themes, which are led by Group Operational Risk and allow the Group to assess the impacts of pan-divisional risks and macroeconomic stresses (e.g. eurozone distress).

Stress testing

The Group further refined its approach to assessing the impact of the economic cycle on its operational risk losses by specifically assessing the impact of the FSA's published Anchor II scenario, which describes a series of country-specific shocks around the world on:

- expected levels of operational risk losses; and
- capital adequacy requirements for operational risk.

The impact of the FSA Anchor II scenario on the Group's operational risk capital, as calculated under the standardised approach, was also projected based on the outputs of the Group's stress-testing exercises.

Operational risk impacts are also assessed based on additional economic stress scenarios developed internally.

Capital model development

The Group has continued with the development of its statistical modelling capability for operational risk based on the requirements set out under the Basel II advanced measurement approach. The model considers internal and external loss data as well as scenarios and business environment and internal control factors. The primary use of the model will be to contribute to the economic capital calculation and to help test the Group's capital adequacy requirement. Embedding of the model outputs is continuing in 2013.

Management, monitoring and reporting

Issues management

The objective of the operational risk issues management framework is the adoption of a consistent approach to the identification, capture, classification, monitoring, closure and acceptance of operational risk issues and associated actions across the Group.

This element of the operational risk framework continues to be enhanced in areas such as analysis of common issues on an aggregated basis across the Group to identify emerging trends and improvements to the quality of data captured.

Event and loss data management

Event and loss data management covers the discovery, escalation, capture, investigation, approval and closure, and reporting and analysis of operational risk events and loss data. It also provides for clear, simple, quick and consistent communication of operational risk events that meet defined threshold criteria to those members of the Group's senior management and executives who need to know of these events.

The Group has continued to focus on the timely, accurate capture of operational risk losses; the use of a single Group-wide repository; and the escalation of material operational risk events. This has resulted in enhanced completeness and accuracy of the Group's internal loss data, and transparency of operational risk events, which allows the Group to manage its operational risk profile more effectively.

The event and loss data process will continue to evolve to keep apace with changing regulatory and industry standards regarding the collection of internal loss data.

Insurance

The Group purchases insurance to provide the business with financial protection against specific losses and to comply with statutory or contractual requirements. Insurance is used to help manage the Group's exposures, providing protection against financial loss once a risk has crystallised.

Monitoring and reporting

Monitoring and reporting forms an integral part of all of the Group's operational risk management processes, which are designed to ensure that risks and issues are identified, escalated and managed on a timely basis. Exposures for each division are reported through monthly risk and control reports, which provide detail on the risk exposures and action plans.

Enhancements made during 2012 include single-source extraction and publication of operational risk data across the Group, such as operational risk events and losses. This has resulted in consistent and higher quality information for the purposes of oversight, challenge and operational risk management.

Other risks: Operational risk* continued

Control environment certification

Control Environment Certification (CEC) is used by the Group Executive management to review and assess its internal control framework. Senior management are required to provide a twice-yearly assessment of the robustness of the Group's internal control environment including:

- compliance with the Group Policy Framework and key divisional/functional policy standards;
- compliance with the requirements of the UK Corporate Governance Code;
- effectiveness of the risk frameworks, culture and governance structures of each division or function to help ensure the Group operates within risk appetite; and
- reporting on the material risks for the business against appetite.

The CEC outcomes are reported at both the divisional risk and audit committees and Group Audit Committee.

Operational risk metrics

Operational risk events (net loss greater than £10,000) by event category

All losses and recoveries associated with an event are reported based on the date of each financial impact. A single event can have multiple losses (or recoveries), which may take a period of time to crystallise. Losses and recoveries will also have been booked during 2012 on events which occurred or were identified in prior years.

Number of events

At 31 December 2012, two categories accounted for around 60% of all operational risk events: (i) clients, products and business practices; and (ii) execution, delivery and process management. This proportion was unchanged from 31 December 2011.

Value of losses

At 31 December 2012, three categories continue to account for 98% of the losses, however technology and infrastructure failures have replaced fraud as one of the primary loss categories. This reflects the value of losses and provisions associated with a major systems incident during 2012 (referred to as the Group technology incident). The majority of the increase in losses associated with the clients, products and business practices event category are the result of increased Payment Protection Insurance provisions, and new provisions in respect of Interest Rate Hedging Products and LIBOR.

A small number of operational risk events contribute a high percentage of the total losses. This is evidenced by the fact that in 2012 only 4% of operational risk events had a value of £1 million or greater (2011 - 3%) but accounted for 97% of the overall losses (2011 - 91%).

Capital

The Group calculates the capital requirement for operational risk using the standardised approach. The capital requirements are as follows:

	2012	2011
	£m	£m
Operational risk minimum capital requirement	3,668	3,034

* unaudited

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Regulatory risk*

Regulatory risk is the risk of material loss or liability, legal or regulatory sanctions, or reputational damage, arising from the failure to comply with (or adequately plan for changes to) relevant official sector policy, laws, regulations, or major industry standards, in any location in which the Group operates. The Group believes that maintaining a strong regulatory risk framework is fundamental to protecting sustainable growth, rebuilding its reputation and maintaining stakeholder confidence.

The regulatory environment remained highly challenging during 2012, as policymakers and regulators continued to strengthen regulation and supervision in response to the events of 2007/2008 and subsequent economic and financial stress.

The regulatory agenda, largely framed by the G20 but with many instances of European Union (EU) and national initiatives, constitutes the most sweeping set of changes seen in many decades. At 31 December 2012, the Group was managing some 105 major regulatory or legislative policy initiatives. During the year as a whole, it had also reviewed over 320 consultations in its core markets. In addition to these changes, many supervisory authorities also continued to intensify their ongoing level of scrutiny and intervention.

These trends have posed multiple challenges for banking groups, including the Group, namely:

- tracking, analysing and engaging with policymakers on proposed changes;
- implementing change programmes to ensure compliance with new requirements;
- revisiting strategy, business and operating models in response to the new environment; and
- driving through cultural and other changes to promote good business practice and to minimise enforcement risks.

Global regulatory developments

The global agenda continues to be guided by the G20, drawing on the original action plan for strengthening financial stability agreed by G20 leaders at the November 2008 Washington summit. Although policy initiation at the G20 level is drawing to an end, a substantial pipeline of policy development remains in train and the Group does not anticipate any easing of this for some time. During 2012, G20 countries continued to implement various elements of this action plan, and further endorsed it at the G20 leaders' summit held in Los Cabos, Mexico in June 2012 and the finance ministers' and central bank governors' meetings, most recently in Mexico City in November 2012.

Key developments during 2012 included the following:

Basel III

Following publication by the Basel Committee on Banking Supervision in December 2010 of rules for the new Basel III capital and liquidity framework, work during 2012 focused on finalising the remaining elements of policy and preparing for implementation. Highlights were:

- Publication of results of the Basel III monitoring exercise at 30 June 2011 (published April 2012) and at 31 December 2011 (published September 2012). The latest results (which ignore the transitional provisions which apply) showed good progress, with an average Common Equity Tier 1 ratio of 7.7% across 102 banks with Tier 1 capital above €3 billion. This compares to an effective target of 7%. However, individual bank shortfalls, including surcharges for systemically important banks where applicable, still totalled €374 billion;

- The finalisation of rules for composition of capital disclosure requirements (June 2012);
- Proposals for monitoring indicators for intra-day liquidity management (July 2012);
- Interim rules for the capitalisation of bank exposures to central counterparties (July 2012);
- Final rules for the regulatory treatment of valuation adjustments to derivative liabilities (July 2012); and
- Final rules amending the liquidity coverage ratio (LCR), including revised definitions of high quality liquid assets and net cash outflows. The LCR will now be phased in from 2015 to 2019 and it was also re-confirmed that a stock of liquid assets would be available for use by banks in stress situations (January 2013).

The Basel Committee also turned its attention increasingly to developments beyond Basel III. In particular, it published an initial consultation paper to launch its fundamental review of the trading book (May 2012). Here, the Committee is seeking to improve the coherence of market risk capital requirements and to enhance the consistency of implementation across jurisdictions and convergence of requirements across the industry.

Systemic financial institutions
With the G20-mandated target of agreeing a framework for dealing with global systemically important financial institutions having been met in 2011, much work in 2012 was at the EU level, with discussions on incorporating a general approach into CRD IV.

Separately, and following consultation, the Basel Committee published a framework to address domestic systemically important banks in November 2012, which followed on from its methodology for identifying global systemically important banks developed in 2011. The framework focuses on the impact that the distress or failure of banks will have on the domestic economy. The correct calibration of linkages between the domestic and international frameworks is now critical.

* unaudited

Other risks: Regulatory risk* continued
Shadow banking
Work in this area, which broadly refers to entities and financial transactions that fall outside the scope of existing financial (banking) regulation, such as hedge funds, money market funds and structured investment vehicles, intensified during 2012.

Globally, Financial Stability Board (FSB) workstreams under relevant bodies including the International Organization of Securities Commissions and the Basel Committee continued in five key areas: banks' interactions with shadow banking entities; ways to reduce the susceptibility of money market funds to runs; the regulation of other shadow banking entities on prudential grounds; retention requirements and transparency in securitisation; and the possible regulation of margins and haircuts in securities lending and repos. The FSB issued an update and a further series of consultation papers on certain workshops in November 2012 and revised recommendations are expected by the G20 St Petersburg leaders' summit in September 2013.

The European Commission began the first stage in its own regulatory process on shadow banking in March 2012, with the release of a Green Paper. A summary of responses published in September 2012 was broadly aligned with industry views.

Other
Other papers issued during the year covered subjects including risk data aggregation and reporting; margin requirements for uncleared derivatives; foreign exchange settlement risk; supervision; financial conglomerates; and revisions to the securitisation framework.

EU regulatory developments
The EU regulatory agenda in 2012 continued to focus mainly on prudential and market structure measures. Retail issues also came under increased focus. Key highlights were as follows:

The Liikanen Review
In November 2011, the EU Commissioner for Internal Market and Services, Michel Barnier, announced the establishment of a High-Level Expert Group to consider structural reform of EU banks and in early 2012 it was convened under the chairmanship of Erkki Liikanen, the Governor of the Bank of Finland. The group was mandated to consider measures to improve EU banks' stability and efficiency. In addition to any new measures, it was tasked to look at ongoing structural reforms, including the UK Independent Commission on Banking and the US 'Volcker Rule'.

The Expert Group's proposals in October 2012 contained five recommendations: a ring-fence of trading book activities where they form a significant part of a bank's activity; effective recovery and resolution plans (with authorities empowered to require further structural reform if that improves resolvability); specific 'bail-in' instruments (rather than a general bail-in power applied to existing liabilities); stricter capital treatment of trading book and real estate exposures; and a number of corporate governance, risk management and remuneration proposals.

The Commission is considering the Expert Group's recommendations and has said that it will formally respond by September 2013. Member state views on the Expert Group's proposals, where expressed, have been mixed. The UK is meanwhile pushing ahead with implementation of its own ring-fencing reforms, as set out by the Independent Commission on Banking. These go further than the Expert Group's proposals. France and Germany have also published draft legislation of their own on ring-fencing, which focus mainly on separating out proprietary trading (but allowing market making activities to remain within the deposit-taking bank).

Crisis management and banking union proposals
In June 2012, the EU Commission published proposals for an EU-wide recovery and resolution regime, providing for banks and authorities to maintain plans for each firm, setting out measures to set right or resolve businesses should they face difficulties. Authorities would receive a number of powers to intervene in banks for these purposes, including early intervention powers ahead of problems coming to light, and a minimum set of tools to restructure or wind up a failed firm.

Among the new tools is the power to 'bail in' senior creditors when resolving a firm, to ensure losses are spread among shareholders and creditors, without recourse to tax-payer funding. Bailed-in creditors take a loss and become shareholders in the new entity created.

These proposals are likely to be agreed in 2013, with member states and banks in compliance from 2015, and bail-in provisions from 2018.
Notwithstanding these developments, the euro-area crisis continued to develop and in July 2012, the President of the European Council, Herman Van Rompuy, set out a road-map for further euro-area financial integration. This aims to both resolve the current crisis and tackle longstanding structural problems in the single-currency zone. Fundamental to these proposals are banking and fiscal union and further economic integration. The President's banking union proposal comprises: a Single Supervisory Mechanism; and mutualisation of bank losses through common deposit guarantee and resolution funding arrangements. The latter two elements are planned to follow agreement of the recovery and resolution regime in 2013.

In September, the Commission published its proposal for a Single Supervisory Mechanism, designating the European Central Bank (ECB) as primary prudential supervisor for all euro-area banks, with opt-ins available for EU member states outside the euro-area. The Council of the EU agreed to these proposals, with the proviso that the ECB would directly supervise only larger banks and those in receipt of state aid, while retaining some oversight of smaller banks that fall under the remit of national supervisors.

The European Parliament is now considering the proposals, with agreement expected in early 2013. The ECB will not acquire full supervisory authority until March 2014 and there is scope to delay this. Operational elements, such as how the ECB will be staffed, how it will interact with national supervisors and how it will implement its new macro-prudential responsibilities, remain to be seen. More detail should emerge during 2013.

* unaudited

Prudential and related reforms
A key focus during 2012 was work on agreeing the EU's Capital Requirements Directive (CRD) following the publication of draft legislative text in 2011 for the CRD IV package to implement Basel III in the EU.

Progress of the legislation was slower than hoped and did not conclude before the Basel III start date of 1 January 2013. Nevertheless, the European Banking Authority did press ahead with proposals for a number of the technical standards mandated by CRD IV, including: reporting of own funds, liquidity, leverage and large exposures; gain on sale of associated with future margin income in a securitisation context; credit valuation adjustment; and prudent valuation.

Other prudential initiatives have included, notably: continued work on developing the Solvency II framework for insurers; capital requirements for central counterparties; corporate governance in financial institutions; and supervision of financial conglomerates.

Market and structural reforms
Key developments included:

- European Markets Infrastructure Regulation - the regulation came into force on 16 August 2012. In many areas, the European Securities and Markets Authority (ESMA) is yet to finalise draft technical standards. Full implementation is likely to be in the third quarter of 2013, when the final technical standards are due to be released by the ESMA.

- Markets in Financial Instruments Directive - the European Parliament voted on the proposal in September 2012 but the Council of the EU had not agreed its final position by the end of 2012. The new Irish Presidency of the Council plans to finalise the proposals before the end of its term in June 2013.

- Financial Transaction Tax - the EU Commission has previously published proposals, which would see trades in bonds and shares taxed at 0.1% and complex derivatives taxed at 0.01%. While the original EU-wide proposal was rejected due to opposition from several member states, including the UK, a subset of eleven EU member states has agreed to proceed via the Enhanced Cooperation Mechanism. The Commission set out detailed proposals for this in February 2013.

- Other initiatives - these have included proposals to revise the Data Protection Directive, further changes to the market abuse regime and prospectus requirements, further legislative developments impacting credit rating agencies and changes to depositor and investor protection.

EU retail market reforms
Notwithstanding the focus on prudential and market reforms in response to the financial crisis, the EU Commission during 2012 also continued to work on a wide range of retail agenda initiatives. These included:

- bank account transparency, switching and the potential for making basic bank accounts a legal right for EU citizens;

- the Insurance Mediation Directive II, which could have implications for packaged accounts with inbuilt insurance products;

- multilateral interchange fees; and

- the Mortgage Credit Directive, which is still progressing through the legislative process and which covers areas including responsible lending and pre-contract disclosure.

Regulatory architecture reforms

The Financial Services Act to introduce the “twin peaks” model of financial regulation received Royal Assent in December 2012 and so the formal split of the FSA into the Prudential Regulation Authority and the Financial Conduct Authority will take place on 1 April 2013 as expected. In the meantime, the FSA continued to alter its structure in anticipation of the split. The Group has been closely involved in work with trade associations to respond to a number of related consultations, notably to the ‘Journey to the FCA’ document.

UK regulatory developments

UK regulatory developments during 2012 continued to be extensively determined by global and EU developments, with UK regulators working to implement requirements coming into force and actively participating in policy development at the EU and global levels. There was less focus on prudential reviews issued by UK authorities in 2012 but nevertheless a number of papers were published, including consultations on macro-prudential tools and large exposures. In addition, there were a number of other developments specific to the UK.

The future of banking

The Group has actively engaged with, and contributed to, a number of inquiries regarding the future of banking. These included the Government’s White Paper on the implementation of the Independent Commission on Banking recommendations, a Parliamentary inquiry into banking standards and various inquiries (in Europe as well as the UK) looking more specifically at LIBOR and other benchmarks. The Group is represented on, and is working closely with, the British Bankers’ Association Taskforce on Banking Standards, and the Group have specifically welcomed the developing role of the Chartered Banker: Professional Standards Board. In addition, work continued on the finalisation of recovery and resolution planning frameworks.

Other risks: Regulatory risk* continued

Retail conduct issues

In addition to EU retail initiatives, the UK authorities continued to pursue additional issues during 2012. These included initiatives relating to Universal Credit, a review into the personal current account market and continuing work on the Retail Distribution Review ahead of its implementation on 31 December 2012. Work also continues on the Mortgage Market Review, Packaged Accounts and Simple Financial Products. Preparation for the new Financial Conduct Authority (FCA) stepped up, including papers on its powers, regulatory approach and the desire for transparency in areas such as product intervention and publication of Ombudsman decisions. The Group expects significant implementation and ongoing costs to arise from changes to documentation, structure and processes as well as increased regulatory fees.

Furthermore, the Government proposed a transfer of consumer credit regulation from the Office of Fair Trading to the FCA and it may also replace current Consumer Credit Act legislation with an FCA rulebook, changing rules in the process.

Supervisory developments

In line with other regulatory authorities, the FSA's supervisory scrutiny has continued to intensify in response to the financial crisis and ongoing market stresses.

