RBS

The Royal Bank of Scotland

Annual Report and Accounts 2009

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Board of directors and secretary

Chairman
Philip Hampton
N (Chairman)

Executive directors
Stephen Hester
Gordon Pell FCIBS, FCIB
Bruce Van Saun

Non-executive directors
Colin Buchan*
A, N, R (Chairman), Ri

Sandy Crombie*
Senior Independent Director
N, R, Ri

Penny Hughes*
N, R

Archie Hunter*
A (Chairman), N, Ri

Joe MacHale*
A, N, Ri

John McFarlane*
N, R

Arthur 'Art' Ryan*
N

Philip Scott*
A, N, Ri (Chairman)

Secretary
Miller McLean FCIBS, FIB

A member of the Group Audit Committee
N member of the Nominations Committee
R member of the Remuneration Committee
Ri member of the Board Risk Committee
* independent non-executive director

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The Royal Bank of Scotland plc
Registered in Scotland No. 90312

Description of business

Introduction

The Royal Bank of Scotland plc ('the Royal Bank' or 'the Bank') is a wholly-owned subsidiary of The Royal Bank of Scotland Group plc ('the holding company'), a large banking and financial services group. The 'Group' comprises the Bank and its subsidiary and associated undertakings. The Group has a large and diversified customer base and provides a wide range of products and services to personal, commercial and large corporate and institutional customers. 'RBS Group' comprises the holding company and its subsidiary and associated undertakings.

Following placing and open offers in December 2008 and April 2009, HM Treasury currently own approximately 70.3% of the enlarged ordinary share capital of the holding company.

In December 2009, the holding company issued £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 one capital.

Following the issuance of B shares, HM Treasury's holding of ordinary shares of the holding company remained at 70.3% although its economic interest rose to 84.4%.

HM Treasury has agreed not to convert its B shares into ordinary shares to the extent that its holding of ordinary shares following the conversion would represent more than 75% of the holding company's issued ordinary share capital.

Organisational structure and business overview

Following a comprehensive strategic review, changes have been made to the Group's operating segments in 2009. A Non-Core division has been created comprising those lines of business, portfolios and individual assets that the Group intends to run off or sell. Furthermore, Business Services (formerly Group Manufacturing) is no longer reported as a separate division and its costs are now allocated to the customer-facing divisions along with certain central costs. UK Retail & Commercial Banking has been split into three segments (UK Retail, UK Corporate and Wealth). Ulster Bank has become a specific segment. The remaining elements of Europe & Middle East Retail & Commercial Banking, Asia Retail & Commercial Banking and Share of shared assets form part of Non-Core. The segment measure is now Operating profit/(loss) before tax which differs from Contribution used previously. Comparative data have been restated accordingly.

UK Retail offers a comprehensive range of banking products and related financial services to the personal market. It serves customers through the RBS and National Westminster Bank Plc ('NatWest') networks of branches and ATMs in the United Kingdom, and also through telephone and internet channels.

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 RBS Coutts.

Global Banking & Markets (GBM) is a leading banking partner to major corporations and financial institutions around the world, providing an extensive range of debt and equity financing, risk management and investment services to its customers. The division is organised along six principal business lines: money markets; rates flow trading; currencies and commodities; equities; credit markets and portfolio management & origination.

Global Transaction Services ranks among the top five global transaction services providers, offering global payments, cash and liquidity management, and trade finance and commercial card products and services. It includes the Group's corporate money transmission activities in the United Kingdom and the United States as well as Global Merchant Services, the Group's United Kingdom and international merchant acquiring business.

Ulster Bank is the leading retail and commercial bank in Northern Ireland and the third largest banking group on the island of Ireland. It provides a comprehensive range of financial services through both its Retail Markets division which has a network of branches and operates in the personal and bancassurance sectors, and its Corporate Markets division which provides services to SME business customers, corporates and institutional markets.

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. It ranks among the top five banks in New England.

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.

Central Functions comprises group and corporate functions, such as treasury, funding and 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 GBM division, including RBS Sempra Commodities, linked to proprietary trading, higher risk profile asset portfolios including excess risk concentrations, and other illiquid portfolios. It also includes a number of retail and corporate businesses in the UK, US and Ireland that the Group has concluded are no longer strategic.

Business divestments

To comply with EC state aid requirements the RBS Group has agreed a series of restructuring measures to be implemented over a four year period. This will supplement the measures in the strategic plan previously announced by the RBS Group. These include divesting fully RBS Insurance, Global Merchant Services and RBS Sempra Commodities, as well as divesting the RBS branch-based business in England & Wales and the NatWest branches in Scotland, along with the Direct SME customers across the UK.

Competition

The Group faces strong competition in all the markets it serves. However, the global banking crisis has reduced either the capacity or appetite of many institutions to lend and has resulted in the withdrawal or disappearance of a number of market participants and significant consolidation of competitors, particularly in the US and UK. Competition for retail deposits has intensified significantly as institutions have re-oriented their funding strategies following the difficulties experienced in the wholesale markets since late 2007.

Competition for corporate and institutional customers in the UK is from UK banks and from large foreign financial institutions who are also active and offer combined investment and commercial banking capabilities. In asset finance, the Group competes with banks and specialised 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 banks, building societies and major retailers. In the mortgage market, the Group competes with UK banks and building societies. A number of competitors have either left or scaled back their lending in the mortgage and unsecured markets.

In the UK credit card market, large retailers and specialist card issuers, including major US operators, 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.

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.

In the United States, 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.

Risk factors

Most of the risk factors facing the RBS Group also apply to the Royal Bank and are discussed in this section. References in this section to 'the company' refer to the holding company.

Set out below are certain risk factors which could affect the RBS Group's future results and cause them to be materially different from expected results. The RBS Group's results are also affected by competition and other factors. The factors discussed in this report should not be regarded as a complete and comprehensive statement of all potential risks and uncertainties.

Risks relating to the company

The company and its United Kingdom bank subsidiaries may face the risk of full nationalisation or other resolution procedures under the Banking Act 2009.

Under the provisions of the Banking Act 2009, substantial powers have been granted to HM Treasury and the Bank of England as part of the special resolution regime to stabilise banks that are in financial difficulties (the "SRR"), which includes certain consultation and consent rights granted to the FSA (the FSA, together with HM Treasury and the Bank of England, the "Authorities"). The SRR confers powers on the Bank of England: (i) to transfer to the private sector all or part of the business of a United Kingdom incorporated institution with permission to accept deposits pursuant to Part IV of the Financial Services and Markets Act 2000 (FSMA) (a "relevant entity") or its securities of such relevant entity; (ii) to transfer all or part of the business of the relevant entity to a "bridge bank" established by the Bank of England and also confers a power on HM Treasury to transfer into temporary public ownership (nationalise) the relevant entity or its United Kingdom incorporated holding company. The Banking Act also provides for two new insolvency and administration procedures for relevant entities.