Front-end supervisory resources have been increased and existing tools have been used more frequently and robustly evidenced, for instance, in terms of the heightened number of information requests, the increased deployment by the FSA of skilled person reports as well as the increased fines charged against the industry. Across the industry, fines for 2012 totalled £311.6 million, compared with £66.1 million in 2011, and £5.3 million as the financial crisis began in 2007.

In addition, the FSA moved to a "twin peaks" organisational structure in April 2012, with the creation of new conduct and prudential business units which form separate teams supervising systemically important firms from a conduct and prudential perspective. The FSA has continued to develop new supervisory approaches to align to the new regulatory structure. The prudential framework includes the Core Prudential Programme for those major financial institutions it oversees, which includes in-depth rolling thematic assessments on governance, business models, risk management, capital and liquidity. The conduct framework includes a greater focus on business models and strategic analysis.

US regulatory developments

In the US, activity continued to be dominated by rulemaking following the 2010 Dodd-Frank Act.

Key final rules were issued on a range of issues, including prudential standards for systemically important financial institutions, removal of certain references to credit rating agencies, Basel 2.5 market risk standards and final definitions of swap dealers, major swap participants and swaps. Requirements for the registration of entities as swap dealers took effect from 12 October 2012, with registration commencing from 31 December 2012 once firms reach certain activity thresholds. RBS plc was one of 65 global entities which registered with effect from 31 December 2012.

Proposed rules issued in December 2012 included important changes to the Federal Reserve Board's approach to supervisory and prudential requirements for foreign banking organizations (FBOs). These proposals would require the Group and other FBOs to establish a single US-incorporated intermediate holding company for all the Group's US subsidiaries (although not the US branches of RBS plc or RBS N.V.). Enhanced prudential standards would also be

required, including for the US branches.

Other proposals included Basel III capital and leverage standards and disclosures and other rules relating to mortgages. The Volcker Rule, which restricts proprietary trading and investments in private equity/hedge funds, was not finalised by its effective date of 21 July 2012 but in April 2012 the Federal Reserve Board issued an interpretation which provided some guidance to the effect that banks should demonstrate their 'good faith' planning efforts in the two-year conformance period to July 2014.

Regulatory risk management

The Group manages its regulatory risk through a regulatory affairs framework covering over 120 different regulatory bodies and central banks, wherever the Group operates. This framework is managed by the Group's Regulatory Affairs function and includes: the tracking and management of regulatory developments and regulatory relationship management, together with ownership of the connected regulatory risk policies; assurance and monitoring; and training and awareness.

Against the backdrop of intensified regulatory pressure, Group Regulatory Affairs has managed the increased levels of scrutiny and legislation by increasing the capacity of its team, as well as improving and refining its operating model, tools, systems and processes.

* unaudited

Management of regulatory change
The early identification and effective management of changes in legislative, regulatory and other requirements that may impact the Group is critical to the successful mitigation of prudential and conduct risk.

Group Regulatory Affairs maintains a well-established policy and supporting processes for the identification and management of such changes across the Group. Group Board and Executive Committee oversight is supported by a Prudential Regulatory Developments Executive Steering Group, which was formed in early 2010 to provide a specific focus on a range of key regulatory changes augmented by more specialised groups which cover capital, liquidity, prudential and wholesale market and retail conduct issues. In addition, there is a divisional Heads of Regulatory Developments forum and an RBS Americas regional forum.

Reporting and internal communications activity expanded in 2012 in response to the growing regulatory change agenda. This included:

- monthly reporting of key developments to the Group Risk Committee;
- substantial enhancements to the suite of tools used to monitor and react to regulatory developments; and
- increased communications, such as staff seminars, publication of additional information such as house views on key issues on internal websites and the weekly Regulatory Affairs Flash Report, circulated widely across the Group, which captures key regulatory developments and relationship topics.

Regulatory relationship management
The Regulatory Relations Forum, chaired by Group Regulatory Affairs, meets fortnightly and now has global coverage with representatives from all divisions and regions. It facilitates the sharing of key regulatory engagements.

Quarterly reporting to the Group Audit Committee captures all material regulatory reviews and investigations and upstream regulatory developments worldwide, as well as tracking the status and trends in key regulatory relationships.

Key regulatory policies - ‘Group Relationships with Regulators’ and ‘Political, Legislative and Regulatory Environment’, are kept under annual review. Each incorporates a new risk appetite statement, relevant benchmarking activity against the Group's peer banks and, for the latter, an end-to-end review and mapping of the upstream risk management process.

Recovery and resolution planning
As advocates of effective recovery and resolution planning, the Group continues to work towards the implementation of effective plans. In order to be able to deal effectively with any future severe stress events, the Group has developed a range of recovery options in the form of a detailed recovery plan.

Individual country regulators are developing and implementing their rules according to their own timescales. This emphasises the need for consistency of approach, both by the regulatory bodies and internally within the Group, to ensure effective management of financial stability across jurisdictions, and to avoid duplication and inefficiency for cross-border banks. The Group has worked with trade associations to provide feedback on the FSB’s consultative document on operationalising recovery and resolution planning, published in November 2012.

The Group intends to continue its activities aimed at producing robust and effective plans and to proactively influence policy makers regarding the most practical approach to implementing the regulations. It will also be important to consider how individual regulations might be implemented in a manner that takes advantage of any potential synergies and avoids unnecessary re-work. The potential overlaps between recovery and resolution planning and the proposals arising from the Independent Commission on Banking, the US and the EU will provide an area of focus in this regard.

Other risks continued

Conduct risk*

Conduct risk is 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 by breaching regulatory rules or laws, or failing to meet customers' or regulators' expectations of the Group. Activities through which conduct risk may arise include: personal account dealing; privacy and data protection; conflicts of interest; money laundering; and bribery and corruption.

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. It also reflects the changing regulatory environment in the UK, with the establishment of the Financial Services Conduct Business Unit (forerunner to the Financial Conduct Authority), and the increasing focus of overseas regulators on conduct risk.

The Group's compliance functions are responsible for monitoring the management of conduct risk, including anti-money laundering (AML); sanctions and terrorist financing; and anti-bribery and corruption. In doing so, they design, implement and maintain an effective management framework to enable consistent identification, assessment, monitoring and reporting of conduct risk.

Policy design and implementation

Placing conduct risk at the centre of the Group's philosophy promotes a customer-oriented culture that informs and challenges business strategy, delivers fair outcomes and promotes behaviours consistent with regulatory and legal standards across its retail and wholesale markets.

The Group has established a defined and measurable appetite for conduct risk to ensure commercial decisions take into account any conduct risk implications. During 2012, the foundations of the Group's conduct risk framework were delivered. Key milestones were:

- Agreeing and establishing the Group's conduct risk policies under four pillars: employee conduct; corporate conduct; market conduct; and conduct towards the Group's customers. Each is designed to provide high-level direction to the Group and is supported by the Group's Code of Conduct;

- Launching a phased roll-out of these policies, in order of materiality and scheduled to complete in June 2013;

- Developing and delivering awareness initiatives and targeted conduct risk training for each policy, aligned to the phased roll-out, to assist businesses and executives in embedding the understanding of conduct risk and provide the necessary clarity for staff on their conduct risk requirements;

- Establishing effective leadership and a supporting governance framework, with the participation of all divisions, to oversee the Group's conduct agenda, notably the new Conduct Risk Committee; and

- Completion by the separate AML Change Programme of its Group-wide gap analysis and benchmarking against enhanced policies, including recording identified issues, establishing a new AML organisational reporting and accountability hierarchy, initiating comprehensive and continuing tailored staff training; and establishing a global AML assurance programme.

Training and awareness

Maintaining compliance with existing rules and regulations requires continued investment in professional training, as well as maintaining risk awareness. During 2012, the Group continued to focus on strengthening the capabilities of its compliance functions, at both Group and divisional level. In addition, it facilitated training on conduct risk through Executive education, including master classes and workshops, and computer-based Group Policy Learning modules. Each module addresses the specific regulatory content of relevant Group Policy Standards.

A comprehensive and progressive training programme supports the professional development of the Group's compliance teams. All members of these teams are engaged in compliance eLearning, including a mandatory 'essentials' course, and RBS Risk Academy, through which all staff are required to complete foundation courses in other risk disciplines, such as operational risk, market risk and retail credit risk. Formal training is supplemented by regulatory familiarisation, designed to share knowledge and support both personal development and technical training across the Group's wider risk community.

Assurance and monitoring

Assurance and monitoring activities are essential to ensure that the Group can: demonstrate compliance with existing rules and regulations; assess whether it is managing its conduct risks appropriately; and determine whether key controls are fit for purpose and effective.

During 2012, as well as providing thematic process reviews and assurance over specific compliance topics, the Group Compliance assurance teams, working with its divisional counterparts, validated the closure of issues it identified during the 2011 programme of Group-wide assurance reviews, and identified common issues between divisions.

* unaudited

Reputational risk*

Reputational risk is the risk of brand damage and/or financial loss due to a failure to meet stakeholders' expectations of the Group's conduct and performance.

Stakeholders include customers, investors, rating agencies, employees, suppliers, government, politicians, regulators, special interest groups, consumer groups, media and the general public. Brand damage can be detrimental to the business in a number of ways, including an inability to build or sustain business relationships with customers, low staff morale, regulatory censure or reduced access to funding sources.

One of the most fundamental stakeholder expectations is that a bank is financially prudent, safe and sound. The Group has made significant progress in meeting this expectation through the execution of its Strategic Plan in restructuring its balance sheet and improving its capital and funding position. Major reforms have also been made to strengthen its risk identification, evaluation and management processes. Further work remains, but the Group is now in a much stronger financial position to face challenges and uncertainties in its economic and operating environment.

Restoring the reputation of the Group and the wider banking sector is built upon the role of banks as good companies that perform well for their owners, regulators, employees and communities and, above all else, serve their customers well.

The Group has put the focus on serving customers well at the heart of its strategic objectives that, combined with a safe and sound bank, will build a culture and reputation in line with our stakeholder expectations. There are still legacy issues to work through, but dealing with them in an open and direct manner is a necessary part of the ability to move forward.

The Group's reputational risk management framework is aligned with its strategic objectives and its risk appetite goal of maintaining stakeholder confidence. It is designed to embed, at different points of decision-making processes, a series of reputational filters and controls that examine products, services and activities through the lenses of sustainability, transparency and fairness.

This approach recognises that reputational risk can arise across a range of actions taken (or not taken) by the Group, as well as its wider conduct, policies and practices. Therefore, it is aligned with the management of a range of risk types that have a high reputational sensitivity.

The Group Board risk report contains a 'top slice' view of key embedded risks, including a reputational risk impact assessment of each key risk. In addition, the divisions report to their own committees and Boards on relevant barometers of reputational risk and actions to manage reputational events according to the source.

For example, an Environmental, Social and Ethical (ESE) risk management function assesses the ESE risks associated with business engagements and business divisions, while the Group Policy Framework includes a range of policies relating to conduct and reputational matters. (For credit risk specific information on ESE risk policies, refer to Credit risk management framework on page 119).

The Group Board has ultimate responsibility for managing the Group's reputation, though all parts of the Group have responsibility for any reputational impact arising from their operations. The Board's oversight of reputational issues is supported by executive risk committees (including a new Conduct Risk Committee) and by the Group Sustainability Committee. Emerging reputational issues are pro-actively identified and assessed by a dedicated working group, and

escalated through the appropriate governance channels where necessary.

Business risk*

Business risk is the risk that the Group suffers losses as a result of adverse variance in its revenues and/or costs relative to its business plan and strategy. Such variance may be caused by internal factors such as volatility in pricing, sales volumes and input costs and/or by external factors such as the Group’s exposure to macroeconomic, regulatory and industry risks.

Business risk is impacted by other risks the Group faces that may contribute to the adverse changes in the Group's revenues and/or costs, were these risks to crystallise. Examples of such risks include funding risk (through volatility in cost of funding), interest rate risk in the banking book, operational risk, conduct risk and reputational risk.

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. Expected profiles for revenues and costs are determined, on a bottom-up basis, through plans reflecting expectations of the external environment and the Group’s strategic priorities. These profiles are tested against a range of stress scenarios and factors to identify the key risk drivers behind any potential volatility, along with management actions to address and manage them.

The Group operates a rolling forecast process which identifies projected changes in, or risks to operating profit and ensures appropriate actions are taken.

The Group Board has ultimate responsibility for the impact of any volatility in revenues and costs on the Group’s performance. Business risk is incorporated within the Group’s risk appetite target for earnings volatility, with an assessment of volatility in revenues and costs a key component in determining whether the Group and its underlying businesses are within risk appetite.

The management of business risk lies primarily with divisions, with oversight at the Group level led by Finance. Divisions are responsible for delivery of their business plans and management of such factors as pricing, sales volumes, marketing spend and other factors that can introduce volatility into earnings.

* unaudited

Other risks continued

Pension risk*

The Group is exposed to risk from its defined benefit pension schemes to the extent that the assets of the schemes do not fully match the timing and amount of the schemes' liabilities. Pension scheme liabilities vary with changes in long-term interest rates and inflation in particular, as well as pensionable salaries, the longevity of scheme members and changes in legislation. The Group is exposed to the risk that the market value of the schemes' assets, together with future returns and any additional future contributions could be considered insufficient to meet the liabilities as they fall due. In such circumstances, the Group could be obliged, or may choose, to make additional contributions to the schemes or be required to hold additional capital to mitigate such risk.

The RBS Group Pension Fund ('Main scheme') is the largest of the schemes and the main source of pension risk. The Main scheme operates under a trust deed under which the corporate trustee, RBS Pension Trustee Limited, is a wholly owned subsidiary of The Royal Bank of Scotland plc. The trustee board comprises six directors selected by the Group and four directors nominated by members.

The trustee is solely responsible for the investment of the Main scheme's assets which are held separately from the assets of the Group. Significant changes to asset strategy are discussed with the Group's Pension Risk Committee, which was established in 2011. The Group and the trustee must also agree on the Main scheme's funding plan.

In October 2006, the Main scheme was closed to new employees. In November 2009, the Group confirmed that it was making changes to the Main scheme and a number of other defined benefit schemes including the introduction of a limit of 2% per annum (or the annual change in the Consumer Price Index, if lower) to the amount of any salary increase that will count for pensionable purposes. In October 2012, the Group confirmed that it was increasing the charge made through its flexible benefits programme for membership of the Main scheme by 5% of salaries, with employees having the alternative of accepting an increase in their Normal Pension Age from 60 to 65 in respect of service from October 2012 at no additional cost.

Risk appetite and investment policy are agreed by the trustee with quantitative and qualitative input from the scheme actuaries and investment advisers. The Investment Executive, which acts on behalf of the trustee of the Group's largest pension schemes, also consults with the Group to obtain its view on the appropriate level of risk within the pension fund.

Risk management framework

The Group manages the risk it faces as a sponsor of its defined benefit pension schemes using a pension risk management framework that encompasses risk reporting and monitoring, stress testing, modelling and an associated governance structure that helps ensure the Group is able to fulfil its obligation to support the defined benefit pension schemes to which it has exposure.

Reporting and monitoring

The Group maintains an independent view of risk from a sponsor perspective within its pension funds. It achieves this through regular pension risk reporting and monitoring to the Group Board, Group Executive Committee and Group Board Risk Committee on the material pension schemes that the Group has an obligation to support.

Stress testing and modelling

Throughout 2012, various pension risk stress testing initiatives were undertaken, focused both on internally defined scenarios and on scenarios to meet integrated FSA stress testing requirements. On an annual basis, the Internal Capital

Adequacy Assessment Process is also modelled. This entails assessing changes in pension asset and liability values over a 12-month horizon under various stresses and scenarios.

Governance

A key component of the pension risk framework is the Pension Risk Committee. This committee also serves as a formal link between the Group and the Investment Executive, which acts on behalf of the trustee of the Group's largest pension schemes, on risk management, asset strategy and financing issues and has facilitated an agreement between the two on mechanisms for reducing risk within the RBS Group Pension Fund.

As part of the continuing development of the pension risk management framework within the Group, key achievements in 2012 focused on developing an improved pension risk reporting, monitoring, modelling and stress testing capability for the Group. The focus for 2013 will revolve around extending and embedding these improvements across the Group.

Main scheme

The most recent funding valuation, at 31 March 2010, was agreed during 2011. It showed that the value of liabilities exceeded the value of assets by £3.5 billion at 31 March 2010, a ratio of assets to liabilities of 84%. In order to eliminate this deficit, the Group agreed to pay additional contributions each year over the period 2011 to 2018. These contributions started at £375 million per annum in 2011, increasing to £400 million per annum in 2013 and from 2016 onwards will be further increased in line with price inflation. Further details are provided in Note 4 of the consolidated accounts. The next funding valuation is due at 31 March 2013.

The assets of the Main scheme, which represent 85% of Group pension plan assets at 31 December 2012, are invested in a diversified portfolio of quoted and private equity, government and corporate fixed interest and index-linked bonds, and other assets including property and hedge funds. The trustee has taken measures to partially mitigate inflation and interest rate risks both by investing in suitable physical assets and by entering into inflation and interest rate swaps. The Main scheme also uses derivatives within its portfolio to manage the allocation to asset classes and to manage risk within asset classes.

* unaudited

Business review Risk and balance sheet management continued

The table below shows the sensitivity of the Main scheme's assets and liabilities (measured according to IAS 19 'Employee Benefits') to changes in interest rates and equity values at the year end, taking account of the current asset allocation and hedging arrangements.

	Change in value of assets £m	Change in value of liabilities £m	Increase in net pension obligations £m
At 31 December 2012			
Fall in nominal swap yields of 0.25% at all durations with no change in credit spreads or real swap yields	76	255	(179)
Fall in real swap yields of 0.25% at all durations with no change in credit spreads or nominal swap yields	578	995	(417)
Fall in credit spreads of 0.25% at all durations with no change in nominal or real swap yields	71	1,261	(1,190)
Fall in equity values of 10%	(862)	—	(862)
At 31 December 2011			
Fall in nominal swap yields of 0.25% at all durations with no change in credit spreads or real swap yields	106	200	(94)
Fall in real swap yields of 0.25% at all durations with no change in credit spreads or nominal swap yields	557	911	(354)
Fall in credit spreads of 0.25% at all durations with no change in nominal or real swap yields	104	1,118	(1,014)
Fall in equity values of 10%	(935)	—	(935)
At 31 December 2010			
Fall in nominal swap yields of 0.25% at all durations with no change in credit spreads or real swap yields	67	193	(126)
Fall in real swap yields of 0.25% at all durations with no change in credit spreads or nominal swap yields	355	799	(444)
Fall in credit spreads of 0.25% at all durations with no change in nominal or real swap yields	98	1,005	(907)
Fall in equity values of 10%	(1,083)	—	(1,083)

Governance report

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Letter from the Chairman

Dear Shareholder,

I am pleased to present our Corporate governance report for the 2012 financial year.

It has been a challenging year for the Group, and the banking sector as a whole, against a backdrop of difficult market conditions and a fast moving regulatory environment. We are fortunate to have engaged and dedicated Board members willing to commit extensive time, individually and collectively, to work towards the recovery of the Group and to build a sustainable business.

The Board

The Board has dealt with a very full agenda and key priorities during 2012 have been conduct risk and culture, the changing regulatory architecture and regulatory investigations. It is recognised that a real change is required in the culture of the banking industry and the Board is committed to driving the required change and setting the appropriate "tone from the top". The Board is fully engaged in the work to improve standards of behaviour within the RBS Group. We have also continued to drive the delivery of the Group's Strategic Plan and ensure the Group has sufficient capital and funding to make it safer and stronger for the long term. During 2013, the Board is expected to continue to focus on capital, funding and risk as well as delivery of the Strategic Plan.

As mentioned in my earlier letter to shareholders, events like the IT incident in the summer of 2012 and investigations into LIBOR and Markets controls have significantly increased the workload of the Board during the year. The Board has demonstrated strong engagement and leadership in dealing with these matters, and Board committees have also taken a very prominent role, assuming responsibility for specific issues. For example, the Group Audit Committee has assisted in the management of the intense regulatory agenda, the remediation of control issues in Markets and International Banking and the review of LIBOR, the Board Risk Committee has undertaken a review of the circumstances surrounding the IT incident and the Group Performance and Remuneration Committee has had an increased focus on accountability matters and stakeholder engagement. The Group Sustainability Committee has expanded its remit, as described below. As a result, the time commitment required from our non-executive directors is extremely onerous and I am grateful for their support.

The remit of the Group Remuneration Committee was reviewed during the year in light of the Group's Purpose, Vision and Values programme. Whilst the Committee already takes into account wider issues relating to people in making decisions about pay, it was agreed to give the Committee an expanded oversight role of performance in the round and the name of the Committee was changed to the Group Performance and Remuneration Committee to reflect this. The Group Sustainability Committee has also been given an enhanced role including sustainability and reputation issues related to customer and citizenship activities; overseeing delivery of the Purpose, Vision and Values cultural and behavioural change; and overseeing the sustainability aspects of the people agenda.

Further details on the role and principal activities of the Board are contained within the Corporate governance report on pages 253 to 301. Individual reports from the Group Audit Committee, Board Risk Committee and Group Performance and Remuneration Committee are also contained within the Corporate governance report.

Corporate Governance in RBS

We remain committed to the highest standards of governance, integrity and professionalism throughout the Group. As a global financial organisation, our governance framework operates across both our divisional and functional operating structure and geographically in the regions in which we operate. During 2012, we have continued to monitor

compliance with the Corporate Governance policy that we introduced in 2011 and key areas of focus have included risk governance and regional governance, both of which were reviewed by the Board Risk Committee on behalf of the Board.

Our statement of compliance with the UK Corporate Governance Code (the “Code”) dated June 2010 is set out on page 302. Our Corporate governance report also includes additional disclosures representing early compliance with a number of the new provisions introduced by the UK Corporate Governance Code dated September 2012 (the “2012 Code”). Reporting under the 2012 Code will take effect for our 2013 financial year.

Board and Committee Membership
We have had a period of stability recently in terms of Board membership and this has provided valuable continuity during a very busy year. John McFarlane stepped down from the Board in March 2012 and the experience and knowledge that he brought to the Board and the Group Performance and Remuneration Committee were greatly appreciated.

Some changes were made during the year to the composition of Board committees. Baroness Noakes joined the Board Risk Committee, Art Ryan joined the Group Performance and Remuneration Committee and Alison Davis became a member of the Group Sustainability Committee. These committees have benefitted from the skills and experience of these directors.

Whilst no new directors were appointed in 2012, the composition of the Board has been kept under review by the Group Nominations Committee during the year and we will continue to ensure that there is an appropriate balance of skills, experience and knowledge on the Board. The Board operates a formal boardroom diversity policy which aims to promote diversity in the composition of the Board. Under this policy, all Board appointments will be made on the basis of individual competence, skills and expertise measured against identified objective criteria and we already meet the target of 25 per cent female board representation. Further details on the boardroom diversity policy can be found on page 266.

Leadership and Board Effectiveness
As Chairman, I am responsible for ensuring we have an effective Board and for leading the Board. I am supported by the Group Nominations Committee in reviewing Board composition and the recruitment of new directors and by the Group Secretary on induction, continuing professional development, Board process (including information flows) and evaluation.

In leading the Board, I need to ensure that directors develop a good understanding of the Group's business and can support the executive team in delivering the Group's Strategic Plan. Directors' knowledge is enhanced through site visits, in-depth board presentations and, for new directors, their induction programme. I actively encourage a culture and environment in the boardroom that facilitates debate and where non-executive directors are able to provide constructive challenge to management.

We conduct an annual evaluation of the effectiveness of the Board and this year's evaluation was facilitated externally. I also evaluate the individual performance of each of the non-executive directors and all directors stand for re-election annually. This year's evaluation has concluded that the Board is operating effectively and has suggested some further improvements that could be made to the operation of the Board and we will be acting upon these suggestions during 2013. Further details on performance evaluation are set out on page 264.

Finally, I would like to thank both the executive and non-executive directors for their outstanding commitment and their contributions to the Board and committees in 2012.

Philip Hampton
Chairman of the Board of directors
27 February 2013

Our governance structure

Group Board and Board committee structure

Group Board is the main decision making forum at Group level, setting the strategic direction of the Group and ensuring that the Group manages risk effectively. The Board is accountable to shareholders for financial and operational performance.

Group Audit Committee assists the Board in discharging its responsibilities for the disclosure of the financial affairs of the Group. It reviews the accounting policies, financial reporting and regulatory compliance practices of the Group and the Group's system and standards of internal controls, and monitors the Group's processes for internal audit and external audit.

Board Risk Committee provides oversight and advice to the Board on current and potential future risk exposures of the Group and risk strategy. It reviews the Group's performance on risk appetite and oversees the operation of the Group Policy Framework.

Group Performance and Remuneration Committee (formerly Group Remuneration Committee) has oversight of the Group's policy on remuneration. It also considers senior executive remuneration and makes recommendations to the Board on remuneration of executive directors.

Group Nominations Committee assists the Board in the selection and appointment of directors. It reviews the structure, size and composition of the Board, and membership and chairmanship of Board committees.

Group Sustainability Committee is responsible for overseeing and challenging how management is addressing sustainability and reputation issues relating to all stakeholder groups, except where such issues have already been dealt with by other Board committees.

Executive Committee is responsible for managing Group-wide issues and those operational issues that affect the broader Group. It reviews strategic issues and initiatives, monitors financial performance and capital allocations and considers risk strategy, policy and risk management.

Our board

Chairman		
	Philip Hampton (age 59) Date of appointment: appointed to the Board on 19 January 2009 and to the position of Chairman on 3 February 2009 Previously chairman of J Sainsbury plc and group finance director at Lloyds TSB Group, BT Group plc, BG Group plc, British Gas and British Steel plc, an executive director of Lazards and a non-executive director of RMC Group plc and Belgacom SA. He is also a former chairman of UK Financial Investments Limited, which manages the UK Government's shareholdings in banks.	External appointments · Non-executive director of Anglo American plc Board Committee membership · Group Nominations Committee (Chair)
Executive directors		
Group Chief Executive	Stephen Hester (age 52) Date of appointment: appointed to the Board on 1 October 2008 and to the position of Group Chief Executive on 21 November 2008 Previously chief executive of The British Land Company PLC, chief operating officer of Abbey National plc and prior to that held positions with Credit Suisse First Boston including chief financial officer, head of fixed income and co-head of European investment banking. After nationalisation in 2008, he served as non-executive Deputy Chairman of Northern Rock plc.	External appointments · Trustee of The Foundation and Friends of the Royal Botanical Gardens, Kew Board Committee membership · Executive Committee
Group Finance Director	Bruce Van Saun (age 55) Date of appointment: 1 October 2009 Extensive leadership experience with 30 years in the financial services industry. From 1997 to 2008 he held a number of senior positions with Bank of New York and later Bank of New York Mellon, most recently as vice-chairman and chief financial officer and before that was responsible for Asset Management and Market Related businesses. Prior to that he held senior positions with Deutsche Bank, Wasserstein Perella Group and Kidder Peabody & Co. He has served on several corporate boards as a non-executive director and has been active in	External appointments · Non-executive director of Direct Line Insurance Group plc · Non-executive director of Lloyd's of London Franchise Board · Non-executive director of Worldpay (Ship Midco Limited) Board Committee membership · Executive Committee

numerous community organisations.

Our board continued

Independent non-executive directors

Sandy Crombie (age 64)
Senior Independent Director
Date of appointment: 1 June 2009

Previously group chief executive of Standard Life plc. He was also previously a director of the Association of British Insurers, a member of the former Chancellor of the Exchequer's High Level Group on Financial Services and Chairman of the Edinburgh World City of Literature Trust. In 2007 he was the Prince of Wales' Ambassador for Corporate Social Responsibility in Scotland.

External appointments
- Chairman of Creative Scotland
- Member and vice-chairman of the Board of Governors of The Royal Conservatoire of Scotland
- President of the Cockburn Association

Board Committee membership
- Group Sustainability Committee (Chair)
- Board Risk Committee
- Group Nominations Committee
- Group Performance and Remuneration Committee

Alison Davis (age 51)
Date of appointment: 1 August 2011

Former director of City National Bank, First Data Corporation and chair of the board of LECG Corporation. She previously worked at McKinsey & Company, AT Kearney, as chief financial officer at Barclays Global Investors (now BlackRock) and managing partner of Belvedere Capital, a private equity firm focused on buy-outs in the financial services sector.

External appointments
- Non-executive director of Unisys Corporation
- Non-executive director, chair of compensation committee and member of audit committee of Diamond Foods Inc.
- Non-executive director, chair of audit committee and member of compliance committee of Xoom Corporation
- Chair of the Governing Board of Women's Initiative for Self Employment

Board Committee membership
- Group Nominations Committee
- Group Performance and Remuneration Committee
- Group Sustainability Committee

Tony Di Iorio (age 69)
Date of appointment: 1 September 2011

Has worked for a variety of financial institutions starting with Peat Marwick (now

External appointments
- None

Board Committee membership
- Board Risk Committee

KPMG) and then Goldman Sachs, ultimately as controller of the global firm. He was chief financial officer of the investment bank of NationsBank (now Bank of America) before joining Paine Webber and then Deutsche Bank where he became chief financial officer in 2006. After retiring in 2008 he served as senior adviser to Ernst & Young working with the firm's financial services partners in the UK, Europe, the Middle East and Africa.

- Group Audit Committee
- Group Nominations Committee

Independent non-executive directors

Penny Hughes, CBE (age 53)
Date of appointment: 1 January 2010

Previously a director and chairman of the Remuneration Committee of Skandinaviska Enskilda Banken AB and a non-executive director of Home Retail Group plc and chairman of its Remuneration Committee. She spent the majority of her executive career at Coca-Cola where she held a number of leadership positions, latterly as President, Coca-Cola Great Britain and Ireland. Former non-executive directorships include Vodafone Group plc, Reuters Group PLC, Cable & Wireless Worldwide plc and The Gap Inc.

External appointments

- Non-executive director, chair of corporate compliance and responsibility committee and member of audit, nomination and remuneration committees of Wm Morrison Supermarkets plc
- Trustee of the British Museum

Board Committee membership

- Group Performance and Remuneration Committee (Chair)
- Group Nominations Committee

Joe MacHale (age 61)
Date of appointment: 1 September 2004

Held a number of senior executive positions with J.P. Morgan between 1979 and 2001 and was latterly chief executive of J P Morgan Europe, Middle East and Africa Region. Previously held non-executive roles at The Morgan Crucible Company plc and Brit Insurance Holdings plc and former Trustee of MacMillan Cancer Support. He is a Fellow of the Institute of Chartered Accountants.

External appointments

- Chairman of Prytania Holdings LLP
- Chairman of the Brendoncare Foundation
- Non-executive director of Huntsworth plc

Board Committee membership

- Board Risk Committee
- Group Nominations Committee

Brendan Nelson (age 63)
Date of appointment: 1 April 2010

Former global chairman, financial services for KPMG. Previously held senior leadership roles within KPMG including as a member of the KPMG UK board from 1999 to 2006 and as vice chairman from 2006. Chairman of the Audit Committee of the Institute of Chartered Accountants of Scotland from 2005 to 2008.

External appointments

- Non-executive director and chairman of the audit committee of BP plc
- Board member of Financial Skills Partnership
- Member of the Financial Reporting Review Panel
- Deputy President of the Institute of Chartered Accountants of Scotland

Board Committee membership

- Group Audit Committee (Chair)
- Board Risk Committee

- Group Nominations Committee

Baroness Noakes, DBE (age 63)
Date of appointment: 1 August 2011

An experienced director on UK listed company boards with extensive and varied political and public sector experience. A qualified chartered accountant, she previously headed KPMG's European and International Government practices and has been President of the Institute of Chartered Accountants in England and Wales. She was appointed to the House of Lords in 2000 and has served on the Conservative front bench in various roles including as shadow treasury minister between 2003 and May 2010. Previously held non-executive roles on the Court of the Bank of England, Hanson, ICI, John Laing and SThree.

External appointments

- Non-executive director and chairman of audit committee of Severn Trent plc
- Deputy chairman and senior independent director and chairman of the nominations committee of Carpetright plc
- Trustee of the Thomson Reuters Founders Share Company Ltd

Board Committee membership

- Board Risk Committee
- Group Audit Committee
- Group Nominations Committee

Our board continued

Independent non-executive directors

Arthur 'Art' Ryan (age 70)
Date of appointment: 1 October 2008

Former chairman, chief executive officer and president of Prudential Financial Inc. Previously he held senior positions with Chase Manhattan Bank N.A. and was a founding member of the Financial Services Forum. He is a non-executive director of RBS Citizens Financial Group, Inc.

External appointments

- Non-executive director of Regeneron Pharmaceuticals Inc.
- Active member of numerous community boards

Board Committee membership

- Group Nominations Committee
- Group Performance and Remuneration Committee

Philip Scott (age 59)
Date of appointment: 1 November 2009

Wide-ranging experience of financial services and risk management, including previous responsibility for Aviva's continental European and International life and long-term savings businesses. He held a number of senior executive positions during his career at Aviva including his role as group finance director until January 2010. President of the Institute and Faculty of Actuaries and Fellow of the Association of Certified Public Accountants.

External appointments

- Non-executive director and chairman of the audit committee of Diageo plc

Board Committee membership

- Board Risk Committee (Chair)
- Group Audit Committee
- Group Nominations Committee

Group Secretary

Aileen Taylor (age 40)
Date of appointment: 1 May 2010

A qualified solicitor, joined RBS in 2000. She was appointed Deputy Group Secretary and Head of Group Secretariat in 2007, and prior to that held various legal, secretariat and risk roles including Head of External Risk, Retail, Head of Regulatory Risk, Retail Direct and Head of Legal and Compliance at Direct Line Financial Services.

She is a fellow of the Chartered Institute of Bankers in Scotland and a member of the European Corporate Governance Council.

Executive Committee

Stephen Hester, Group Chief Executive
Bruce Van Saun, Group Finance Director
For biographies see page 257

Ellen Alemany (age 57)
Chief Executive, RBS Citizens and Head of Americas
Ellen Alemany joined the RBS Group in June 2007 as Head of RBS Americas. She became Chief Executive Officer of RBS Citizens Financial Group, Inc. in March 2008 and Chairman in March 2009. Prior to these appointments, Ellen was the chief executive officer for Global Transaction Services at Citigroup, one of Citi's 12 publicly reported product lines. Ellen joined Citibank in 1987 and held various positions including executive vice-president for Commercial Business Group, chairman and chief executive officer for Citibank International plc and Citibank's European bank. She also served on the Citibank, N.A., Board of Directors. Ellen was elected to serve on the Board of Directors of Automatic Data Processing, Inc., beginning in January 2012.

Nathan Bostock (age 52)
Head of Restructuring & Risk
Nathan Bostock joined the RBS Group in June 2009. He is Head of Restructuring and Risk with responsibility for Risk Management, Legal & Regulatory Affairs and the Global Restructuring Group. Before joining RBS, Nathan spent eight years with Abbey National plc in several roles and was latterly the chief financial officer and main board director responsible for Products & Marketing, HR, Insurance and Cards. Before joining Abbey in 2001, Nathan spent ten years with RBS in a number of roles, including Chief Operating Officer of Treasury and Capital Markets and Group Risk Director. A Chartered Accountant, Nathan worked with Coopers & Lybrand, before starting his career in banking. He spent seven years in Chase Manhattan Bank in a variety of areas and functions. He also holds a BSc (Hons) in Mathematics.