The purpose of the stabilisation options is to address the situation where all or part of the business of a relevant entity has encountered, or is likely to encounter, financial difficulties. Accordingly, the stabilisation options may only be exercised if the FSA is satisfied that (i) a relevant entity such as the company's United Kingdom banking subsidiaries, including the Royal Bank and NatWest, is failing, or is likely to fail, to satisfy the threshold conditions set out in Schedule 6 to the FSMA; and (ii) having regard to timing and other relevant circumstances, it is not reasonably likely that (ignoring the stabilisation options) action will be taken that will enable the relevant entity to satisfy those threshold conditions. The threshold conditions are conditions which an FSA-authorised institution must satisfy in order to retain its FSA authorisation. They are relatively wide-ranging and deal with most aspects of a relevant entity's business, including, but not limited to, minimum capital resource requirements. It is therefore possible that the FSA may trigger one of the stabilisation options before an application for an insolvency or administration order could be made.

The stabilisation options may be exercised by means of powers to transfer property, rights or liabilities of a relevant entity and shares and other securities issued by a relevant entity. HM Treasury may also take the parent company of a relevant entity (such as the company) into temporary public ownership provided that certain conditions set out in Section 82 of the Banking Act are met. Temporary public ownership is effected by way of a share transfer order and can be actioned irrespective of the financial condition of the parent company.

If HM Treasury makes the decision to take the company into temporary public ownership, it may take various actions in relation to any securities issued by the company or its subsidiaries (the "Securities") without the consent of holders of the Securities, including (among other things):

(i) transferring its Securities free from any contractual or legislative restrictions on transfer;

(ii) transferring its Securities free from any trust, liability or encumbrance;

(iii) extinguishing any rights to acquire Securities;

(iv) delisting the Securities;

(v) converting its Securities into another form or class (including for example, into equity securities); or

(vi) disapplying any termination or acceleration rights or events of default under the terms of its Securities which would be triggered by the transfer.

Where HM Treasury has made a share transfer order in respect of securities issued by the holding company of a relevant entity, HM Treasury may make an order providing for the property, rights or liabilities of the holding company or of any relevant entity in the holding company group to be transferred and where such property is held on trust, removing or altering the terms of such trust.

Accordingly, there can be no assurance that the taking of any such actions would not adversely affect the rights of holders of its Securities and/or adversely affect the price or value of their investment or that the ability of the company to satisfy its obligations under contracts related to its Securities would be unaffected. In such circumstances, such holders may have a claim for compensation under one of the compensation schemes currently existing under, or contemplated by, the Banking Act if any action is taken in respect of its Securities (for the purposes of determining an amount of compensation, an independent valuer must disregard actual or potential financial assistance provided by the Bank of England or HM Treasury). There can be no assurance that holders of its Securities would thereby recover compensation promptly and/or equal to any loss actually incurred.

If the company was taken into temporary public ownership and a partial transfer of its or any relevant entity's business was effected, or if a relevant entity were made subject to the SRR and a partial transfer of its business to another entity was effected, the transfer may directly affect the company and/or its RBS Group companies by creating, modifying or cancelling their contractual arrangements with a view to ensuring the provision of such services and facilities as are required to enable the bridge bank or private sector purchaser to operate the transferred business (or any part of it) effectively. For example, the transfer may (among other things) (i) require the company or RBS Group companies to support and co-operate with the bridge bank or private sector purchaser; (ii) cancel or modify contracts or arrangements between the company or the transferred business and a RBS Group company; or (iii) impose additional obligations on the company under new or existing contracts. There can be no assurance that the taking of any such actions would not adversely affect the ability of the company to satisfy its obligations under the issued Securities or related contracts.

If the company was taken into temporary public ownership and a partial transfer of its or any relevant entity's business was effected, or if a relevant entity were made subject to the SRR and a partial transfer of its business to another entity was effected, the nature and mix of the assets and liabilities not transferred may adversely affect the company's financial condition and increase the risk that the company may eventually become subject to administration or insolvency proceedings pursuant to the Banking Act.

While the main provisions of the Banking (Special Provisions) Act 2008 were in force, which conferred certain transfer powers on HM Treasury, the United Kingdom Government took action under that Act in respect of a number of United Kingdom financial institutions, including, in extreme circumstances, full and part nationalisation. There have been concerns in the market in the past year regarding the risks of such nationalisation in relation to the company and other United Kingdom banks. If economic conditions in the United Kingdom or globally were to deteriorate, or the events described in the following risk factors occur to such an extent that they have a materially adverse impact on the financial condition, perceived or actual credit quality, results of operations or business of any of the relevant entities in the RBS Group, the United Kingdom Government may decide to take similar action in relation to the company under the Banking Act. Given the extent of the Authorities' powers under the Banking Act, it is difficult to predict what effect such actions might have on the RBS Group and any Securities issued by the company or RBS Group companies. However, potential impacts may include full nationalisation of the company, the total loss of value in Securities issued by the company and the inability of the company to perform its obligations under the Securities.

If the relevant stabilisation option was effected in respect of the company or the stabilisation options were effected in respect of a relevant entity or its business within the RBS Group, HM Treasury would be required to make certain compensation orders, which will depend on the stabilisation power adopted. For example, in the event that the Bank of England were to transfer some of the business of a relevant entity to a bridge bank, HM Treasury would have to make a resolution fund order including a third party compensation order pursuant to the Banking Act (Third Party Compensation Arrangements for Partial Property Transfers) Regulations 2009. However, there can be no assurance that compensation would be assessed to be payable or that holders of its Securities would recover any compensation promptly and/or equal to any loss actually incurred.

The RBS Group's businesses, earnings and financial condition have been and will continue to be affected by the global economy and instability in the global financial markets.

The performance of the RBS Group has been and will continue to be influenced by the economic conditions of the countries in which it operates, particularly the United Kingdom, the United States and other countries throughout Europe, the Middle East and Asia. The outlook for the global economy over the near to medium term remains challenging, particularly in the United Kingdom, the United States and other European economies. In addition, the global financial system has yet to fully overcome the difficulties which first manifested themselves in August 2007 and financial markets conditions have not yet fully normalised. These conditions led to severe dislocation of financial markets around the world and unprecedented levels of illiquidity in 2008 and 2009, resulting in the development of significant problems at a number of the world's largest corporate institutions operating across a wide range of industry sectors, many of whom are the RBS Group's customers and counterparties in the ordinary course of its business. In response to this economic instability and illiquidity in the market, a number of governments, including the United Kingdom Government, the governments of the other EU member states and the United States Government, have intervened in order to inject liquidity and capital into the financial system, and, in some cases, to prevent the failure of these institutions.

Despite such measures, the volatility and disruption of the capital and credit markets have continued, with many forecasts predicting only modest levels of GDP growth over the course of 2010. Similar conditions are likely to exist in a number of the RBS Group's key markets, including those in the United States and Europe, particularly Ireland. These conditions have exerted, and may continue to exert, downward pressure on asset prices and on availability and cost of credit for financial institutions, including the company, and will continue to impact the credit quality of the RBS Group's customers and counterparties. Such conditions, alone or in combination with regulatory changes or actions of other market participants, may cause the RBS Group to incur losses or to experience further reductions in business activity, increased funding costs and funding pressures, lower share prices, decreased asset values, additional write-downs and impairment charges and lower profitability.