Ross McEwan (age 55)
Chief Executive, UK Retail
Ross McEwan was appointed Chief Executive Officer for UK Retail in August 2012. Ross joined RBS from Commonwealth Bank of Australia where he was Group Executive for Retail Banking Services for 5 years and prior to that position Ross was Executive General Manager in charge of its branch network, contact centres and third party mortgage brokers. Ross has worked in the insurance and investment industries both in Australia and New Zealand for more than 25 years. He has extensive management experience having spent 18 years in senior executive roles including Managing Director of stockbroking business First NZ Capital Securities and Chief Executive of National Mutual Life Association of Australasia Ltd/AXA New Zealand Ltd. Ross holds a Bachelor of Business Studies, majoring in Industrial Relations & Personnel Management.

John Hourican (age 42)
Chief Executive, Markets & International Banking
John Hourican was appointed Chief Executive, Markets & International Banking in January 2012 having served as Chief Executive of its predecessor, Global Banking & Markets, since October 2008. Prior to this John held a variety of positions across the RBS Group. John is a fellow of the Institute of Chartered Accountants in Ireland and received a degree in Economics and Sociology from the National University of Ireland and a Postgraduate Diploma in Accounting from Dublin City University.

On 6 February 2013, the Group announced that John Hourican 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 all will report directly to the Group Chief Executive.

Chris Sullivan (age 55)
Chief Executive, Corporate Banking
Chris Sullivan was appointed Chief Executive of the Corporate Banking Division in August 2009 and also has responsibility for Ulster Bank Group. Chris' previous role was as Chief Executive of RBS Insurance. Prior to this, Chris was Chief Executive of Retail and Deputy Chief Executive of Retail Markets. Chris is the Group sponsor for Gender Diversity and the Group's internal Women's Networks and was recognised as the European Diversity Champion of the Year in 2011. He is an active sponsor of professional and leadership development and is a member of the Chartered Banker Professional Standards Board and Governor of both Ashridge College and the ifs School of Finance. Chris holds a number of positions outside the Group including Chairman of both the Global Banking Alliance and the Inter-Alpha Group of Banks. Chris earned his Fellowship of the Chartered Institute of Bankers in Scotland for his services to Scottish Banking.

Ron Teerlink (age 52)
Chief Administrative Officer
Ron Teerlink joined the RBS Group in April 2008 as Chief Executive of Business Services, becoming the Group Chief Administrative Officer in February 2009. At the same time he was re-appointed to the Managing Board of ABN AMRO to oversee the integration programme. Ron started his career with ABN Bank in 1986 as an IT/Systems analyst and held various functional positions before becoming Chief Operating Officer of the Wholesale Clients Business in 2002. He was appointed Chief Executive Officer of Group Shared Services in 2004 and joined ABN AMRO's Managing Board in January 2006, where he was responsible for Services and Market Infrastructure. Ron holds a Masters degree in Economics from Amsterdam's Vrije Universiteit. Ron will step down from his role at RBS in the first half of 2013.

Management Committee
The Management Committee, comprising our major business and functional leaders, meets as required to review strategy and business performance.

It comprises members of the Executive Committee plus a number of other senior executives. Full details of membership of the Management Committee can be found on the Group's website www.rbs.com

Corporate governance

The Role of the Board

The Board is the main decision-making forum for the company. It is collectively responsible for the long-term success of the company and is accountable to shareholders for financial and operational performance.

The Board has overall responsibility for:

- establishment of Group strategy and consideration of strategic challenges;
- management of the business and affairs of the Group;
- ensuring the Group manages risk effectively through the approval and monitoring of the Group's risk appetite;
- considering stress scenarios and agreed mitigants and identifying longer term strategic threats to the Group's business operations;
- the allocation and raising of capital; and
- the preparation and approval of the Group's annual report and accounts.

The Board's terms of reference include key aspects of the company's affairs reserved for the Board's decision and are reviewed at least annually. The terms of reference are available on the Group's website www.rbs.com.

There are a number of areas where the Board has delegated specific responsibility to management, including to the Group Chief Executive and the Group Finance Director. These include responsibility for the operational management of the Group's businesses as well as reviewing high level strategic issues and considering risk appetite, risk policies and risk management strategies in advance of these being considered by the Board and/or its Committees. Specific delegated authorities are also in place in relation to business commitments across the Group.

All directors participate in discussing strategy, performance and the financial and risk management of the company. Meetings of the Board are structured to allow sufficient time for consideration of all items and the Chairman encourages constructive challenge and debate.

Membership of the Board

The Board currently comprises the Chairman, two executive directors and nine independent non-executive directors, one of whom is the Senior Independent Director. The Board functions effectively and efficiently and is considered to be of an appropriate size. The directors provide the Group with the knowledge, mix of skills and experience required. The Board committees comprise directors with a variety of relevant skills and experience so that no undue reliance is placed on any individual.

The names and biographical details of the current members of the Board are shown on pages 257 to 260.

The Board is aware of the other commitments of its directors and is satisfied that all directors allocate sufficient time to enable them to discharge their responsibilities effectively.

Under the Companies Act 2006, directors have a duty to avoid conflicts of interest unless authorised. The Board has, since this duty was introduced in 2008, operated procedures for ensuring that the Board's powers for authorising directors' conflicts of interest (as set out in the Articles of Association) are being operated effectively. The Board has

therefore considered, and where appropriate authorised, any actual or potential conflicts of interest that directors may have. The Board reviews its conflicts register annually.

Election and re-election of directors

In accordance with the provisions of the Code, all directors of the company are required to stand for re-election annually by shareholders at the company's Annual General Meeting. Further information in relation to the company's Annual General Meeting can be found in the Chairman's letter to shareholders that accompanies the notice of meeting.

Board balance and independence

The roles of Chairman and Group Chief Executive are distinct and separate, with a clear division of responsibilities. The Chairman leads the Board and ensures the effective engagement and contribution of all executive and non-executive directors. The Group Chief Executive has responsibility for all Group businesses and acts in accordance with the authority delegated by the Board.

The non-executive directors combine broad business and commercial experience with independent and objective judgement. The non-executive directors provide independent challenge to the executive directors and the leadership team. The balance between non-executive and executive directors enables the Board to provide clear and effective leadership across the Group's business activities.

The Board considers that the Chairman was independent on appointment and that all non-executive directors are independent for the purposes of the Code. The standard terms and conditions of appointment of non-executive directors are available on the Group's website www.rbs.com and copies are available on request from RBS Secretariat.

Board meetings
In 2012, nine Board meetings were scheduled and individual attendance by directors at these meetings is shown in the following table. One of the Board meetings took place overseas during the Board's visit to the Group's US businesses.

In addition to the nine scheduled meetings, 28 additional meetings of the Board and Committees of the Board were held, including meetings to consider and approve financial statements. The Chairman and the non-executive directors meet at least once per year without executive directors present.

Total number of Board meetings in 2012	Attended/ scheduled
Sandy Crombie	9/9
Alison Davis	9/9
Tony Di Iorio	9/9
Philip Hampton	9/9
Stephen Hester	9/9
Penny Hughes	9/9
Joe MacHale	9/9
Brendan Nelson	9/9
Baroness Noakes	9/9
Art Ryan (1)	6/9
Philip Scott	9/9
Bruce Van Saun	9/9
Former director	
John McFarlane (2)	2/2

Notes:
(1) Unable to attend a number of Board meetings during 2012 due to family illness.
(2) Retired from the Board on 31 March 2012.

Principal activities of the Board during 2012
In advance of each Board meeting, the directors were supplied with comprehensive papers in hard copy and/or electronic form.

At each Board meeting, the Chairman provided a verbal update on his activities and external engagement and the Group Chief Executive provided a written report on business activities. The Board's key priorities during 2012 have been conduct risk and culture, regulatory developments and investigations and the continued delivery of the Group's Strategic Plan. The directors received reports on the Group's financial performance, capital, funding and liquidity positions and risk management together with regular reports on strategy, risk appetite, litigation and treating customers fairly. Specific strategy sessions were held in January, April and June. Other matters considered by the Board during 2012 included the Independent Commission on Banking reports, Recovery and Resolution Planning and Technology. Strategy, capital, funding and risk are expected to remain key areas of focus for the Board during 2013.

Members of the executive management team attend and make regular presentations at meetings of the Board to give the directors greater insight into the business areas.

An annual programme of divisional presentations is agreed by the Board each year. During 2012, the Board received in-depth presentations from Direct Line Group, Wealth, Global Restructuring Group, UK Corporate, Non-Core, Ulster Bank Group, RBS Citizens Financial Group, UK Retail, Markets and International Banking. These presentations

enhance the Board's knowledge of the Group's key divisions and afford directors the opportunity for discussion and debate with divisional senior management.

Board committees
In order to provide effective oversight and leadership, the Board has established a number of Board committees with particular responsibilities. The Committee chairmanship and membership are reviewed on a regular basis. The names and biographies of all Board Committee members are set out on pages 257 to 260.

The terms of reference of the undernoted committees, together with the Group Nominations Committee and Group Sustainability Committee, are available on the Group's website www.rbs.com and copies are available on request from RBS Secretariat.

The Board committees are discussed in their individual reports:

Group Audit Committee - pages 268 to 274.
Board Risk Committee - pages 275 to 278.
Group Performance and Remuneration Committee - pages 279 to 299.

Information, induction and professional development
All directors receive accurate, timely and clear information on all relevant matters. All directors also have access to the advice and services of the Group Secretary who is responsible to the Board for ensuring that Board procedures are followed and for advising on all governance matters. In addition, all directors are able, if necessary, to obtain independent professional advice at the company's expense.

In line with the recommendations of the Walker Review of Governance in Banks and Financial Institutions (the Walker Review) and the Code, the Group has a comprehensive induction programme for new directors that is kept under review by the Group Secretary. Each new director receives a formal induction on joining the Board, including visits to the Group's major divisions and meetings with directors and senior management and key stakeholders. Each induction programme includes a mandatory element which comprises 12 meetings, visits and sessions. The remainder of the induction programme is tailored to the new director's specific requirements and includes meetings with key executives and their teams and visits to divisions, businesses and Group functions, both in the UK and overseas.

As part of their ongoing professional development, directors are advised of appropriate external training and professional development opportunities and undertake the training and professional development they consider necessary to assist them to carry out their duties as directors. Internal training is also provided, tailored to the business of the Group. Continuing professional development logs are maintained by the Group Secretary and are reviewed regularly with directors to ensure training and development opportunities are tailored to individual directors' requirements.

Corporate governance continued

In 2012, as part of their ongoing development, the directors received briefings on the UK Bribery Act 2010, the new UK regulatory regime, various Financial Reporting Council consultations (including amendments to the Code, audit committee guidelines, the stewardship code and international standards on auditing for the UK and Ireland), a number of government consultations on narrative reporting, executive remuneration and shareholder voting rights and the draft proposals under the Capital Requirements Directive IV, as well as other regulatory consultations.

Business visits are also arranged as part of the Group Audit Committee and Board Risk Committee schedule and all non-executive directors are invited to attend. The Group Audit Committee and the Board Risk Committee undertook a total of six visits in 2012 to RBS Risk Management (2), Group Internal Audit (2), Group Finance and Business Services to review the Change programme.

Performance evaluation
In accordance with the Code, an external evaluation of the Board takes place every three years. An internal evaluation takes place in the intervening years.

The 2011 evaluation was conducted internally by the Group Secretary and a number of initiatives were implemented aimed at improving the overall performance and effectiveness of the Board. These included additional improvements to the flow of information to the Board, appointment of additional Directors to Board committees and additional succession planning sessions. The 2012 evaluation concluded that the recommendations from the 2011 evaluation had been implemented in full.

In 2012, the Board and Committee evaluation process was independently facilitated by IDDAS Limited, a specialist board evaluation consultancy. IDDAS Limited were selected following a competitive tender and the Board is satisfied that IDDAS Limited has no other connection with the Group.

Performance evaluation process
IDDAS Limited undertook a formal and rigorous evaluation by:

- using a detailed framework of questions which was used to structure individual meetings held with each director;
- discussing the outcomes and recommendations with the Chairman; and;
- recommending the outcomes and areas for improvement to the Board members.

Amongst the areas reviewed were Board structure, membership (including diversity) and processes, Board committees, Director competence, independence and behaviour.

Outcomes of the 2012 performance evaluation
The 2012 performance evaluation has concluded that the Board and Board committees are operating effectively. The key findings were as follows:-

- the Group has a highly capable Board which is well-balanced and diverse, with the skills required to respond to the very full agenda and key priorities of the Group;
- Board composition and executive succession planning should remain under review;
-

the Board is headed by a strong and effective Chairman and Board meetings are open and transparent with constructive discussion, particularly around culture. The skills and contribution that the executive directors bring to the Board was recognised;

- as a result of the continued challenging external and regulatory environment, and the number of regulatory investigations, a substantial time commitment is required from the non-executive directors;

- whilst improvements in the quality and clarity of Board and Board Committee papers during 2012 was acknowledged, Board information flows should remain under review so that improvements can be made on a continuous basis;

- Board committees continue to play a key role supporting the work of the Board and the directors, individually and collectively, dedicate extensive time to the Group; and

- given the increased focus on culture, the role and responsibilities of the Group Sustainability Committee should be enhanced in respect of cultural and behavioural issues.

A summary of the key themes arising from 2012 performance evaluation is set out below, together with an overview of the proposed actions:

Key themes included	Proposed action
Board composition	The composition of the Board and Board committees to remain under review to ensure the board has the appropriate balance of skills, experience, independence and knowledge.
Board and executive succession planning	The Board and Group Nominations Committee to review board and executive succession planning.
Board Papers	RBS Secretariat to establish a board-sponsored, multi-disciplinary project, to devise an optimal board information pack, with summaries and levels of depth to suit each reporting area or issue.
Group Sustainability Committee	The Group Sustainability Committee to be given an expanded remit for customer related sustainability and reputation issues, oversight of cultural and behavioural change, and sustainability aspects of the people agenda.

Individual director and Chairman effectiveness reviews
The Chairman met with each director individually to discuss their own performance and ongoing professional development and also shared peer feedback that had been provided as part of the evaluation process. Separately, IDDAS Limited sought feedback on the Chairman's performance and prepared the Chairman's development report. The Senior Independent Director also canvassed the views on the Chairman's performance from the non-executive directors collectively. The results of the Chairman's effectiveness review were then discussed by the Chairman and the Senior Independent Director.

Group Nominations Committee
Role of the Group Nominations Committee
The Group Nominations Committee is responsible for:

- reviewing the structure, size and composition of the Board and making recommendations to the Board on any appropriate changes;

- assisting the Board in the formal selection and appointment of directors (executive and non-executive) having regard to the overall balance of skills, knowledge, experience and diversity on the Board;

- reviewing membership and chairmanship of Board committees;

- considering succession planning for the Chairman and the executive and non-executive directors, taking into account the skills and expertise which will be needed on the Board in the future. No director is involved in decisions regarding his or her own succession; and

- making recommendations to the Board concerning the re-election by shareholders of directors under the provisions of the Code. In so doing, they will have due regard to their performance and ability to continue to contribute to the Board in light of the knowledge, skills and experience required and the need for progressive refreshing of the Board.

The Group Nominations Committee engages with external consultants, considers potential candidates and recommends appointments of new directors to the Board. The terms of reference of the Group Nominations Committee are available on the Group's website www.rbs.com

Membership of the Group Nominations Committee
All non-executive directors are members of the Group Nominations Committee which is chaired by the Chairman of the Group. The Group Chief Executive is invited to attend meetings. The Group Nominations Committee holds at least two scheduled meetings per year, and also meets on an ad hoc basis as required. In 2012, four meetings of the Group Nominations Committee were held.

The Chairman and members of the Committee during 2012, together with their attendance at meetings in 2012, is shown below.

Total number of meetings in 2012	Attended/ scheduled
Philip Hampton (Chairman)	4/4
Sandy Crombie	4/4
Alison Davis	4/4
Tony Di lorio	4/4
Penny Hughes	4/4

Joe MacHale	4/4
Brendan Nelson	4/4
Baroness Noakes	4/4
Art Ryan (1)	3/4
Philip Scott	4/4
Former member	
John McFarlane (2)	1/1

Notes:
(1) Unable to attend one Committee meeting during 2012 due to family illness.
(2) Retired from the Board on 31 March 2012.

The table below sets out the tenure of non-executive directors.

Principal activity of the Group Nominations Committee during 2012

Consideration of new non-executive directors

During 2012, the Group Nominations Committee kept the structure, size and composition of the Board under review as well as the diversity of skills and experience. Given that Joe MacHale was expected to step down from the Board during 2013, having served as a Non-executive Director since 2004, the Group Nominations Committee agreed to commence a search for a potential additional non-executive director.

The Chairman and Group Secretary developed a role profile and skills matrix and engaged Egon Zehnder International, specialist search consultants, to compile a list of candidates with relevant skills and experience. This was to ensure that the Group Nominations Committee had access to a wide pool of potentially suitable candidates and the search for potential candidates remains ongoing. Egon Zehnder International does not provide services to any other part of the Group.

Board and Committee membership
At the request of the Board and taking into consideration feedback from the Board committee evaluations and John McFarlane's departure, the Group Nominations Committee reviewed the membership of the Board committees. The Group Nominations Committee agreed to strengthen the Board Risk Committee with the appointment of Baroness Noakes, the Group Performance and Remuneration Committee with the appointment of Art Ryan, and the Group Sustainability Committee with the appointment of Alison Davis.

Boardroom diversity
The Board remains supportive of Lord Davies' recommendations and currently meets the target of 25 per cent female board representation as set out in Lord Davies' report. In accordance with the recommendations contained within Lord Davies' report, the Board operates a boardroom diversity policy and a copy of the Board's diversity statement is available on www.rbs.com

The Group understands the importance of diversity and recognises the importance of women having greater representation at key decision making points in organisations. The search for Board candidates will continue to be conducted, and nominations/appointments made, with due regard to the benefits of diversity on the Board. One of the challenges the Group faces in the promotion of gender diversity is identifying suitably qualified female Board candidates. Where appropriate, the Group has engaged specialist search consultants to assist in the search for suitable candidates. However, all appointments to the Board are ultimately based on merit, measured against objective criteria, and the skills and experience the individual can bring to the Board.