In addition, the RBS Group will continue to be exposed to the risk of loss if major corporate borrowers or counterparty financial institutions fail or are otherwise unable to meet their obligations. The RBS Group currently experiences certain business sector and country concentration risk, primarily focused in the United States, the United Kingdom and the rest of Europe and relating to personal and banking and financial institution exposures. The RBS Group's performance may also be affected by future recovery rates on assets and the historical assumptions underlying asset recovery rates, which (as has already occurred in certain instances) may no longer be accurate given the unprecedented market disruption and general economic instability. The precise nature of all the risks and uncertainties the RBS Group faces as a result of current economic conditions cannot be predicted and many of these risks are outside the control of the RBS Group.

The RBS Group was required to obtain State aid approval, for the aid given to the RBS Group by HM Treasury and for the RBS Group's State aid restructuring plan, from the European Commission. The RBS Group is subject to a variety of risks as a result of implementing the State aid restructuring plan. The State aid restructuring plan includes a prohibition on the making of discretionary dividend or coupon payments on existing hybrid capital instruments (including preference shares and B shares) for a two-year period commencing no later than 30 April 2010, which may impair the RBS Group's ability to raise new Tier 1 capital through the issuance of ordinary shares and other Securities.

The RBS Group was required to obtain State aid approval for the aid given to the RBS Group by HM Treasury as part of the First Placing and Open Offer undertaken by the company in December 2008, the issuance of £25.5 billion of B shares in the capital of the company which are, subject to certain terms and conditions, convertible into ordinary shares in the share capital of the company to HM Treasury, a contingent commitment by HM Treasury to subscribe for up to an additional £8 billion of B shares if certain conditions are met and the RBS Group's participation in the Asset Protection Scheme (the "APS") (the "State aid").

As a result of the First Placing and Open Offer (approved as part of the European Commission's approval of a package of measures to the banking industry in the United Kingdom in October 2008), the RBS Group was required to cooperate with HM Treasury to submit a forward plan to the European Commission. This plan was submitted and detailed discussions took place between HM Treasury, the RBS Group and the European Commission. The plan submitted not only had regard to the First Placing and Open Offer, but also the issuance of B shares to HM Treasury, the commitment by HM Treasury to subscribe for additional B shares if certain conditions were met and the RBS Group's participation in the APS. As part of its review, the European Commission was required to assess the State aid and to consider whether the RBS Group's long-term viability would be assured, that the RBS Group makes a sufficient contribution to the costs of its restructuring and that measures are taken to limit any distortions of competition arising from the State aid provided to the RBS Group by the United Kingdom Government. The RBS Group, together with HM Treasury, agreed in principle with the European Competition Commissioner the terms of the State aid and the terms of a restructuring plan (the "State aid restructuring plan"). On 14 December 2009, the European Commission formally approved the RBS Group's participation in the APS, the issuance of £25.5 billion of B shares to HM Treasury, a contingent commitment by HM Treasury to subscribe for up to an additional £8 billion of B shares and the State aid restructuring plan. The prohibition on the making of discretionary dividend (including preference shares and B shares) or coupon payments on existing hybrid capital instruments for a two-year period commencing no later than 30 April 2010 will prevent the company from paying dividends on its ordinary and preference shares and coupons on other Tier 1 securities for the same duration, and it may impair the RBS Group's ability to raise new Tier 1 capital through the issuance of ordinary shares and other securities.

It is possible a third party could challenge the approval decision in the European Courts (within specified time limits). The RBS Group does not believe that any such challenge would be likely to succeed but, if it were to succeed, the European Commission would need to reconsider its decision, which might result in an adverse outcome for the RBS Group, including a prohibition or amendment to some or all of the terms of the State aid. The European Commission could also impose conditions that are more disadvantageous, potentially materially so, to the RBS Group than those in the State aid restructuring plan.

The RBS Group is subject to a variety of risks as a result of implementing the State aid restructuring plan. There is no assurance that the price that the RBS Group receives for any assets sold pursuant to the State aid restructuring plan will be at a level the RBS Group considers adequate or which it could obtain in circumstances in which the RBS Group was not required to sell such assets in order to implement the State aid restructuring plan or if such sale were not subject to the restrictions (including in relation to potential purchasers of the United Kingdom branch divestment) contained in the terms thereof. Further, should the RBS Group fail to complete any of the required disposals within the agreed timeframes for such disposals, under the terms of the State aid clearance, a divestiture trustee can be empowered to conduct the disposals, with the mandate to complete the disposal at no minimum price.

Furthermore, if the RBS Group is unable to comply with the terms of the State aid approval it could constitute a misuse of aid. In circumstances where the European Commission doubts that the RBS Group is complying with the terms of the State aid approval, it may open a formal investigation. At the conclusion of this investigation, if the European Commission decides that there has been misuse of aid, it can issue a decision requiring HM Treasury to recover the misused aid which could have a material adverse impact on the RBS Group.

In implementing the State aid restructuring plan, the RBS Group will lose existing customers, deposits and other assets (both directly through the sale and potentially through the impact on the rest of the RBS Group's business arising from implementing the State aid restructuring plan) and the potential for realising additional associated revenues and margins that it otherwise might have achieved in the absence of such disposals. Further, the loss of such revenues and related income may extend the time period over which the RBS Group may pay any amounts owed to HM Treasury under the APS or otherwise. The implementation of the State aid restructuring plan may also result in disruption to the retained business and give rise to significant strain on management, employee, operational and financial resources, impacting customers and giving rise to separation costs which could be substantial.

The implementation of the State aid restructuring plan may result in the emergence of one or more new viable competitors or a material strengthening of one or more of the RBS Group's competitors in the RBS Group's markets. The effect of this on the RBS Group's future competitive position, revenues and margins is uncertain and there could be an adverse effect on the RBS Group's operations and financial condition and its business generally.

If any or all of the risks described above, or any other currently unforeseen risks, materialise, there could be a materially negative impact on the RBS Group's business, operations, financial condition, capital position and competitive position.

The RBS Group's ability to implement its strategic plan depends on the success of the RBS Group's refocus on its core strengths and the balance sheet reduction programme arising out of its previously announced non-core restructuring plan and the State aid restructuring plan.

In light of the changed global economic outlook, the RBS Group has embarked on a financial and core business restructuring which is focused on achieving appropriate risk-adjusted returns under these changed circumstances, reducing reliance on wholesale funding and lowering exposure to capital intensive businesses. A key part of this restructuring is the programme announced in February 2009 to run-down and sell the RBS Group's non-core assets and the continued review of the RBS Group's portfolio to identify further disposals of certain non-core assets. Assets identified for this purpose and allocated to the RBS Group's Non-Core division totalled £252 billion, excluding derivatives, as at 31 December 2008. At 31 December 2009, this total had reduced to £187 billion, excluding the RBS Group's interest in RBS Sempra Commodities LLP which was transferred to the Non-Core division during 2009. This balance sheet reduction programme will continue alongside the disposals under the State aid restructuring plan approved by the European Commission.