The balance of skills, experience, independence, knowledge and diversity on the Board, and how the Board operates together as a unit is reviewed annually as part of the Board evaluation. Where appropriate, findings from the evaluation will be considered in the search, nomination and appointment process. If appropriate, additional targets on diversity will be developed in due course.

Further details on the Group's approach to diversity can be found on pages 306 and 307.

Succession planning
The Group Nominations Committee considers succession planning on an ongoing basis and succession planning for the Board was considered at all Group Nominations Committee meetings during the year. The Board considered talent and succession planning for the Group Chief Executive and members of the Executive Committee specifically at meetings in June and October 2012, including a review of talent pools and development opportunities for potential successors. The Board continues to monitor succession planning taking into account business requirements and industry developments.

Group Sustainability Committee
During 2012, the Group Sustainability Committee focused on reviewing the Group's overall sustainability strategy, values and policies and aligning the Group's approach to ethical, social and environmental issues. The role, responsibilities and membership of the Committee were reviewed at the end of 2012 as part of the Group's Purpose, Vision and Values programme. In 2013, the Committee's scope will widen to include:-

- sustainability and reputational issues related to customer and 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.

In addition, the Committee will be responsible for overseeing and challenging how management is addressing sustainability and reputation issues relating to all stakeholder groups, except where such issues have already been dealt with by other Board committees.

Membership has been reviewed in line with the increased scope of the Committee and now consists of independent non-executive directors and is chaired by the Senior Independent Director. All key business areas are represented at Committee meetings and the Group Chairman is also invited to attend. The frequency of meetings will also increase from quarterly to six times per annum, in addition to more regular stakeholder engagement sessions.

Relations with investors

The Chairman is responsible for ensuring effective communication with shareholders. The company communicates with shareholders through the Annual Report and Accounts and by providing information in advance of the Annual General Meeting. Individual shareholders can raise matters relating to their shareholdings and the business of the Group at any time throughout the year by letter, telephone or email via the Group’s website www.rbs.com/ir

Shareholders are given the opportunity to ask questions at the Annual General Meeting or can submit written questions in advance. Directors including the chairs of the Group Audit, Board Risk, Group Performance and Remuneration and Group Nominations Committees are available to answer questions at the Annual General Meeting. The Senior Independent Director is also available.

Communication with the company's largest institutional shareholders is undertaken as part of the Investor Relations programme:

- the Group Chief Executive and Group Finance Director meet regularly with UKFI, the organisation set up to manage the Government's investments in financial institutions, to discuss the strategy and financial performance of the Group. The Group Chief Executive and Group Finance Director also undertake an extensive annual programme of meetings with the company's largest institutional shareholders.

- the Chairman independently meets with the Group's largest institutional shareholders annually to hear their feedback on management, strategy, business performance and corporate governance. Additionally, the Chairman, Senior Independent Director and chairs of the Board committees met with the governance representatives of a number of institutional shareholders during the year.

- the Senior Independent Director is available if any shareholder has concerns that they feel are not being addressed through the normal channels.

- the Chair of the Group Performance and Remuneration Committee consults extensively with institutional shareholders in respect of the Group's remuneration policy.

Throughout the year, the Chairman, Group Chief Executive, Group Finance Director and Chair of the Group Performance and Remuneration Committee communicate shareholder feedback to the Board and the directors receive independent analyst notes and reports reviewing share price movements and the Group's performance against the sector. Detailed market and shareholder feedback is also provided to the Board after major public announcements such as results announcements. The arrangements used to ensure that directors develop an understanding of the views of major shareholders and other stakeholders are considered as part of the annual Board evaluation.

The Group's Investor Relations programme also includes communications aimed specifically at its fixed income (debt) investors. The Group Finance Director and/or Group Treasurer give regular presentations to fixed income investors to discuss strategy and financial performance. Further information is available on the Group's website www.rbs.com/ir

Report of the Group Audit Committee

Letter from Brendan Nelson,
Chairman of the Group Audit Committee

Dear Shareholder,

External market conditions have continued to be difficult and managing the intensity of the regulatory agenda while remediating existing and certain new issues has inevitably determined the focus of the Group Audit Committee during 2012. However, I am pleased to report that against this challenging backdrop, the Committee continued to meet its key objectives in the period in accordance with its terms of reference.

The Group Audit Committee exercised oversight of the Group's financial reporting and policy. It monitored the integrity of the financial statements of the Group and reviewed significant financial and accounting judgements. The Committee sought to understand and to challenge management's accounting judgements and satisfied itself that disclosures in the financial statements about these judgements and estimates were transparent and appropriate. The Group Audit Committee also met the External Auditors in private in advance of key meetings in order to obtain an independent view on the key disclosure issues and risks in relation to the financial statements.

In particular, the Committee has considered:

- the directors' going concern disclosure including the Group's capital, liquidity and funding position;
- the adequacy of the Group's loan impairment provisions, focusing particularly on the Ulster Bank loan portfolio and commercial real estate exposures;
- the impact of the Group's forbearance policies on provisioning;
- the Group's valuation methodologies and assumptions for financial instruments measured at fair value;
- the adequacy of the Group's general insurance reserves;
- valuation of the Group's defined benefits pension schemes;
- carrying value of the Group's goodwill and other intangible assets;
- the recoverability of the Group's deferred tax assets;
- the methodology and assumptions underlying the Group's provisions for payment protection insurance and interest rate hedging products redress;
- the Group's provisions for outstanding litigation and regulatory investigations; and
- the impact of the announcement that Santander would not complete its planned purchase of certain UK branch-based businesses.

The Group Audit Committee continued to encourage enhancements to the disclosures in the Group's external financial reports. Revised versions of the UK Corporate Governance Code and related Guidance for Audit Committees were issued by the Financial Reporting Council in September 2012. The Committee considered the new requirements and

has endeavoured to comply early, where appropriate to do so. The Committee also considered the recommendations of the Enhanced Disclosure Task Force of the Financial Stability Board and the Group's plans to meet the recommendations. I am pleased to report that several of the Group's disclosures were highlighted within the report as examples of best practice.

A key responsibility of the Committee is to monitor and review the scope, nature and effectiveness of Internal Audit. As in previous years, I met regularly with the Head of Group Internal Audit. The Committee also held two in depth sessions with Group Internal Audit. These additional meetings enabled the members of the Committee to be briefed on Group Internal Audit's strategy under the leadership of Nicholas Crapp, who joined the Group at the start of the year, and to meet the senior management team. The Committee ensured that the Head of Group Internal Audit has appropriate independence and authority; that the scope of Internal Audit is unrestricted; that planning is appropriately risk based; and that the function has the requisite budget and resource strategy. The Head of Group Internal Audit has a direct reporting line to me and I will continue to work closely with him as we seek to strengthen further the function during 2013.

The Committee also monitored and reviewed aspects of the Group's external audit in the period. It reviewed the scope and planning of the external audit and considered reports and recommendations from the External Auditors. It monitored the External Auditors' independence and objectivity and ensured effective controls were in place to oversee engagements for the External Auditors to provide non-audit services. The Committee undertook an assessment of the External Auditors' performance and recommended to the Board that re-appointment of the External Auditors be submitted to shareholders for approval at the Annual General Meeting in 2013.

During 2012, I met with the FSA and with the External Auditors on a trilateral basis as envisaged by the FSA Code of Practice. The purpose of this meeting was to discuss, in the framework of an open and cooperative relationship between the supervisor and the External Auditors, issues considered to be of interest to the parties in meeting their respective responsibilities. This meeting formed part of the Committee's oversight of the Group's relationship with its regulators.

The Committee reviewed the Group's systems of internal controls and the procedures for monitoring their effectiveness. The Committee placed particular focus in 2012 on ensuring that the Group had articulated an appropriate three lines of defence model that clearly stated individuals' responsibility and accountability for risk and control at all levels. This model is expected to be fully embedded in 2013 and the Group Audit Committee will closely monitor delivery within the divisions and functions.

Litigation and regulatory investigations featured heavily on the agenda of both the Group Audit Committee and Board Risk Committee in the period, highlighting some deficiencies in the control environment. During 2012 the Board asked the Group Audit Committee to monitor progress of the internal and various ongoing regulatory investigations and claims based on allegations that the Group had made inappropriate submissions to influence the setting of interest rates. The Committee met regularly to receive updates on the investigations, including on an ad hoc basis. It worked closely with the Group Performance and Remuneration Committee to make decisions and recommendations in relation to individual accountability.

The implications for the Group's culture and control environment were considered in light of this and other ongoing investigations. The Committee in particular, reviewed proposed enhancements to the culture and control framework in the Markets and International Banking divisions. It has monitored the implementation of remedial action in the Markets business and has overseen liaison with the Group's regulators. Independent assurance has been obtained regarding the comprehensiveness and timeliness of plans. The Committee is confident that the change programme will result in genuine behavioural change across the business as well as robust and sustainable control remediation. It will closely monitor implementation of these plans in 2013.

Inevitably, the challenges that have arisen during the year have meant that members have had to dedicate some considerable time to the work of the Committee. I would like to extend my thanks to my fellow Committee members for their continued dedication and support throughout 2012.

Brendan Nelson
Chairman of the Group Audit Committee
27 February 2013

Report of the Group Audit Committee

Meetings and visits

A total of seven scheduled meetings of the Group Audit Committee were held in 2012, including meetings held immediately before consideration of the annual and interim financial statements and the quarterly interim management statements by the Board. The Group Audit Committee also held five ad hoc meetings. Group Audit Committee meetings are attended by relevant executive directors, the Internal and External Auditors and Finance and Risk Management executives. Other executives, subject matter experts and external advisers are also invited to attend the Group Audit Committee, as required, to present and advise on reports commissioned by the Committee. At least twice a year the Group Audit Committee meets privately with the External Auditors. The Committee also meets privately with the Group Internal Audit management.

The annual programme of joint visits by the Group Audit and Board Risk Committees to the Group's business divisions and control functions continued in 2012. The object of the programme is for members of the Committee to gain a deeper understanding of the Group; invitations to attend are extended to all non-executive directors. During 2012, the Group Audit Committee and the Board Risk Committee undertook a total of six visits - to Risk Management (2), Internal Audit (2), Group Finance and Business Services to review the Group Change portfolio.

Membership of the Group Audit Committee

The Group Audit Committee is made up of at least three independent non-executive directors. The Chairman and members of the Committee, together with their attendance at meetings, are shown below.

	Attended/ scheduled
Brendan Nelson (chairman)	7/7
Tony Di Iorio	7/7
Baroness Noakes	7/7
Philip Scott	7/7

All members of the Group Audit Committee are also members of the Board Risk Committee facilitating effective governance of finance and risk issues. The Group Audit and Board Risk Committees also have strong links with the Group Performance and Remuneration Committee ensuring that levels of compensation reflect relevant finance and risk considerations.

The members of the Group Audit Committee are selected with a view to the expertise and experience of the Group Audit Committee as a whole. The Board is satisfied that all Group Audit Committee members have recent and relevant financial experience, and that each member of the Group Audit Committee is an ‘Audit Committee Financial Expert' and is independent, each as defined in the SEC rules under the US Securities Exchange Act of 1934 (“Exchange Act”) and related guidance. Full biographical details of the Committee members are set out on pages 257 to 260.

Performance evaluation

An external review evaluating the effectiveness of the Group Audit Committee takes place every three to five years with internal reviews by the Board in the intervening years. An external review of the Board and its senior committees took place during 2012. Overall, the review concluded that the Group Audit Committee continued to operate effectively.

The role and responsibilities of the Group Audit Committee

The Group Audit Committee's primary responsibilities are shown below and are set out in its terms of reference which are reviewed annually by the Group Audit Committee and approved by the Board. These are available on the Group's website www.rbs.com

A report on the activity of the Group Audit Committee in fulfilling its responsibilities was provided to the Board following each Committee meeting. The key considerations of the Committee during 2012 are explained more fully below.

Financial reporting and policy
The Group Audit Committee focused on a number of salient judgments and reporting issues in the preparation of the 2012 accounts, and considered:

- the directors' going concern conclusion, including the Group's capital, liquidity and funding position. Further information is set out on page 307;

- the adequacy of loan impairment provisions in Ulster Bank. The Irish economy showed some signs of stabilisation but there remained significant uncertainty. The Committee considered the level of provision for loan impairment in light of these uncertainties. It monitored external conditions closely and compared loss experience with forecasts. Loan impairments in the Corporate and Non-core divisions were also carefully reviewed. During 2012, the Committee also revisited the application of IAS 39 to loan impairment rules and concluded that the Group applies them on a neutral and consistent basis;

- the Group's forbearance policies. The Committee considered the impact of forbearance on provision levels and monitored emerging trends and reporting capabilities across the Group's various portfolios;

- the approach to valuation of the Group's financial instruments measured at fair value, including its credit market exposures and liabilities carried at fair value;

- the adequacy of reserves held to meet the claims in the Group's general insurance business. The Committee considered management's assessment of the full cost of settling outstanding general insurance claims including claims estimated to have been incurred but not yet reported and for claims handling expenses. It is comfortable that the level of provision is appropriate based on claims experience and on statistical models;

- valuation of the Group's defined benefit pension scheme. The Committee considered the assumptions that had been set in valuing the fund and the sensitivities on those assumptions;

- carrying value of the Group's goodwill and other intangible assets;

- the background to and the judgements that had been made by management in assessing the recoverability of the Group's deferred tax assets;

- adequacy of the Group's provision held for the mis-selling of payment protection insurance and interest rate hedging products. The Group has established a provision which represents the Group's best estimate of the redress that will be payable by the Group. The Committee challenged management's judgements and is satisfied that the level of provision is appropriate;

- the Group's provisions made for outstanding litigation and regulatory investigations and the extent to which reliable estimates could be made for the purposes of the accounts;

- the Group's provision for redress and other costs following the Group's IT incident in June 2012;

- the impact of the announcement that Santander would not complete its planned purchase of certain UK branch-based businesses. The Committee considered whether the assets and liabilities should continue to be "held for sale" at 31

December 2012 and concluded that they should no longer be held for sale and that they should be reclassified to the relevant balance sheet captions in the consolidated balance sheet; and

- the quality and transparency of disclosures bearing in mind regulatory developments and expectations. The Committee received a report on the recommendations of the Financial Stability Board's Enhanced Disclosure Task Force and the Group's plans to meet the recommendations.

Systems of internal control
Implementation of a clear and effective three lines of defence model was a priority in 2012. The Committee received regular reports on the approach to its implementation across the Group. Focus is now on ensuring the model is fully operational and the Committee will exercise close oversight of progress during 2013.

Regulatory investigations highlighted deficiencies in the control environment in certain parts of the Group, most notably within the Markets and International Banking divisions. Cultural weaknesses were also identified. On behalf of the Board, the Group Audit Committee undertook a detailed review of the divisional remediation plans and sought independent external assurance regarding comprehensiveness and timeliness of those plans. The Committee will closely oversee remediation throughout 2013, receiving quarterly reports.

During the period, the Group Audit Committee reviewed progress against plan for a number of strategic initiatives such as the Finance and Risk Transformation Programme. It also tracked progress in relation to mandatory and remedial projects including the Group's Anti-Money Laundering Programme and the progress of the Group's US regulatory initiatives.

The Committee received reports on the operation of the Group Policy Framework. At its request, a policy standard was developed on the management of model risk across the organisation. This standard sets minimum requirements for ownership, design and use of models in the Group. The Committee will review operation of this and other policy standards, and the outputs of assurance activity in early 2013.

Report of the Group Audit Committee continued

The Committee also reviewed the effectiveness of the Group New Product Approval Process and received quarterly reports from the Credit Quality Assurance function. It considered the Group's compliance with the requirements of the Sarbanes-Oxley Act of 2002 and was regularly advised of whistle blowing disclosures which took place in the Group; complaints raised with members of the Group's executive team; and significant and sensitive internal investigations.

Divisional Risk and Audit Committees have responsibility for individual divisions and report to the Group Audit Committee and Board Risk Committee. Given the size and complexity of the Group, these committees are essential components of the governance framework that supports the effective operation of the Group Audit Committee and Board Risk Committee. The Committee agreed improvements to the divisional risk reporting framework and these changes will be implemented during 2013. Quarterly reports were received by the Group Audit Committee and Board Risk Committee from each Divisional Risk and Audit Committee.

Internal audit

The Group Audit Committee oversaw the work of Group Internal Audit throughout 2012, and received regular reports from the Head of Group Internal Audit. These included bi-annual opinion reports which rated both the quality of the control environment of all the Group's divisions and of management's level of awareness. The reports from Group Internal Audit enabled the Committee to monitor internal control within the Group by reporting on areas where improvements to the control environment were needed.

In response to Group Internal Audit findings during 2012, the Committee requested presentations from the International Banking business on improvements to its control environment. More generally, Group Internal Audit raised observations regarding the Group's management of the conduct risk agenda. Following discussion at the Group Executive Committee, Stephen Hester presented management's action plan responding to these findings to the Committee.

The Group Audit Committee considered Group Internal Audit's annual plan and the adequacy of its resources and budget. Nicholas Crapp joined the function at the beginning of 2012 and the Committee reviewed the strategy for Group Internal Audit under his leadership.

In line with best practice, an external review of the effectiveness of Group Internal Audit takes place every three to five years, with internal reviews continuing in intervening years. In January 2013, the Group Audit Committee undertook an internal evaluation of Group Internal Audit. It concluded that Group Internal Audit had operated effectively throughout 2012. Minor observations and recommendations will be implemented.

Oversight of the Group's relationship with its regulators

The Group Audit Committee has a responsibility to monitor the Group's relationship with the Financial Services Authority (FSA) and other regulatory bodies. During 2012, it received regular reports on the Group's relationship with all its regulators and highlighting significant developments. It received reports on regulatory actions and investigations. Over the course of the year the chairmen of the Group's senior Board committees met with the FSA on an individual basis and also participated in certain Regulatory College meetings with the Group's primary regulators. The FSA attended a Group Audit Committee meeting in October 2012 as an observer.

During 2012, the Chairman of the Group Audit Committee also met with the FSA and with the External Auditors on a trilateral basis.

The Committee closely monitored the Group's relationship with its international regulators and significant time continued to be dedicated in particular to understanding the regulatory requirements in the US and the implications on

the Group's US operations and structure.

Processes for external audit

During 2012, the External Auditors provided the Group Audit Committee with reports summarising their main observations and conclusions arising from their year end audit, half year review and work in connection with the first and third quarters and their recommendations for enhancements to the Group's reporting and controls. The External Auditors also presented for approval to the Committee their audit plan and audit fee proposal and engagement letter, as well as confirmation of their independence and a comprehensive report of all non-audit fees.

The Group Audit Committee undertakes an annual evaluation to assess the independence and objectivity of the External Auditors and the effectiveness of the audit process, taking into consideration relevant professional and regulatory requirements. The annual evaluation is carried out in two stages. An initial review was carried out in early 2013. In assessing the effectiveness of the Group's External Auditors, the Group Audit Committee had regard to:

- the experience and expertise of the senior members of the engagement team;
- the proposed scope of the audit work;
- the quality of dialogue between the External Auditors, the Committee and senior management;
- the clarity and quality and robustness of written reports presented to the Committee setting out the External Auditors' findings;
- the quality of observations provided to the company by the External Auditors on the Group's systems of internal control; and
- the views of management on the performance of the External Auditors.

The second phase of the review will be conducted following completion of all year end processes and will involve targeted interviews with individuals based on outputs from the initial phase and level of interaction with the External Auditors.

In addition to the annual evaluation performed by the Group Audit Committee, the External Auditors will also conduct their own annual review of audit quality. Twelve service criteria for the audit have been defined by the External Auditors to measure their performance against the quality commitments set out in their annual audit plan, under the headings of 'quality of audit, approach and conduct', 'independence and objectivity', 'quality of the team' and 'value added'.

The Group Audit Committee is responsible for making recommendations to the Board in relation to the appointment, re-appointment and removal of the External Auditors. In order to make a recommendation to the Board, the Group Audit Committee considers and discusses the performance of the External Auditors, taking account of the outcomes of the annual evaluation carried out. The Board submits the Group Audit Committee's recommendations to shareholders for their approval at the Annual General Meeting. The Board has endorsed the Group Audit Committee's recommendation that shareholders be requested to approve the reappointment of Deloitte LLP as External Auditors at the Annual General Meeting in 2013. The Group Audit Committee also fixes the remuneration of the External Auditors as authorised by shareholders at the Annual General Meeting.

Deloitte LLP has been the company's auditors since March 2000. There are no contractual obligations restricting the company's choice of External Auditors. A revised version of the UK Corporate Governance Code was issued by the Financial Reporting Council in September 2012 which provides that companies should put the external audit contract out to tender at least every ten years. The Group Audit Committee has considered the requirements and will consider each year whether there are any circumstances or events such that the contract for the audit of the Group should be put out to tender. Furthermore, unless the Committee determines otherwise, the audit contract will be put out to tender every ten years as will any new appointment following the resignation of the incumbent auditors.

Audit and non-audit services

The Group Audit Committee has adopted a policy on the engagement of the External Auditors to supply audit and non-audit services, which takes into account relevant legislation regarding the provision of such services by an external audit firm.

In particular, the Group does not engage the External Auditors to provide any of the following non-audit services:

- bookkeeping or other services related to the accounting records or financial statements;
- financial information systems design and implementation;
- appraisal or valuation services, fairness opinions or contribution-in-kind reports;
- actuarial services;
- internal audit outsourcing services;
- management functions or human resources;
- broker or dealer, investment adviser, or investment banking services;
- legal services and expert services unrelated to the audit; or
- other services determined to be impermissible by the US Public Company Accounting Oversight Board.

The Group Audit Committee reviews the policy annually and prospectively approves the provision of audit services and certain non-audit services by the External Auditors. Annual audit services include all services detailed in the annual engagement letter including the annual audit and interim reviews (including US reporting requirements) and periodic profit verifications.

Annual audit services also include statutory or non-statutory audits required by any Group companies that are not incorporated in the UK. Terms of engagement for these audits are agreed separately with management, and are consistent with those set out in the audit engagement letter insofar as local regulations permit. During 2012, prospectively approved non-audit services included the following classes of service:

- capital raising, including consents, comfort letters and relevant reviews of registration statements;
- provision of accounting opinions relating to the financial statements of the Group and its subsidiaries;
- provision of reports that, according to law or regulation, must be rendered by the External Auditors;
- permissible services relating to companies that will remain outside the Group;
- reports providing assurance to third parties over certain of the Group's internal controls prepared under Standards for Attestation Engagements (SSAE) No. 16 or similar auditing standards in other jurisdictions; and
- reports and letters providing assurance to the Group in relation to a third party company where the Group is acting as equity/ debt underwriter in a transaction, in the ordinary course of business.

Report of the Group Audit Committee continued

For all other permitted non-audit services, Group Audit Committee approval must be sought, on a case by case basis, in advance. The Group Audit Committee reviews and monitors the independence and objectivity of the External Auditors when it approves non-audit work, taking into consideration relevant legislation, ethical guidance and the level of non-audit services relative to audit services. The approval process is rigorously applied to prevent the External Auditors from functioning as management, auditing their own work, or serving in an advocacy role.

A competitive tender process is required for all proposed non-audit services engagements where the fees are expected to exceed £100,000. Engagements below £100,000 may be approved by the Chairman of the Group Audit Committee; as an additional governance control all engagements have to be approved by the Group Chief Accountant and Group Procurement. Where the engagement is tax related, approval must also be obtained from the Head of Group Taxation. Ad hoc approvals of non-audit services are ratified by the Group Audit Committee each quarter. During 2012, the External Auditors were approved to undertake certain significant engagements which are categorised and explained more fully below:

Summary of category of engagement	Reason for selection of External Auditors
Assurance testing and agreed upon procedures to regulators (three engagements)	The External Auditors' knowledge of the Group and extensive experience in such work ensured time and cost savings were achieved in both instances.
Business product development and launch (one engagement)	The External Auditors were selected following a competitive tender. They were appointed based on their firm-wide capability, the quality and relevant expertise of the team, and the competitive fee levels.
Provision of advice to management and independent assurance and assessment (one engagement)	The External Auditors were considered to be the most suitable firm to undertake this work given their extensive knowledge of the Group's systems, end-to-end process and financial reporting framework. The considerable time pressures associated with this project meant that by appointing the External Auditors a number of efficiency savings were ensured.

In addition, the External Auditors are engaged from time to time by the Group to perform restructuring services. The Group is not liable for these fees, and often has a limited role in the selection process. As an additional governance control, these engagements are subject to the ad hoc approval process. Information on fees paid in respect of audit and non-audit services carried out by the External Auditors can be found in Note 5 to the consolidated accounts on page 345.

Brendan Nelson
Chairman of the Group Audit Committee
27 February 2013

Report of the Board Risk Committee

Letter from Philip Scott,
Chairman of the Board Risk Committee

Dear Shareholder,

I report to you following another challenging twelve months for the Board Risk Committee. The already demanding schedule of the Committee was intensified in the period by a number of significant issues, most notably the IT incident that occurred in June 2012. The Board Risk Committee has undertaken, on behalf of the Board, to review the cause, consequence and subsequent management of the IT incident which had such unacceptable consequences for many of our customers. As a priority, the Committee has overseen remediation and has sought to ensure appropriate redress for customers. It will continue carefully to oversee management of residual technology risks and will ensure communication with our regulators and stakeholders on conclusion of the internal and external investigations of the incident, as appropriate.

While 2012 has presented significant challenges, there has also been a great deal of progress on the development and implementation of risk and control throughout the organisation. The Board Risk Committee has been pleased to exercise an oversight role in the development and enhancement of the risk management framework and associated tools that support the Group's aim of being a safer and more sustainable bank. The Committee has provided input into the Group's risk strategy and objectives during 2012 and has overseen the refinement and further embedding of the Group's framework into the business divisions. This has enabled the Committee to gain an improved understanding of the major risks which the Group faces, including market risk, conduct risk, country risk, credit risk (including single name concentrations and sector risk) regulatory risk and operational risk and to ensure robust plans are in place to manage excess exposures. The Group's stress testing capabilities have been developed and are now being used within business as usual as an effective strategic planning and capital management tool.

The Board Risk Committee has supported the articulation of a conduct risk appetite statement which is being embedded strategically within the Group's Policy Framework. Conduct Risk standards are being communicated to staff using the four pillars of conduct risk, employee conduct, market conduct, corporate conduct and conduct towards customers. The Committee will monitor implementation of these enhanced standards during 2013.

Enhancements to risk reporting have continued in the period to ensure that reports are insightful and relevant, and provide more metric based information. Data quality is, of course, critical to the accuracy of reporting and the Committee has received in depth updates on the progress of data quality programmes and reporting initiatives ongoing throughout the organisation, most notably the Finance and Risk Transformation Programme.

However, inevitably risk management tools and measures can only take the organisation so far. The future success of RBS depends upon the correct culture and approach that places the customer at the forefront of all decision making. The Board Risk Committee is fully supportive of the measures being developed to engender the correct behaviours at all levels within the RBS Group. The Committee has worked closely with the Group Performance and Remuneration Committee over the past 12 months to consider issues relating to individual accountability and responsibility for legacy and new issues. Where appropriate, recommendations have been made to the Group Performance and Remuneration Committee in relation to risk performance and reward. Culture, including the role of financial incentives and reward, will continue to be a priority of the Committee during 2013.

The members of the Committee have dedicated significant additional time to the consideration of risk issues during 2012 and I would like to thank them for their dedication and commitment. The business of the Committee is set to be

no less demanding in 2013. The creation of the Prudential Regulatory Authority and the Financial Conduct Authority as part of the UK's twin peaks regulatory framework will be a major influence and the Group will have to adapt to the new regulatory approach and work closely with regulators to implement changes to standards and reporting where required.

More detailed information on the business of the Committee during 2012 is set out in the Board Risk Committee Report that follows.

Philip Scott
Chairman of the Board Risk Committee
27 February 2013

Report of the Board Risk Committee

Meetings and visits

The Board Risk Committee held seven scheduled meetings and three additional ad hoc meetings in 2012. Meetings are held alongside Group Audit Committee meetings to ensure that the work of the two Committees is coordinated and consistent. Board Risk Committee meetings are attended by relevant executive directors, risk management, finance and internal audit executives. External advice may be sought by the Board Risk Committee where considered appropriate. During 2012, the members of Board Risk Committee, in conjunction with the members of the Group Audit Committee, took part in an annual programme of visits to the Group's business divisions and control functions. This programme included two in depth sessions with the Risk Management function to consider key risk areas and the risk strategy and operating model. Full details about the programme of visits is set out in the Report of the Group Audit Committee on page 270.

Membership

The Board Risk Committee comprises at least three independent non-executive directors. The Chairman and members of the Committee, together with their attendance at meetings, are shown below.

	Attended/ scheduled
Philip Scott (chairman)	7/7
Sandy Crombie	7/7
Tony Di Iorio (1)	6/7
Joe MacHale	5/7
Brendan Nelson	7/7
Baroness Noakes (2)	5/5

(1) Missed one meeting owing to travel disruption as a consequence of Hurricane Sandy.

(2) Joined the Committee on 1 March 2012; attended all previous meetings as an attendee.

Philip Scott, Tony Di Iorio, Brendan Nelson and Baroness Noakes are also members of the Group Audit Committee. Sandy Crombie is also a member of the Group Performance and Remuneration Committee. This common membership ensures effective governance across all finance, risk and remuneration issues, and that agendas are aligned and overlap is avoided, where possible.

Role of the Board Risk Committee

The Board Risk Committee is responsible for providing oversight and advice to the Board in relation to current and potential future risk exposures of the Group and future risk strategy, including determination of risk appetite and tolerance. The Committee reviews the performance of the Group relative to risk appetite and provides oversight of the effectiveness of key Group policies. The Board Risk Committee has responsibility for promoting a risk awareness culture within the Group.

Authority is delegated to the Board Risk Committee by the Board and the Committee will report and make recommendations to the Board as required. The terms of reference of the Board Risk Committee are available on the Group's website www.rbs.com and these are considered annually by the Board Risk Committee and approved by the Board.

A report on the activity of the Board Risk Committee in fulfilling its responsibilities was provided to the Board following each Committee meeting. The key considerations of the Committee during 2012 are explained more fully below.

Risk strategy and policy
The RBS Group has a clear risk strategy supported by well defined strategic risk objectives. The members of the Board Risk Committee provide input to the overarching strategy for the Group on an ongoing basis. In the first half of 2012, the Committee reviewed and provided direction to the Group's Resolution submission to the FSA pursuant to its Recovery and Resolution Programme. In conjunction with the Board, the Committee considered the potential implications for the Group of the proposals contained in the UK's White Paper on Banking Reform and its interaction with potential future regulation in Europe and the US. It will continue to monitor developments throughout 2013.

During 2012, the Board Risk Committee reviewed the implementation of the Group Policy Framework across the organisation and reviewed the output of assurance testing to assess how those standards were operating in practice. Governance arrangements were also reviewed during the year. In particular, the Committee considered regional governance arrangements in operation across the Group; local guidance; regulatory expectations; and considered the adequacy of the current Group structure against that backdrop. In conjunction with the Group Audit Committee, the members reviewed how the three lines of defence model was being implemented across the Group and the Committee reinforced with management the importance of ensuring the model operated effectively in practice. The Committee will continue to review governance arrangements and compliance with the Group Policy Framework during 2013.

The Committee regards conduct risk and the delivery of appropriate outcomes to customers to be fundamental to the future success of the RBS Group. As referenced above, in 2012 the Board Risk Committee oversaw the development of the Group conduct risk appetite statement and framework which is now in the process of being fully implemented across all lines of defence in the organisation. Focus of the Committee has now turned to consideration of what measures, standards, training and objectives are required to instil and evidence the correct behaviours in practice.

The Committee also considered conduct risk in the context of product design and regulatory investigations, as referenced below.

Risk profile
Reporting
The Committee received a detailed report on key risks and metrics at each meeting and the Chief Risk Officer provided an oral update on the key risks to the organisation. This enabled the Committee to identify the key risk areas where additional focus was required. Focus sessions were provided by the Heads of Risk disciplines at Board Risk Committee meetings on a rotational basis, to offer the Committee additional insights.

During the period, risk reporting was enhanced and the Committee oversaw the development of a report on the key headline and emerging risks. Likewise, at the request of the Committee, metric based risk reporting in dashboard format was developed and will be extended to cover each of the key risk disciplines during 2013.

The Committee reported to the Board following each meeting on its consideration of the risk profile of the Group and made recommendations as appropriate.

Regulatory Reviews and Investigations
Regulatory risk featured highly on the agenda of the Board Risk Committee and during 2012 the Committee assumed responsibility for considering certain key areas of risk in a deeper level of granularity. Most significantly, as highlighted above, the Committee played a central role in the oversight and remediation of the Group's IT incident. In

order to ensure appropriate outcomes for customers, members reviewed the remediation plans in detail to ensure that they were fair and robust. On behalf of the Board, the Committee oversaw the independent internal investigation of the incident. Interaction with regulators in relation to their investigation of the incident continues and the Committee has committed to ensuring that the investigation is brought to a close, accountability is fully considered and learnings are addressed across the organisation.

A number of other internal and regulatory investigations arose or continued throughout 2012. During the period, the Committee received reports on the investigation of the alleged mis-selling of interest rate hedging products to small and medium sized enterprises; it reviewed ongoing programmes of work, remediation and investigation relating to unauthorised trading events and Anti-Money Laundering; it received reports on required enhancements to the mortgage sales process; and it continued to play an important governance role in the oversight and remediation of known regulatory issues in the RBS Americas region. Where appropriate, the Committee oversaw liaison with regulators; made recommendations regarding required remediation, training and process controls and enhancements; and made recommendations to the Group Performance and Remuneration Committee in relation to accountability. Progress to address identified weaknesses will be closely monitored throughout 2013.

In recognition of the conduct issues under investigation, the Committee reviewed the product approval process. Complex products were reviewed from the perspective of the customer. The Committee intends to look at sales processes and the approvals required for process design in 2013.

Operational risks inherent in the Group’s processes were also considered and the Committee has specifically considered IT continuity, security and data control.

Report of the Board Risk Committee continued

Capital and Liquidity
The Committee reviewed the capital and liquidity position of the Group regularly in light of external conditions. The difficulties being experienced in Europe and the US necessitated a continued focus on market and sovereign risk over the course of 2012 and a number of additional reports in this regard were considered over the course of the year. The Committee made recommendations to the Board in relation to the Individual Liquidity Adequacy Assessment, the Individual Capital Adequacy Assessment and the Contingency Funding Plan, required by the FSA.

The Committee considered pension risk in the context of managing liability and investment strategy. It will continue to monitor these risks in 2013.

Risk appetite, framework and limits
The risk appetite framework for the Group was approved in 2011. During 2012, focus was placed on ensuring that the framework was rolled out and embedded across the business divisions and legal entities within the Group. The Committee has committed to review the risk appetite framework on an annual basis to ensure it remains fit for purpose and will review capital adequacy risk, earnings volatility, and liquidity risk appetite targets in early 2013.