Because the ability to dispose of assets and the price achieved for such disposals will be dependent on prevailing economic and market conditions, which may remain challenging, there is no assurance that the RBS Group will be able to sell or run-down (as applicable) those businesses it is seeking to exit either on favourable economic terms to the RBS Group or at all. Furthermore, where transactions are entered into for the purpose of selling non-core assets and businesses, they may be subject to conditions precedent, including government and regulatory approvals and completion mechanics that in certain cases may entail consent from customers. There is no assurance that such conditions precedent will be satisfied, or consents and approvals obtained, in a timely manner or at all. There is consequently a risk that the RBS Group may fail to complete such disposals by any agreed longstop date. Furthermore, in the context of implementing the State aid restructuring plan, the RBS Group is subject to certain timing and other restrictions which may result in the sale of assets at prices below those which the RBS Group would have otherwise agreed had the RBS Group not been required to sell such assets as part of the State aid restructuring plan or if such sale were not subject to the restrictions contained in the terms of the State aid conditions.

In addition, the RBS Group may be liable for any deterioration in businesses being sold between the announcement of the disposal and its completion. In certain cases, the period between the announcement of a transaction and its completion may be lengthy and may span many months. Other risks that may arise out of the disposal of the RBS Group's assets include ongoing liabilities up to completion of the relevant transaction in respect of the assets and businesses disposed of, commercial and other risks associated with meeting covenants to the buyer during the period up to completion, the risk of employee and customer attrition in the period up to completion, substantive indemnity obligations in favour of the buyer, the risk of liability for breach of warranty, the need to continue to provide transitional service arrangements for potentially lengthy periods following completion of the relevant transaction to the businesses being transferred and redundancy and other transaction costs. Further, the RBS Group may be required to enter into covenants agreeing not to compete in certain markets for specific periods of time. In addition, as a result of the disposals, the RBS Group will lose existing customers, deposits and other assets (both directly through the sale and potentially through the impact on the rest of the RBS Group's business arising from implementing the restructuring plans) and the potential for realising additional associated revenues and margins that it otherwise might have achieved in the absence of such disposals.

Any of the above factors, either in the context of State aid-related or non-core or other asset disposals, could affect the RBS Group's ability to implement its strategic plan and have a material adverse effect on the RBS Group's business, results of operations, financial condition, capital ratios and liquidity and could result in a loss of value in the Securities.

The extensive organisational restructuring may adversely affect the RBS Group's business, results of operations and financial condition.

As part of its refocus on core strengths and its disposal programme, the RBS Group has undertaken and continues to undertake extensive organisational restructuring involving the allocation of assets identified as non-core assets to a separate Non-Core Division, and the run-down and sale of those assets over a period of time. In addition, to comply with State aid clearance, the RBS Group agreed to undertake a series of measures to be implemented over a four-year period from December 2009, which include disposing of RBS Insurance (subject to potentially maintaining a minority interest until the end of 2014). The company will also divest by the end of 2013 Global Merchant Services, subject to the company retaining up to 20 per cent. of each business within Global Merchant Services if required by the purchaser, and its interest in RBS Sempra Commodities, as well as divesting the RBS branch-based business in England and Wales and the NatWest branches in Scotland, along with the direct small and medium-sized enterprise ("SME") customers and certain mid-corporate customers across the United Kingdom. On 16 February 2010, the company announced that RBS Sempra Commodities had agreed to sell its Metals, Oil and European Energy business lines, subject to certain conditions including regulatory approvals. The RBS Group and its joint venture partner, Sempra Energy, are continuing to consider ownership alternatives for the remaining North American Power and Gas businesses of RBS Sempra Commodities.

In order to implement the restructurings referred to above, various businesses and divisions within the RBS Group will be re-organised, transferred or sold, or potentially merged with other businesses and divisions within the RBS Group. As part of this process, personnel may be reallocated, where permissible, across the RBS Group, new technology may be implemented, and new policies and procedures may be established in order to accommodate the new shape of the RBS Group. As a result, the RBS Group may experience a high degree of business interruption, significant restructuring charges, delays in implementation, and significant strain on management, employee, operational and financial resources. Any of the above factors could affect the RBS Group's ability to achieve its strategic objectives and have a material adverse effect on its business, results of operations and financial condition or could result in a loss of value in the Securities.

Lack of liquidity is a risk to the RBS Group's business and its ability to access sources of liquidity has been, and will continue to be, constrained.

Liquidity risk is the risk that a bank will be unable to meet its obligations, including funding commitments, as they fall due. This risk is inherent in banking operations and can be heightened by a number of enterprise specific factors, including an over-reliance on a particular source of funding (including, for example, short-term and overnight funding), changes in credit ratings or market-wide phenomena such as market dislocation and major disasters. During the course of 2008 and 2009, credit markets worldwide experienced a severe reduction in liquidity and term-funding. During this time, perception of counterparty risk between banks also increased significantly. This increase in perceived counterparty risk also led to reductions in inter-bank lending, and hence, in common with many other banking groups, the RBS Group's access to traditional sources of liquidity has been, and may continue to be, restricted.

The RBS Group's liquidity management focuses on maintaining a diverse and appropriate funding strategy for its assets, controlling the mismatch of maturities and carefully monitoring its undrawn commitments and contingent liabilities. However, the RBS Group's ability to access sources of liquidity (for example, through the issue or sale of financial and other instruments or through the use of term loans) during the recent period of liquidity stress has been constrained to the point where it, like other banks, has had to rely on shorter term and overnight funding with a consequent reduction in overall liquidity, and to increase its recourse to liquidity schemes provided by central banks. While during the course of 2009 money market conditions improved, with the RBS Group seeing a material reduction of funding from central banks and the issuance of non-government guaranteed term debt, further tightening of credit markets could have a negative impact on the RBS Group. The RBS Group, in line with other financial institutions, may need to seek funds from alternative sources, potentially at higher costs of funding than has previously been the case.

In addition, there is also a risk that corporate and institutional counterparties with credit exposures may look to reduce all credit exposures to banks, given current risk aversion trends. It is possible that credit market dislocation becomes so severe that overnight funding from non-government sources ceases to be available.

Like many banking groups, the RBS Group relies on customer deposits to meet a considerable portion of its funding. Furthermore, as part of its ongoing strategy to improve its liquidity position, the RBS Group is actively seeking to increase the proportion of its funding represented by customer deposits. However, such deposits are subject to fluctuation due to certain factors outside the RBS Group's control, such as a loss of confidence, increasing competitive pressures or the encouraged or mandated repatriation of deposits by foreign wholesale or central bank depositors, which could result in a significant outflow of deposits within a short period of time. There is currently heavy competition among United Kingdom banks for retail customer deposits, which has increased the cost of procuring new deposits and impacted the RBS Group's ability to grow its deposit base. An inability to grow, or any material decrease in, the RBS Group's deposits could, particularly if accompanied by one of the other factors described above, have a negative impact on the RBS Group's ability to satisfy its liquidity needs unless corresponding actions were taken to improve the liquidity profile of other deposits or to reduce assets. In particular, the liquidity position of the RBS Group may be negatively impacted if it is unable to achieve the run-off and sale of non-core and other assets as expected. Any significant delay in those plans may require the RBS Group to consider disposal of other assets not previously identified for disposal to achieve its funded balance sheet target level.

The governments of some of the countries in which the RBS Group operates have taken steps to guarantee the liabilities of the banks and branches operating in their respective jurisdiction. Whilst in some instances the operations of the RBS Group are covered by government guarantees alongside other local banks, in other countries this may not necessarily always be the case. This may place the RBS Group's subsidiaries operating in those countries, such as Ulster Bank Ireland Ltd, which did not participate in such government guarantee schemes, at a competitive disadvantage to the other local banks and therefore may require the RBS Group to provide additional funding and liquidity support to these operations.

There can be no assurance that these measures, alongside other available measures, will succeed in improving the funding and liquidity in the markets in which the RBS Group operates, or that these measures, combined with any increased cost of any funding currently available in the market, will not lead to a further increase in the RBS Group's overall cost of funding, which could have an adverse impact on the RBS Group's financial condition and results of operations or result in a loss of value in the Securities.

Governmental support schemes may be subject to cancellation, change or withdrawal or may fail to be renewed, which may have a negative impact on the availability of funding in the markets in which the RBS Group operates.

Governmental support schemes may be subject to cancellation, change or withdrawal (on a general or individual basis, subject to relevant contracts) or may fail to be renewed, based on changing economic and political conditions in the jurisdiction of the relevant scheme. To the extent government support schemes are cancelled, changed or withdrawn in a manner which diminishes their effectiveness, or to the extent such schemes fail to generate additional liquidity or other support in the relevant markets in which such schemes operate, the RBS Group, in common with other banking groups, may continue to face limited access to, have insufficient access to, or incur higher costs associated with, funding alternatives, which could have a material adverse impact on the RBS Group's business, financial condition, results of operations and prospects or result in a loss of value in the Securities.

The financial performance of the RBS Group has been and will be affected by borrower credit quality.

Risks arising from changes in credit quality and the recoverability of loans and amounts due from counterparties are inherent in a wide range of the RBS Group's businesses. Whilst some economies stabilised over the course of 2009, the RBS Group may continue to see adverse changes in the credit quality of its borrowers and counterparties, for example, as a result of their inability to refinance their indebtedness, with increasing delinquencies, defaults and insolvencies across a range of sectors (such as the personal and banking and financial institution sectors) and in a number of geographies (such as the United Kingdom, the United States, the Middle East and the rest of Europe, particularly Ireland). This trend has led and may lead to further and accelerated impairment charges, higher costs, additional write-downs and losses for the RBS Group or result in a loss of value in the Securities.

The actual or perceived failure or worsening credit of the RBS Group's counterparties has adversely affected and could continue to adversely affect the RBS Group.

The RBS Group's ability to engage in routine funding transactions has been and will continue to be adversely affected by the actual or perceived failure or worsening credit of its counterparties, including other financial institutions and corporate borrowers. The RBS Group has exposure to many different industries and counterparties and routinely executes transactions with counterparties in the financial industry, including brokers and dealers, commercial banks, investment banks, mutual and hedge funds and other institutional clients. As a result, defaults by, or even the perceived creditworthiness of or concerns about, one or more corporate borrowers, financial services institutions or the financial services industry generally, have led to market-wide liquidity problems, losses and defaults and could lead to further losses or defaults, by the RBS Group or by other institutions. Many of these transactions expose the RBS Group to credit risk in the event of default of the RBS Group's counterparty or client and the RBS Group does have significant exposures to certain individual counterparties (including counterparties in certain weakened sectors and markets). In addition, the RBS Group's credit risk is exacerbated when the collateral it holds cannot be realised or is liquidated at prices not sufficient to recover the full amount of the loan or derivative exposure that is due to the RBS Group, which is most likely to occur during periods of illiquidity and depressed asset valuations, such as those recently experienced. Any such losses could have a material adverse effect on the RBS Group's results of operations and financial condition or result in a loss of value in the Securities.

The RBS Group's earnings and financial condition have been, and its future earnings and financial condition may continue to be, affected by depressed asset valuations resulting from poor market conditions.

Financial markets continue to be subject to significant stress conditions, where steep falls in perceived or actual asset values have been accompanied by a severe reduction in market liquidity, as exemplified by recent events affecting asset-backed collateralised debt obligations, residential mortgage-backed securities and the leveraged loan market. In dislocated markets, hedging and other risk management strategies have proven not to be as effective as they are in normal market conditions due in part to the decreasing credit quality of hedge counterparties, including monoline and other insurance companies and credit derivative product companies. Severe market events have resulted in the RBS Group recording large write-downs on its credit market exposures in 2007, 2008 and 2009. Any deterioration in economic and financial market conditions could lead to further impairment charges and write-downs. Moreover, market volatility and illiquidity (and the assumptions, judgements and estimates in relation to such matters that may change over time and may ultimately not turn out to be accurate) make it difficult to value certain of the RBS Group's exposures. Valuations in future periods, reflecting, among other things, then-prevailing market conditions and changes in the credit ratings of certain of the RBS Group's assets, may result in significant changes in the fair values of the RBS Group's exposures, even in respect of exposures, such as credit market exposures, for which the RBS Group has previously recorded write-downs. In addition, the value ultimately realised by the RBS Group may be materially different from the current or estimated fair value. Any of these factors could require the RBS Group to recognise further significant write-downs or realise increased impairment charges, any of which may adversely affect its capital position, its financial condition and its results of operations or result in a loss of value in the Securities.

The value or effectiveness of any credit protection that the RBS Group has purchased from monoline and other insurers and other market counterparties (including credit derivative product companies) depends on the value of the underlying assets and the financial condition of the insurers and such counterparties.

The RBS Group has credit exposure arising from over-the-counter derivative contracts, mainly credit default swaps ("CDSs"), which are carried at fair value. The fair value of these CDSs, as well as the RBS Group's exposure to the risk of default by the underlying counterparties, depends on the valuation and the perceived credit risk of the instrument against which protection has been bought. Since 2007, monoline and other insurers and other market counterparties (including credit derivative product companies) have been adversely affected by their exposure to residential mortgage linked and corporate credit products, whether synthetic or otherwise, and their actual and perceived creditworthiness has deteriorated rapidly, which may continue. If the financial condition of these counterparties or their actual or perceived creditworthiness deteriorates further, the RBS Group may record further credit valuation adjustments on the credit protection bought from these counterparties under the CDSs in addition to those already recorded and such adjustments may have a material adverse impact on the RBS Group's financial condition and results of operations.

Changes in interest rates, foreign exchange rates, credit spreads, bond, equity and commodity prices and other market factors have significantly affected and will continue to affect the RBS Group's business.

Some of the most significant market risks the RBS Group faces are interest rate, foreign exchange, credit spread, bond, equity and commodity price risks. Changes in interest rate levels, yield curves and spreads may affect the interest rate margin realised between lending and borrowing costs, the effect of which may be heightened during periods of liquidity stress, such as those experienced in the past year. Changes in currency rates, particularly in the sterling-US dollar and sterling-euro exchange rates, affect the value of assets, liabilities, income and expenses denominated in foreign currencies and the reported earnings of the company's non-United Kingdom subsidiaries (principally Citizens and RBS Securities Inc.) and may affect income from foreign exchange dealing. The performance of financial markets may affect bond, equity and commodity prices and, therefore, cause changes in the value of the RBS Group's investment and trading portfolios. This has been the case during the period since August 2007, with market disruptions and volatility resulting in significant reductions in the value of such portfolios. While the RBS Group has implemented risk management methods to mitigate and control these and other market risks to which it is exposed, it is difficult, particularly in the current environment, to predict with accuracy changes in economic or market conditions and to anticipate the effects that such changes could have on the RBS Group's financial performance and business operations.