Significant improvements were made to the Group's integrated stress testing capabilities over the course of 2012 and the Committee reviewed the output of stress tests and considered how these informed risk appetite and key strategic decisions. Reports on reverse stress testing, including key sensitivities and vulnerabilities were reviewed. The Committee monitored progress in the development of an economic capital model and will review how these measures and tools work together in an integrated manner.

The Committee received reports on the new Country Risk Appetite Framework that was developed in 2012. The members reviewed the approach to assessment of the potential for losses due to country risk shocks and how the framework informed the setting of country risk limits within the Group's Risk Appetite Framework.

As more fully set out in the Group Audit Committee report on page 272, a framework of Divisional Risk and Audit Committees is responsible for reviewing the business of each division and reporting to the Group Audit Committee and Board Risk Committee. During 2012, the risk agenda of these committees continued to evolve alongside the Board Risk Committee agenda. The Material Integrated Risk Assessment process that was introduced in 2011 continued to be refined in 2012 and the Committee received reports on progress.

Risk management operating model
The Committee reviewed planned improvements to the risk management operating model and noted the proposed enhancements and the additional assurance that the revised model seeks to introduce. Members of the Committee reviewed the calibre of senior risk personnel and succession planning arrangements. Adequacy of resource was considered in the context of the scope and nature of work undertaken by the Risk Management function.

The risk governance model continues to evolve and the Board Risk Committee has and will continue to monitor developments as appropriate.

Risk architecture
The Committee reviewed the standards of data quality across the Group and the programmes in place to improve data quality. It monitored the progress of the Finance and Risk Transformation Programme, designed to develop a golden source of data for use in reporting across the Group. Improvements to data quality, management information and reporting have been identified as key areas of focus for the Committee in 2013.

Remuneration
The Committee recognises that embedding the correct conduct and culture in the organisation requires an emphasis on performance management and conduct and standards. The Board Risk Committee continued to strengthen its coordination with the Group Performance and Remuneration Committee during the period, with the aim of ensuring that risk was adequately reflected in objectives and compensation arrangements and decisions. The members of the Committee met regularly during 2012, including on an ad hoc basis, to consider specific regulatory and operational issues and to consider accountability and the potential impact upon remuneration.

Performance evaluation
An external review of the effectiveness of the Board and senior committees, including the Board Risk Committee, during 2012 was conducted. The Committee has considered and discussed the report on the outcomes of the evaluation and is satisfied with the way in which the evaluation has been conducted, the conclusions and the recommendations for action. Overall, the review concluded that the Board Risk Committee continued to operate effectively. The outcomes of the evaluation have been reported to the Board, and during 2013, the Committee will place focus on driving further improvements to risk reporting and prioritisation of Committee time.

Philip Scott
Chairman of the Board Risk Committee
27 February 2013

Directors' remuneration report

Letter from Penny Hughes
Chair of the Group Performance and Remuneration Committee

Dear Shareholder

There is no doubt that 2012 has been another challenging year and events such as attempts to manipulate LIBOR and the IT incident have had a direct impact on the Group, both from a financial and a reputational point of view. The Board has acknowledged the serious shortcomings in systems and controls which were uncovered as part of the investigations into LIBOR and deeply regrets the lack of integrity shown by a small group of employees.

I would like to assure you that the Committee has spent a great deal of time challenging and taking action in response to past events and considering how remuneration can help to drive appropriate behaviours at RBS in future. Individuals found culpable in relation to LIBOR have left the Group with no annual incentive awards for 2012 and full clawback of outstanding awards. The Committee has also taken action across the Group, particularly in the Markets division, to account for the reputational damage of these events.

Against this backdrop, we should not lose sight of the fact that the vast majority of employees at RBS continue to do their jobs well and are not responsible for the events that have made headlines. Around one third of our employees joined after the financial crisis. During the IT incident, there was a very positive illustration of the loyalty and determination of staff to support customers during a difficult and regrettable period. It is vital that we retain and motivate good people as the foundation upon which we will generate a valuable business for shareholders and a bank that society can respect.

Considerable progress has been made over the past four years and the Committee remains focused on delivering remuneration structures that complement our goal of rebuilding a safer and more sustainable business, capable of serving customers and shareholders well in the long term. It is a difficult but important balance that we are trying to achieve, reducing overall spend on pay and increasing accountability whilst nurturing the business from which future profits can flow. We have sought to strike this balance fairly, whilst demonstrating our ongoing commitment to restraint, reflecting the nature of our ownership.

I have set out below a summary of how the Committee approached the year: how performance has been assessed; the decisions that have been reached on pay for 2012 and how past mistakes have been taken into account; and changes that we are making to ensure a fair and transparent remuneration policy.

Review of Group Performance
A number of significant milestones were reached during the year as part of the Group's turnaround plan including:

- Repayment of the liquidity support to UK Government in May 2012;
- The successful flotation of more than one third of our stake in Direct Line Insurance Group plc in difficult market conditions; and
- The exit from the Asset Protection Scheme in October 2012.

Key financial achievements for 2012 were:

- Core Operating Profit of £6.3 billion, which represents a strong performance;

- Further significant progress in removing Non-Core assets, a key part in managing down legacy issues. Non-Core third party assets are down £36 billion in 2012 to £57 billion, representing 92% progress towards the 2013 target of c.£40 billion;

- Capital, funding and liquidity positions remain robust with key performance indicators (KPIs) on short-term wholesale funding, liquidity portfolio, leverage ratio, Core Tier 1 capital ratio and loan:deposit ratio all exceeding or in line with medium-term targets;

- Core Return on Equity (ROE) was 10%, with Retail & Commercial ROE at 10% or 14% excluding Ulster Bank. The ROE for Markets was 10% in challenging market conditions;

- Group expenses were 6% lower than in 2011 with staff costs down 6%; and

- Impairment losses totalled £5.3 billion, down 29% from 2011.

As well as financial achievements, the Committee takes into account performance against a broader range of objectives, including support to customers. For example, in 2012 the Group accounted for 36% of all Small and Medium Enterprises (SME) lending, compared with its overall customer market share of 24%. The Group advanced £16 billion of UK home loans, including £3 billion to first time buyers. Using the Bank of England’s Funding for Lending Scheme the Group has offered lower interest rates and waived arrangement fees on certain SME loans, benefiting over 11,000 SMEs in the second half of 2012.

Decisions made on pay

In addition to financial and non-financial measures, the Committee applies a rigorous accountability review process in determining pay outcomes. This framework enables us to claw back awards made in previous years where current or new information would change the decisions made in previous years. The review considers not only financial losses but also behavioural and reputational issues that have arisen.

Whilst the Group made significant progress across a range of measures in 2012, the Committee, in conjunction with the Board, agreed that the reduction to shareholder value and reputational damage caused by incidents such as the LIBOR settlement should result in a reduction of this year's variable pools and the application of clawback. Further details of the impact of these incidents on remuneration is set out on page 300. Some of the key outcomes on pay are as follows:

- Total variable compensation has been reduced from 2011 by 14% at a Group level and 20% for Markets (the reductions are 23% and 40% respectively after the application of clawback) as further evidence of the action that has been taken to bring down overall levels of pay;

- Variable compensation (pre clawback) as a percentage of operating profit before variable compensation decreased from 28% to 16% for 2012 for the Group and from 25% to 16% for Markets. Full details can be found in Note 3 to the consolidated accounts on pages 339 and 340;

- Since 2010, total variable compensation for the Group has been reduced by over 50%;

- Within the context of reduced variable pools, incentive awards continue to be targeted towards high performers and, as a consequence, 40% of employees eligible for an award will receive zero for 2012;

- Of those employees who do receive an award for 2012, 68% will receive less than £2,000 in total and 81% will receive less than £5,000; and

- Average salary increases across the Group for 2013 will be less than 2%.

The CEO, Stephen Hester, will not receive any salary increase in 2013. In addition, he decided during the year that it would not be appropriate for him to be considered for any annual incentive award. Whilst respecting his decision, I would like to put on record that the Committee believes the CEO continues to demonstrate strong performance and leadership. The Committee receives regular encouragement from institutional shareholders to improve the delivery of market competitive remuneration to the CEO.

Enhancements to remuneration policy

The Committee continues to recognise the importance of driving cultural change both in terms of pay and in a wider sense. As Chair, I am actively involved in a number of initiatives relating to diversity, graduate recruitment and management development and many of these initiatives have received award-winning recognition.

It is clear that challenges remain in rebuilding the reputation of banks but progress has been made in evolving the culture of RBS. Our remuneration policy underpins this work by encouraging appropriate behaviours and adjusting for risk. Examples of enhancements are as follows:

-

Simplification of sales incentives with a broad move to a balanced scorecard type approach focused on customer service and risk;

- All executives and Code Staff have culture included as part of their 2013 objectives supported by quantitative and qualitative measures;
- Full review of balanced scorecard metrics, supported by independent control function review in advance of variable pools being agreed;
- This year, all our employees will be paid salaries at or above the Living Wage; and
- Shareholding requirements for the executive directors have been strengthened and new requirements introduced for senior executives to better align their interests with those of shareholders.

We will continue to monitor external developments and, where appropriate, refine our remuneration policy, for example, in light of the requirements of CRD IV.

Enhancements to remuneration governance and reporting
In recognition that the Committee considers issues wider than just remuneration, the name of the Committee was changed to the Group Performance and Remuneration Committee. This reflects the Committee's broader oversight role to consider performance in the round in supporting the Group's purpose, vision and values aspirations. During 2012, the Committee has worked closely with the Board Risk Committee and Group Audit Committee, both of which have provided valuable input on key risk and control issues.

Changes have been made to this report in line with a number of anticipated government reforms on remuneration reporting. The Remuneration Governance section covers the activities and decision-making process of the Committee; the Policy Report covers future remuneration policy; and the Implementation Report demonstrates how pay arrangements have been implemented over the past year.

As in previous years, we have consulted with our major shareholders, including UKFI, on remuneration matters. I would like to thank those shareholders who continue to recognise and support our efforts to reform remuneration practices at RBS. In this turnaround period where it has not been possible to pay ordinary dividends to shareholders, this support on pay decisions has been an essential part of our restructuring programme.

Finally, I would also like to thank my fellow Committee members for their expertise and guidance and all those who have supported the Committee in its efforts to make fair and appropriate judgements.

Penny Hughes
Chair of the Group Performance and Remuneration Committee
27 February 2013

Directors' remuneration report- Remuneration Governance

Report of the Group Performance and Remuneration Committee
The role and responsibilities of the Committee
The Committee is responsible for setting the Group's policy on remuneration and overseeing its implementation. It reviews performance and makes recommendations to the Board in respect of the Group's variable incentive pools and the remuneration arrangements of the executive directors of the Group. No director is involved in decisions regarding his or her own remuneration.

The Committee is also responsible for approving remuneration and severance arrangements for members of the Group's Executive and Management Committees, FSA 'Code Staff', as well as overseeing arrangements for employees who are 'In-Scope' under the Asset Protection Scheme (APS). Details of the FSA Remuneration Code can be found at www.fsa.gov.uk and a definition of Code Staff is provided on page 284.

The terms of reference of the Group Performance and Remuneration Committee are available on the Group's website www.rbs.com and these are reviewed at least annually by the Committee and approved by the Board.

Summary of the principal activity of the Committee during 2012
Set out below is a summary of the activity of the Committee on a quarterly basis:

First quarter
- Year end performance reviews and remuneration arrangements for members of the Group's Executive and Management Committees and objectives for 2012. The year end performance reviews included input from the Board Risk Committee on the risk management performance of Executive and Management Committee members;
- Year end performance reviews and remuneration arrangements for APS in scope employees, Code Staff, and High Earners;
- Approval of Group and Divisional variable pay pools;
- Approval of the Directors' remuneration report;
- Outcomes of the annual performance evaluation of the Committee;
- Remuneration arrangements for executive directors which included a reduction to the LTIP award level for executive directors;
- Introduction of a new accountability review process which informs clawback decisions; and
- Assessment of the performance to date of unvested LTIP awards and award levels and performance targets for 2012 awards.

Second quarter
- Outcomes of the first quarter accountability reviews;
- Review of remuneration proposals for Direct Line Insurance Group plc on divestment;
- Presentation from the Wealth division on business and strategic priorities and people plan;

- Review of government proposals on Shareholder Voting Rights and remuneration aspects of CRD IV; and
- Update on LTIP performance conditions and vesting outcomes for executive directors 2009 long term incentive awards.

Third quarter
- Half year performance reviews for executive directors, Group Executive and Management Committee members;
- Outcomes of the second quarter accountability reviews;
- Formal remuneration strategy session to discuss and agree remuneration approach and priorities for the forthcoming year;
- Presentation from Markets and International Banking on business and strategic priorities and people plan; and
- Approval of remuneration arrangements for Direct Line Insurance Group plc on divestment.

Fourth quarter
- Approval of remuneration approach for the most senior and highest paid employees in the Group (including executive directors and Group Executive and Management Committee members);
- Outcomes of the third quarter accountability reviews;
- Assessed and affirmed accountability review decision making principles;
- 2012 preliminary variable pay pool discussions for Group and Divisions;
- Content for shareholder consultations undertaken in December 2012 and January 2013;
- Review of Committee remit and name;
- Review of incentive plans;
- Approval of revised shareholding requirements for executive directors and the introduction of new shareholding requirements for Group Executive Committee members; and
- Improved review of performance across key areas of customer; risk; people and financial.

Directors' remuneration report- Remuneration Governance continued

Performance evaluation process
An external review of the effectiveness of the Board and Senior Committees, including the Group Performance and Remuneration Committee, was conducted during 2012. The Committee considered the outcomes of the evaluation and is satisfied with the way in which the evaluation has been conducted.

The review concluded that the Committee continued to operate effectively and the continued importance of the remuneration agenda and the commitment of the Committee members was recognised. The outcomes of the evaluation have been reported to the Board. As Board interest in remuneration matters remains intense and all directors understand the sensitivities involved, reporting on remuneration matters to the Board will be further enhanced during 2013.

How risk is reflected in our remuneration process
Focus on risk is achieved through clear risk input into incentive plan design and target setting, as well as thorough risk review of performance, variable pools and clawback. The Committee is supported in this by the Group Audit Committee, the Board Risk Committee and the Group's risk management function.

A robust process is used to assess risk performance. A range of measures are considered, including funding, liquidity, credit, regulatory, operational and market risk. The steps we take to ensure appropriate and thorough risk adjustment continue to be refined and are fully disclosed and discussed with the FSA.

Variable pay pool determination
The process for determining variable pools is discretionary, to avoid the unintended consequences of formulaic systems. However, the Committee's discretion is applied within a structured framework which starts with an assessment of risk adjusted financial performance measured against budget, prior year and long-term strategic plans. This analysis is used to adjust for performance and then consider outcomes in the context of competitive variable pay funding levels.

Risk is taken into account in the performance assessment through a thorough risk analysis carried out by the Group's risk management function to a pre-agreed framework. Performance assessments may be adjusted in situations where risk performance is outside risk appetite or strategic plans. Non-financial factors such as progress on customer issues, turnover, succession planning, market environment and franchise development are then taken into account in developing a final variable pay proposal. Variable pay proposals are reviewed in the context of key compensation framework ratios including: compensation to revenues, compensation to pre-compensation profit and variable pay to pre- variable pay profit. These ratios help to ensure appropriate sharing of value between employees and shareholders. Finally, variable pay proposals are reviewed against our capital adequacy framework to ensure that regulatory requirements are met.

Accountability review process
A summary of the accountability review process is as follows:

- Exists to enable RBS to respond in instances where current and/or new information would change the annual incentive and/or LTIP decisions made in previous years, and/or the decisions made in the current year.

- The process for review assessments (which consider material risk management, control and general policy breach failures, accountability for those events and appropriate action against individuals) is operated across divisions and functions. Divisional reviews are undertaken on a quarterly basis.

- A Group Accountability Review Panel ensures consistency of decision making across the Group.
- Decisions must take into account not only any financial losses but also behavioural issues and reputational or internal costs.
- Actions may include recommendations for compensation adjustments (e.g. current year variable pay reduction, clawback) disciplinary investigations and performance adjustments (e.g. a change to performance rating).
- Clawback may be up to 100% of unvested awards and can be applied regardless of whether or not disciplinary action has been undertaken.
- A key principle is that clawback quantum should not be formulaic.
- Collective responsibility may be considered where a committee or group of employees are deemed to have not appropriately discharged their duties.
- These principles apply to all of our people and any leavers with unvested awards.

How have we applied this in practice?
The assessment undertaken by the risk function and Board Risk Committee confirmed that, for some divisions, a number of risk-related events needed to be taken account of when determining variable pay pools, including regulatory, compliance and credit and market risk issues. The Board Risk Committee has concluded that the accountability review assessments approach is robust and complete from a perspective of all known material events having been considered.

The accountability review process is now fully embedded and during 2012 a number of issues were considered under the framework.

The outcomes for the 2012 performance year cover a range of actions and have included: reduction of current year variable pay awards; dismissal; clawback of previously awarded deferred and LTIP awards; and suspended vesting pending further investigation.

Key inputs to the Group Performance and Remuneration Committee to assist its decision-making
The Committee receives regular updates on regulatory developments and general remuneration issues, as well as market and benchmarking data to support its decisions. It also received information from a number of external and internal sources during 2012. The diagram below illustrates this:

Directors' remuneration report- Policy Report

Policy Report

Our Group-wide Remuneration Policy

The remuneration policy supports the Group's business strategy and is designed to:

- attract, retain, motivate and reward high-calibre employees to deliver long term business performance within acceptable risk parameters; and

- provide clear alignment between annual and long-term targets for individuals and Group/divisional strategic plans.

Consultation on remuneration policy takes place with our social partners, including representatives from UNITE. The National Living Wage and London Living Wage are important benchmarks that we monitor each year as part of the annual pay review process. An annual Group-wide employee opinion survey takes place which includes a number of pay related questions.