The RBS Group's borrowing costs and its access to the debt capital markets depend significantly on its and the United Kingdom Government's credit ratings.

The company and other RBS Group members have been subject to a number of downgrades in the recent past. Any future reductions in the long-term or short-term credit ratings of the company or one of its principal subsidiaries (particularly the Royal Bank) would further increase its borrowing costs, require the RBS Group to replace funding lost due to the downgrade, which may include the loss of customer deposits, and may also limit the RBS Group's access to capital and money markets and trigger additional collateral requirements in derivatives contracts and other secured funding arrangements. Furthermore, given the extent of the United Kingdom Government ownership and support provided to the RBS Group through HM Treasury's guarantee scheme (announced by the United Kingdom Government on 8 October 2008) (the "Credit Guarantee Scheme"), any downgrade in the United Kingdom Government's credit ratings could adversely affect the RBS Group's own credit ratings and may have the effects noted above. All credit rating agencies have reaffirmed the United Kingdom Government's AAA rating, although S&P changed its outlook to "negative" on 21 May 2009. Fitch reaffirmed the United Kingdom Government's stable outlook on 31 July 2009 and Moody's reiterated the United Kingdom Government's stable outlook on 26 October 2009. Credit ratings of the company, the Royal Bank, ABN AMRO Holding N.V. ("ABN AMRO"), The Royal Bank of Scotland N.V., Ulster Bank and Citizens are also important to the RBS Group when competing in certain markets, such as over-the-counter derivatives. As a result, any further reductions in the company's long-term or short-term credit ratings or those of its principal subsidiaries could adversely affect the RBS Group's access to liquidity and competitive position, increase its funding costs and have a negative impact on the RBS Group's earnings and financial condition or result in a loss of value in the Securities.

The RBS Group's business performance could be adversely affected if its capital is not managed effectively or if there are changes to capital adequacy and liquidity requirements.

Effective management of the RBS Group's capital is critical to its ability to operate its businesses, to grow organically and to pursue its strategy of returning to standalone strength. The RBS Group is required by regulators in the United Kingdom, the United States and in other jurisdictions in which it undertakes regulated activities, to maintain adequate capital resources. The maintenance of adequate capital is also necessary for the RBS Group's financial flexibility in the face of continuing turbulence and uncertainty in the global economy. Accordingly, the purpose of the issuance of the £25.5 billion of B shares, the grant of the Contingent Subscription and the previous placing and open offers was to allow the RBS Group to strengthen its capital position. The FSA's recent liquidity policy statement articulates that firms must hold sufficient eligible securities to survive a liquidity stress and this will result in banks holding a greater amount of government securities, to ensure that these institutions have adequate liquidity in times of financial stress.

In addition, on 17 December 2009, the Basel Committee on Banking Supervision (the "Basel Committee") proposed a number of fundamental reforms to the regulatory capital framework in its consultative document entitled "Strengthening the resilience of the banking sector". If the proposals made by the Basel Committee are implemented, this could result in the RBS Group being subject to significantly higher capital requirements. The proposals include: (a) the build-up of a counter-cyclical capital buffer in excess of the regulatory minimum capital requirement, which is large enough to enable the RBS Group to remain above the minimum capital requirement in the face of losses expected to be incurred in a feasibly severe downturn; (b) an increase in the capital requirements for counterparty risk exposures arising from derivatives, repo-style transactions and securities financing transactions; (c) the imposition of a leverage ratio as a supplementary measure to the existing Basel II risk-based measure; (d) the phasing out of hybrid capital instruments as Tier 1 capital and the requirement that the predominant form of Tier 1 capital must be common shares and retained earnings; and (e) the imposition of global minimum liquidity standards that include a requirement to hold a stock of unencumbered high quality liquid assets sufficient to cover cumulative net cash outflows over a 30-day period under a prescribed stress scenario. The proposed reforms are subject to a consultative process and an impact assessment and are not likely to be implemented before the end of 2012. The Basel Committee will also consider appropriate transition and grandfathering arrangements.

These and other future changes to capital adequacy and liquidity requirements in the jurisdictions in which it operates may require the RBS Group to raise additional Tier 1, Core Tier 1 and Tier 2 capital by way of further issuances of securities, including in the form of ordinary shares or B shares and could result in existing Tier 1 and Tier 2 securities issued by the RBS Group ceasing to count towards the RBS Group's regulatory capital, either at the same level as present or at all. The requirement to raise additional Core Tier 1 capital could have a number of negative consequences for the company and its shareholders, including impairing the company's ability to pay dividends on or make other distributions in respect of ordinary shares and diluting the ownership of existing shareholders of the company. If the RBS Group is unable to raise the requisite Tier 1 and Tier 2 capital, it may be required to further reduce the amount of its risk-weighted assets and engage in the disposition of core and other non-core businesses, which may not occur on a timely basis or achieve prices which would otherwise be attractive to the RBS Group. In addition, pursuant to the State aid approval, should the RBS Group's Core Tier 1 capital ratio decline to below 5 per cent. at any time before 31 December 2014, or should the RBS Group fall short of its funded balance sheet target level (after adjustments) for 31 December 2013 by £30 billion or more, the RBS Group will be required to reduce its risk-weighted assets by a further £60 billion in excess of its plan through further disposals of identifiable businesses and their associated assets. As provided in the Acquisition and Contingent Capital Agreement, the RBS Group would also be subject to restrictions on payments on its hybrid capital instruments should its Core Tier 1 ratio fall below 6 per cent. or if it would fall below 6 per cent. as a result of such payment.

Any change that limits the RBS Group's ability to manage effectively its balance sheet and capital resources going forward (including, for example, reductions in profits and retained earnings as a result of write-downs or otherwise, increases in risk-weighted assets, delays in the disposal of certain assets or the inability to syndicate loans as a result of market conditions, a growth in unfunded pension exposures or otherwise) or to access funding sources, could have a material adverse impact on its financial condition and regulatory capital position or result in a loss of value in the Securities.

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.

Under IFRS, the RBS Group recognises at fair value: (i) financial instruments classified as "held-for-trading" or "designated as at fair value through profit or loss"; (ii) financial assets classified as "available-for-sale"; and (iii) derivatives. Generally, to establish the fair value of these instruments, the RBS Group relies on quoted market prices or, where the market for a financial instrument is not sufficiently active, internal valuation models that utilise observable market data. In certain circumstances, the data for individual financial instruments or classes of financial instruments utilised by such valuation models may not be available or may become unavailable due to changes in market conditions, as has been the case during the recent financial crisis. In such circumstances, the RBS Group's internal valuation models require the RBS Group to make assumptions, judgements and estimates to establish fair value. In common with other financial institutions, these internal valuation models are complex, and the assumptions, judgements and estimates the RBS Group is required to make often relate to matters that are inherently uncertain, such as expected cash flows, the ability of borrowers to service debt, residential and commercial property price appreciation and depreciation, and relative levels of defaults and deficiencies. Such assumptions, judgements and estimates may need to be updated to reflect changing facts, trends and market conditions. The resulting change in the fair values of the financial instruments has had and could continue to have a material adverse effect on the RBS Group's earnings and financial condition. Also, recent market volatility and illiquidity have challenged the factual bases of certain underlying assumptions and have made it difficult to value certain of the RBS Group's financial instruments. Valuations in future periods, reflecting prevailing market conditions, may result in further significant changes in the fair values of these instruments, which could have a negative effect on the RBS Group's results of operations and financial condition or result in a loss of value in the Securities.

The RBS Group operates in markets that are highly competitive and consolidating. If the RBS Group is unable to perform effectively, its business and results of operations will be adversely affected.

Recent consolidation among banking institutions in the United Kingdom, the United States and throughout Europe is changing the competitive landscape for banks and other financial institutions. If financial markets continue to be volatile, more banks may be forced to consolidate. This consolidation, in combination with the introduction of new entrants into the United States and United Kingdom markets from other European and Asian countries, could increase competitive pressures on the RBS Group.

In addition, certain competitors may have access to lower cost funding and/or be able to offer retail deposits on more favourable terms than the RBS Group and may have stronger multi-channel and more efficient operations as a result of greater historical investments. Furthermore, the RBS Group's competitors may be better able to attract and retain clients and talent, which may have a negative impact on the RBS Group's relative performance and future prospects.

Furthermore, increased government ownership of, and involvement in, banks generally may have an impact on the competitive landscape in the major markets in which the RBS Group operates. Although, at present, it is difficult to predict what the effects of this increased government ownership and involvement will be or how they will differ from jurisdiction to jurisdiction, such involvement may cause the RBS Group to experience stronger competition for corporate, institutional and retail clients and greater pressure on profit margins. Future disposals and restructurings by the RBS Group and the compensation structure and restrictions imposed on the RBS Group may also have an impact on its ability to compete effectively. Since the markets in which the RBS Group operates are expected to remain highly competitive in all areas, these and other changes to the competitive landscape could adversely affect the RBS Group's business, margins, profitability and financial condition or result in a loss of value in the Securities.

As a condition to HM Treasury support, the company has agreed to certain undertakings which may serve to limit the RBS Group's operations

Under the terms of the First Placing and Open Offer, the company provided certain undertakings aimed at ensuring that the subscription by HM Treasury of the relevant ordinary shares and preference shares and the RBS Group's participation in the Credit Guarantee Scheme offered by HM Treasury as part of its support for the United Kingdom banking industry are compatible with the common market under EU law. These undertakings include (i) supporting certain initiatives in relation to mortgage lending and lending to SMEs until 2011, (ii) regulating management remuneration and (iii) regulating the rate of growth of the RBS Group's balance sheet. Under the terms of the placing and open offer undertaken by the company in April 2009, the RBS Group's undertakings in relation to mortgage lending and lending to SMEs were extended to larger commercial and industrial companies in the United Kingdom. Pursuant to these arrangements, the company agreed to make available to creditworthy borrowers on commercial terms, £16 billion above the amount the company had budgeted to lend to United Kingdom businesses and £9 billion above the amount the company had budgeted to lend to United Kingdom homeowners in the year commencing 1 March 2009.

In relation to the 2009 commitment period, which ended on 28 February 2010, the RBS Group's net mortgage lending to UK homeowners was £12.7 billion above the amount it had originally budgeted to lend. In relation to its business lending commitment, the RBS Group achieved £60 billion of gross new lending to businesses, including £39 billion to SMEs but, in the economic environment prevailing at the time, many customers were strongly focused on reducing their borrowings and repayments consequently increased. Moreover, the withdrawal of foreign lenders was less pronounced than anticipated, there was a sharp increase in capital market issuance and demand continued to be weak. As a result, the RBS Group's net lending did not reach the £16 billion targeted.

In March 2010, the company agreed with the United Kingdom government certain adjustments to the lending commitments for the 2010 commitment period (the 12 month period commencing 1 March 2010), to reflect expected economic circumstances over the period. As part of the amended lending commitments, the company has committed, among other things, to make available gross new facilities, drawn or undrawn, of £50 billion to UK businesses in the period 1 March 2010 to 28 February 2011. In addition, the company has agreed with the United Kingdom government to make available £8 billion of net mortgage lending in the 2010 commitment period. This is a decrease of £1 billion on the net mortgage lending target that previously applied to the 2010 commitment period which ends on 28 February 2011, to reflect that the mortgage lending commitment for the 2009 commitment period was increased from £9 billion to £10 billion.

The RBS Group has also agreed to certain other commitments, which are material for the structure of the RBS Group and its operations, under the State aid restructuring plan approved by the European Commission in relation to State aid.

In addition, the RBS Group, together with HM Treasury, has agreed with the European Commission a prohibition on the making of discretionary dividends (including on preference shares and B Shares) or coupon payments on existing hybrid capital instruments for a two-year period from a date commencing no later than 30 April 2010 (which the RBS Group has subsequently announced shall be 30 April 2010). It is possible that the RBS Group may, in future, be subject to further restrictions on payments on such hybrid capital instruments, whether as a result of undertakings given to regulatory bodies, changes to capital requirements such as the proposals published by the Basel Committee on 17 December 2009 or otherwise. The RBS Group has also agreed to certain other undertakings in the Acquisition and Contingent Capital Agreement.

The undertakings described above may serve to limit the RBS Group's operations.

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

The RBS Group's ability to implement its strategy depends on the ability and experience of its senior management, which may include directors, and other key employees. The loss of the services of certain key employees, particularly to competitors, could have a negative impact on the RBS Group's business. The RBS Group's future success will also depend on its ability to attract, retain and remunerate highly skilled and qualified personnel competitively with its peers. This cannot be guaranteed, particularly in light of heightened regulatory oversight of banks and heightened scrutiny of, and (in some cases) restrictions placed upon, management compensation arrangements, in particular those in receipt of Government funding (such as the company). The RBS Group has made a commitment to comply with the FSA Remuneration Code. These rules came into force on 1 January 2010 and are in line with the agreement reached by the G-20, setting global standards for the implementation of the Financial Stability Board's remuneration principles. The RBS Group agreed that it will be at the leading edge of implementing the G-20 principles and granted UK Financial Investments Limited ("UKFI") consent rights over the shape and size of its aggregate bonus pool for the 2009 performance year. The level of the 2009 bonus pool and the deferral and claw-back provisions implemented by the RBS Group may impair the ability of the RBS Group to attract and retain suitably qualified personnel in various parts of the RBS Group's businesses.

The RBS Group is also altering certain of the pension benefits it offers to staff. Some employees continue to participate in defined benefit arrangements. The following two changes have been made to the main defined benefit pension plans: (i) a yearly limit on the amount of any salary increase that will count for pension purposes; and (ii) a reduction in the severance lump sum for those who take an immediate undiscounted pension for redundancy. In addition to the effects of such measures on the RBS Group's ability to retain senior management and other key employees, the marketplace for skilled personnel is becoming more competitive, which means the cost of hiring, training and retaining skilled personnel may continue to increase. The failure to attract or retain a sufficient number of appropriately skilled personnel could place the RBS Group at a significant competitive disadvantage and prevent the RBS Group from successfully implementing its strategy, which could have a material adverse effect on the RBS Group's financial condition and results of operations or result in a loss of value in the Securities.