The remuneration policy applies the same principles to all employees including Code Staff (1). The current key principles underpinning the Group-wide remuneration policy are set out below:

Element of pay	Objective	Operation
Base salary	To attract and retain employees by being competitive in the specific market in which the individual works.	Base salaries are reviewed annually and should reflect the talents, skills and competencies that the individual brings to the Group. Salaries should be sufficient so that inappropriate risk-taking is not encouraged.
Annual incentives	To support a culture where employees recognise the importance of serving customers well and are rewarded for superior individual performance.	The annual incentive pool is based on a balanced scorecard of measures including customer, financial, risk and people measures. Allocation from the pool depends on divisional, functional and individual performance. Individual performance assessment is supported by a structured performance management framework. Our policy is that awards are subject to individual performance. Guaranteed awards are only used in very limited circumstances in accordance with the FSA Remuneration Code. Immediate cash awards are limited to a maximum of £2,000. Under the Group-wide deferral arrangements a significant proportion of annual incentive awards for our more senior employees are deferred over a three year period. Deferred awards are subject to clawback. For Code Staff, 50% of any annual incentive is delivered in the form of Group shares and subject to an additional six month retention period post vesting. In certain circumstances, formulaic short-term incentive arrangements are used to align the objectives of employees with

		the strategy of the relevant division in which they work. All incentive awards are subject to appropriate governance, including independent review by the risk management, finance and human resources functions, with oversight from the Group Performance and Reward Committee, which has delegated authority from the Committee over incentive schemes operating over a period of 12 months or less.
Long-term Incentive Plan (LTIP)	To encourage the creation of value over the long term and to align further the rewards of the participants with the returns to shareholders.	The Group provides certain employees in senior roles with long-term incentive awards. Awards are structured as performance-vesting shares. Vesting after a three year period will be based partly on divisional or functional performance and partly on performance across the Group. All awards are subject to clawback.
Other share plans	To offer employees in certain jurisdictions the opportunity to acquire Group shares.	Employees in certain countries are eligible to contribute to share plans which are not subject to performance conditions.
Benefits (including pension)	To give employees an opportunity to provide for their retirement.	In most jurisdictions, employee benefits or a cash equivalent are provided from a flexible benefits account.

Note:

(1)The following groups of employees have been identified as meeting the FSA's criteria for Code Staff:

- Members of the Group Board and Group Executive and Management Committees;
- Staff performing a Significant Influence Function within RBS Group;
- Employees who have approval authorities such that their decision-making could have a material impact on the RBS Group income statement;
- Employees who are responsible for a business or businesses whose performance could have a material impact on the RBS Group income statement; and
- Key control function roles.

Summary of remuneration policy for executive directors for 2013

The remuneration policy for executive directors follows the Group-wide policy applicable to other employees but with greater emphasis on variable performance-related pay. This is to ensure that delivery of total remuneration to executive directors is more dependent on performance and can only be achieved if specific strategic targets and other measures are met. The structure of remuneration for executive directors involves greater delivery in shares in order to align further their reward with the long-term interests of shareholders. A summary is set out below:

Element of pay	Operation	Maximum potential	Performance metrics and period	Changes to policy since last approved
Base salary	Reviewed annually and considered against annual market data and in the context of wider Group increases.	Rate at 1 January 2013: Stephen Hester: £1,200,000 Bruce Van Saun: £750,000	N/A	A 2% increase to the salary of Bruce Van Saun to £765,000 with effect from 1 April 2013.
Annual incentive	Any annual incentive to be awarded entirely in shares. Shares vest in two equal tranches on the first and second anniversary of the date of grant. Provision for clawback prior to vesting. Additional six month holding period post vesting.	Normal maximum: 200% of base salary Exceptional maximum: 250% of base salary	Balanced scorecard of KPIs measured over the financial year. KPIs are: · Strategic progress; · Business delivery and financial performance; · Risk and control; · Stakeholder management; and · People management See page 287 for further details	No change.
Long-term incentive	Awards granted over shares which vest at the end of a three year period subject to performance conditions being met. Provision for clawback prior to vesting.	Maximum under plan rules is 400% of salary. 2013 LTIP awards will be granted subject to an overall cap of 300% of salary at grant. Each of the four performance	Performance conditions measured over three financial years. Performance measures and relative weightings are: · Core Bank Economic Profit - 25% · Total Shareholder Return (TSR) relative to comparator group of	No change.

	Additional six month holding period post vesting.	elements has the potential to deliver shares worth 100% of salary at grant. However, there is an overall cap on vesting equivalent to 300% of salary at grant. The notional value of these awards would be 45% of face value, which is 135% of salary.	international banks - 25% · Balance sheet and risk - 25% · Strategic scorecard - 25% · Financial and risk performance underpin. The LTIP measures have been selected in consultation with shareholders. The objective is to have a balanced range of measures that encourage the building of a safer, stronger and more sustainable business. See page 288 for further details on the measures.	
Benefits (including pension)	Flexible benefits opportunity as for all employees. Pension allowance. Opportunity to sacrifice salary into defined contribution pension scheme.	Pension allowance of 35% of salary.	N/A	No change.

Directors' remuneration report- Policy Report continued

Recruitment policy

The policy on the recruitment of new executive directors aims to structure pay broadly in line with the framework and quantum applicable to current executive directors, taking into account that some variation may be necessary to secure the preferred candidate and to reflect the skills and experience required. Any awards granted to replace awards forfeited on leaving a previous employer will be on a comparable basis taking account of anticipated performance outcomes and the proportion of time elapsed. Full details will be disclosed in the next remuneration report following recruitment.

The mix of executive directors' remuneration

The charts below show the composition of remuneration opportunity for on-target annual performance, with the long-term incentive awards shown at median performance vesting. Annual incentive payments earned in relation to 2013 performance will be deferred and will vest, subject to satisfactory performance. The actual value of the long term incentive awards will depend on performance over the period 2013 to 2015 and the share price at the time the awards vest.

Group Chief Executive - Stephen Hester

Group Finance Director - Bruce Van Saun

2010-2012 average compensation outcome for Group Chief Executive

The preceding charts are based on target/expected values of total compensation. Press commentary tends to focus either on these values, or on maximum values assuming all performance conditions are met. However, in practice over the period 2010 to 2012, the value received will be significantly less than the maximum or even target value of incentives, in light of waivers, performance conditions and share price changes over the period. The chart below shows the likely average pay-out to the Group Chief Executive over the 2010-2012 period.

The data shows that Stephen Hester is likely to receive just 22% of the maximum value of his incentives awarded over the last three years, and around 38% of his maximum total compensation. This is despite strong progress against a range of financial and non-financial targets measured over the three year period since 2010.

Annual incentive awards - performance criteria for 2013
The executive directors' annual performance objectives, as set out below, are approved by the Committee. The risk objectives are reviewed by the Board Risk Committee.

Core objectives	Stephen Hester	Bruce Van Saun
Strategic progress	Revise original Strategic Plan to respond to significant changes in the macro environment. Deliver execution of revised strategy including focus on brand values and fair outcomes for customers. Develop strategy for implementation of ring-fencing. Progress plans towards Government exit.	Monitor and improve the Group and divisional strategic plans. Drive effective design and implementation of revised plan.
Business delivery and financial performance	Lead delivery of overall performance, including measures relating to ROE, cost management, Core Tier 1 capital ratio, funding and risk profile, lending, and EU mandated disposals.	Ensure statutory, regulatory and management reporting is compliant with all external and internal standards. Continue to improve 'best in class' external reporting. Provide strong Group Finance Director role to the business through strategic planning, budgeting, forecasting and reporting. Monitor and control Group budget. Ensure a robust capital and funding planning framework. Drive efficiency. Successful further Direct Line Insurance Group plc 'selldown' and re-plan of EU mandated branch disposals.
Risk and control	Delivery of measures relating to wholesale funding reliance, liquidity reserves and leverage ratio. Further progress on risk appetite, risk frameworks and conduct risk, in support of the continued culture change across the Group.	Progress on key risk requirements. Implementation of effective regulatory changes impacting capital, funding, and liquidity. Improve quality of risk and financial data. Continue development of Group Internal Audit function.
Stakeholder management	Achievement of customer performance measures. Build/maintain strong and effective relationships with external stakeholders, including senior leaders in the new UK regulatory framework.	Continue to develop effective external relationships, including investors, rating agencies and regulators.
People management	Ensure each division/function has a people plan. Embed the Group's purpose, vision and values through high	Lead upgraded team and build positive culture and sense of purpose. Contribute to overall Group management. Partner

	quality leadership teams. Build talent management and performance management. Maintain leadership and employee engagement as measured by the employee survey.	colleagues in leading the Group's purpose, vision and values to support culture change.

The Committee will determine the actual value of any award by reference to the extent to which executive directors have met the performance targets. Awards will be paid entirely in shares and will vest in two equal tranches on the first and second anniversaries of the date of grant. Clawback provisions will apply prior to the vesting of the shares. An additional six month holding period will apply post vesting.

Directors' remuneration report- Policy Report continued

LTIP awards - performance criteria for awards to be granted in 2013 and due to vest in 2016
Awards that will be granted to executive directors in 2013 will be subject to four performance categories, each with equal weighting. These are set out below.

Core bank economic profit (25%)
The Economic Profit measure is focused on the Core bank to ensure that performance reflects enduring earnings for the bank. Economic Profit, being a risk-adjusted financial measure, is consistent with the FSA Code and also provides a balance between measuring growth and the cost of capital employed in delivering that growth. Core bank Economic Profit is defined as Core bank Operating Profit after Tax less attributed equity multiplied by the cost of equity, where:

Core bank Operating Profit after Tax is Core Operating Profit taxed at a standard tax rate.

Attributed Equity is defined as equity allocated to the Core businesses, calculated as a function of the Core businesses risk-weighted asset base.

Current Cost of Equity is 11.5%, which is subject to review at least annually.

Details of the actual targets, and performance against these, will be disclosed retrospectively once the awards vest.

Relative Total Shareholder Return (25%)
The relative TSR measure provides a direct connection between executive directors' awards and relative performance delivered to shareholders. The measure compares the Group's performance against a group of comparator banks from the UK and overseas, weighted towards those companies most similar to the Group. Performance is measured over a three year performance period.

Relative TSR Comparator Group

		Weighting
1	Barclays	200%
2	Lloyds Banking Group	
3	HSBC	150%
4	Standard Chartered	
5 to 20	Bank of America, BBVA, BNP Paribas, Citigroup, Credit Agricole, Credit Suisse Group, Deutsche Bank, JP Morgan Chase, National Australia Bank Limited, Royal Bank of Canada, Santander, Societe Generale, The Toronto-Dominion Bank Group, UBS, Unicredito, Wells Fargo & Company	50%

- 20% of the award will vest if the Group's TSR is at the median of the companies in the comparator group.

- 100% of the award will vest if the Group's TSR is at the upper quartile of the companies in the comparator group.

Balance Sheet & Risk (25%)
The Balance Sheet & Risk measures have a particular focus on risk reduction, the resolution of the Non-Core business and the building of a sustainable and responsible franchise for the Group.

Strategic Scorecard (25%)
The balanced Strategic Scorecard rewards management for delivering a robust basis for future growth in terms of the strength of our franchise, efficiency, reputation, and the engagement of employees.

Performance measures	
Balance Sheet and Risk measures and targets	Non-Core Run-Down
	Core Tier 1 capital ratio
	Wholesale funding
	Liquidity reserves
	Leverage ratio
	Loan:deposit ratio
Strategic Scorecard measures and targets	Earnings volatility
	Customer franchise
	Cost:income ratio in Core bank
	Lending targets
	Sustainability performance
	Progress in people issues

Both quantitative and qualitative strategic measures are used, including measures relating to reputation, customer excellence, organisational capability and sustainability, given that these will support the long-term goals of the business. Targets for each measure are set at the start of the performance period and, where applicable, are aligned with the Group's Strategic Plan targets. Commentary will be provided on an annual basis in relation to progress against the targets, where these are not commercially sensitive.

Vesting point		Indicative performance
Does not meet	0%	Over half of objectives not met
Partially meets	25%	Half of objectives met
Significantly meets	62.5%	Two-thirds of objectives met
Fully meets	100%	Objectives met or exceeded in all material respects

Qualified by Group Performance and Remuneration Committee discretion taking into account changes in circumstances over the performance period, the relative importance of the measures, the margin by which individual targets have been missed or exceeded, and any other relevant factors.

Risk underpin and clawback
The Committee will also review financial and operational performance against the Strategic Plan and risk performance prior to agreeing vesting of awards. In assessing this, the Committee will be advised independently by the Board Risk Committee. If the Committee considers that the vesting outcome calibrated in line with the performance conditions outlined above does not reflect the Group's underlying financial results or if the Committee considers that the financial results have been achieved with excessive risk, then the terms of the awards allow for an underpin to be used to reduce vesting of an award, or to allow the award to lapse in its entirety. All awards are subject to clawback.

Shareholders views and their impact on remuneration policy
In late 2012 and early 2013, an extensive consultation was undertaken with institutional shareholders and other stakeholders on the Group's remuneration approach.

The consultation process involved one-to-one meetings, a roundtable session hosted by the Association of British Insurers and National Association of Pension Funds and a number of follow-up letters and meetings. Meetings have taken place involving around 20 institutional shareholders and shareholder bodies representing a substantial proportion of the non-UKFI shareholding. Topics discussed included financial progress and building a sustainable business, our remuneration strategy to date and the future shape of pay. UKFI were also consulted and as with other shareholders, the Committee received their input.

Investors recognised the challenge faced by the Committee in balancing the need to pay competitively to support business goals but at the same time being mindful of the wider economic environment and the need to show restraint. Shareholders were supportive of the work being undertaken by the Committee and the Board, and recognised the progress the Group is making towards recovery.

There was widespread support for the Group Chief Executive and the efforts being made by the Committee to seek to reward him fairly for performance. There was discussion of the accountability review process and in particular the impact of major events such as LIBOR, together with questions around culture, turnover and the extent of people risk as a result of the Group's pay positioning. The possible use of alternative plan structures was raised by certain shareholders supporting a requirement to hold shares until retirement, although there was not widespread support for this approach. The importance of value sharing between investors and employees remains a key concern for shareholders.

The Committee and the Board have considered carefully their responsibilities and have applied judgement to achieve a balance whereby our remuneration policy supports business goals without causing unacceptably high people risks.

The support received from shareholders during the consultation period has been greatly encouraging. Shareholders have played a key role in developing remuneration practices that support the long-term goals of the business. Our remuneration approach of delivering a significant proportion of variable pay for senior executives in shares with deferral periods and clawback provisions provides strong alignment with the interests of shareholders.

Service contracts and exit payment policy
The company's policy in relation to the duration of contracts with directors is that executive directors' contracts generally continue until termination by either party, subject to the required notice, or until retirement. The notice period under the service contracts of executive directors will not normally exceed twelve months.

In relation to newly recruited executive directors, subject to the prior approval of the Committee, the notice period may be extended beyond twelve months if there is a clear case for this. Where a longer period of notice is initially approved on appointment, it will normally be structured such that it will automatically reduce to twelve months in due course. All new service contracts for executive directors are subject to approval by the Committee.

Those contracts normally include standard clauses covering remuneration arrangements and discretionary incentive schemes, the performance review process, the company's normal disciplinary procedure, and terms for dismissal in the event of failure to perform or in situations involving actions in breach of the Group's policies and standards.

Any compensation payment made in connection with the departure of an executive director will be subject to approval by the Committee, having regard to the terms of the service contract and the reasons for termination.

Information regarding the executive directors' service contracts is shown below:

	Date of current contract	Notice period - from the company	Notice period - from executive
Stephen Hester	4 November 2008	12 months	12 months
Bruce Van Saun	8 September 2009	12 months	12 months

Except as noted below, in the event of severance where any contractual notice period is not worked, the employing company may pay a sum to the executive in lieu of the notice period. In the event of situations involving breach of the employing company's policies resulting in dismissal, reduced or no payments may be made to the executive. Depending on the circumstances of the termination of employment, the executive may be entitled, or the Committee may allow, outstanding awards under long-term incentive arrangements to vest, subject to the rules of the relevant plan.

Directors' remuneration report- Policy Report continued

Stephen Hester
In the event of his personal underperformance, the company is entitled, after giving reasonable opportunity to remedy any failure, to terminate Stephen Hester's contract by giving written notice with immediate effect and without making any payment in lieu of notice and Stephen Hester will forfeit any unvested stock awards. In the event that Stephen Hester's employment is terminated by the company (other than by reason of his personal underperformance or in circumstances where the company is entitled to dismiss without notice), or if he resigns in response to a fundamental breach of contract by the company, he will be entitled to receive a payment in lieu of notice to the value of base salary, annual incentive and benefits (including pension contributions). If he resigns voluntarily and the company does not require him to work out his notice period, Stephen Hester may receive a payment in lieu of notice based on salary only (i.e. no annual incentive or benefits). In both cases the treatment of any other unvested stock awards will be determined by the Committee and the Board, having due regard to the circumstances of the departure.

Bruce Van Saun
In the event of his personal underperformance, the company is entitled, after giving reasonable opportunity to remedy any failure, to terminate Bruce Van Saun's contract by giving written notice with immediate effect and without making any payment in lieu of notice and Bruce Van Saun will forfeit any unvested stock awards. Any payment in lieu of notice that may be made to Bruce Van Saun would be based on salary only (i.e. no annual incentive or benefits). The company has agreed that, provided certain conditions are met, on leaving employment, Bruce Van Saun will not forfeit awards under the rules of the Group's share plans.

Chairman and non-executive directors
Information regarding the terms of appointment for the Chairman and non-executive directors is shown below.

Re-election
Under the Articles of Association of the company, directors must stand for re-election by shareholders at least once every three years. However, in accordance with the provisions of the Code, all directors of the company stand for annual re-election by shareholders at the company's Annual General Meetings.

Letter of engagement