In addition, certain of the RBS Group's employees in the United Kingdom, continental Europe and other jurisdictions in which the RBS Group operates are represented by employee representative bodies, including trade unions. Engagement with its employees and such bodies is important to the RBS Group and a breakdown of these relationships could adversely affect the RBS Group's business, reputation and results. As the RBS Group implements cost-saving initiatives and disposes of, or runs-down, certain assets or businesses (including as part of its expected restructuring plans), it faces increased risk in this regard and there can be no assurance that the RBS Group will be able to maintain good relations with its employees or employee representative bodies in respect of all matters. As a result, the RBS Group may experience strikes or other industrial action from time to time, which could have a material adverse effect on its business and results of operations and could cause damage to its reputation.

Each of the RBS Group's businesses is subject to substantial regulation and oversight. Any significant regulatory developments could have an effect on how the RBS Group conducts its business and on its results of operations and financial condition.

The RBS Group is subject to financial services laws, regulations, corporate governance requirements, administrative actions and policies in each location in which it operates. All of these are subject to change, particularly in the current market environment, where there have been unprecedented levels of government intervention and changes to the regulations governing financial institutions, including recent nationalisations in the United States, the United Kingdom and other European countries. As a result of these and other ongoing and possible future changes in the financial services regulatory landscape (including requirements imposed by virtue of the RBS Group's participation in government or regulator-led initiatives), the RBS Group expects to face greater regulation in the United Kingdom, the United States and other countries in which it operates, including throughout the rest of Europe. Compliance with such regulations may increase the RBS Group's capital requirements and costs and have an adverse impact on how the RBS Group conducts its business, on the products and services it offers, on the value of its assets and on its results of operations and financial condition or result in a loss of value in the Securities.

Other areas where governmental policies and regulatory changes could have an adverse impact include, but are not limited to:

- the monetary, interest rate, capital adequacy, liquidity, balance sheet leverage and other policies of central banks and regulatory authorities;

- general changes in government or regulatory policy or changes in regulatory regimes that may significantly influence investor decisions in particular markets in which the RBS Group operates, increase the costs of doing business in those markets or result in a reduction in the credit ratings of the company or one of its subsidiaries;

- changes to financial reporting standards;

- changes in regulatory requirements relating to capital and liquidity, such as limitations on the use of deferred tax assets in calculating Core Tier 1 and/or Tier 1 capital, or prudential rules relating to the capital adequacy framework;

- other general changes in the regulatory requirements, such as the imposition of onerous compliance obligations, restrictions on business growth or pricing, new levies or fees, requirements in relation to the structure and organisation of the RBS Group and requirements to operate in a way that prioritises objectives other than shareholder value creation;

- changes in competition and pricing environments;

- further developments in financial reporting, corporate governance, corporate structure, conduct of business and employee compensation;

- differentiation among financial institutions by governments with respect to the extension of guarantees to bank customer deposits and the terms attaching to such guarantees, including requirements for the entire RBS Group to accept exposure to the risk of any individual member of the RBS Group, or even third party participants in guarantee schemes, failing;

- implementation of, or costs related to, local customer or depositor compensation or reimbursement schemes;

- transferability and convertibility of currency risk;

- expropriation, nationalisation and confiscation of assets;

- changes in legislation relating to foreign ownership; and

- other unfavourable political, military or diplomatic developments producing social instability or legal uncertainty which, in turn, may affect demand for the RBS Group's products and services.

The RBS Group's results have been and could be further adversely affected in the event of goodwill impairment.

The RBS Group capitalises goodwill, which is calculated as the excess of the cost of an acquisition over the net fair value of the identifiable assets, liabilities and contingent liabilities acquired. Acquired goodwill is recognised initially at cost and subsequently at cost less any accumulated impairment losses. As required by IFRS, the RBS Group tests goodwill for impairment annually or more frequently, at external reporting dates, when events or circumstances indicate that it might be impaired. An impairment test involves comparing the recoverable amount (the higher of value in use and fair value less cost to sell) of an individual cash generating unit with its carrying value. The value in use and fair value of the RBS Group's cash generating units are affected by market conditions and the performance of the economies in which the RBS Group operates. Where the RBS Group is required to recognise a goodwill impairment, it is recorded in the RBS Group's income statement, although it has no effect on the RBS Group's regulatory capital position.

The RBS Group may be required to make further contributions to its pension schemes if the value of pension fund assets is not sufficient to cover potential obligations.

The RBS Group maintains a number of defined benefit pension schemes for past and a number of current employees. Pensions risk is the risk that the liabilities of the RBS Group's various defined benefit pension schemes which are long term in nature will exceed the schemes' assets, as a result of which the RBS Group is required or chooses to make additional contributions to the schemes. The schemes' assets comprise investment portfolios that are held to meet projected liabilities to the scheme members. Risk arises from the schemes because the value of these asset portfolios and returns from them may be less than expected and because there may be greater than expected increases in the estimated value of the schemes' liabilities. In these circumstances, the RBS Group could be obliged, or may choose, to make additional contributions to the schemes, and during recent periods, the RBS Group has voluntarily made such contributions. Given the current economic and financial market difficulties and the prospect that they may continue over the near and medium term, the RBS Group may experience increasing pension deficits or be required or elect to make further contributions to its pension schemes and such deficits and contributions could be significant and have a negative impact on the RBS Group's capital position, results of operations or financial condition or result in a loss of value in the Securities. The next funding valuation of the RBS Group's major defined benefit pension plan, The Royal Bank of Scotland Group Pension Fund, will take place with an effective date of 31 March 2010.

The RBS Group is and may be subject to litigation and regulatory investigations that may impact its business.

The RBS Group's operations are diverse and complex, and it operates in legal and regulatory environments that expose it to potentially significant litigation, regulatory investigation and other regulatory risk. As a result, the RBS Group is, and may in the future be, involved in various disputes, legal proceedings and regulatory investigations in the United Kingdom, the EU, the United States and other jurisdictions, including class action litigation and review by the European Commission under State aid rules. Furthermore, the RBS Group, like many other financial institutions, has come under greater regulatory scrutiny over the last year and expects that environment to continue for the foreseeable future, particularly as it relates to compliance with new and existing corporate governance, employee compensation, conduct of business, anti-money laundering and anti-terrorism laws and regulations, as well as the provisions of applicable sanctions programmes. Disputes, legal proceedings and regulatory investigations are subject to many uncertainties, and their outcomes are often difficult to predict, particularly in the earlier stages of a case or investigation. Adverse regulatory action or adverse judgments in litigation could result in restrictions or limitations on the RBS Group's operations or result in a material adverse effect on the RBS Group's reputation or results of operations or result in a loss of value in the Securities. For details about certain litigation and regulatory investigations in which the Group is involved, see Note 29 on the financial statements.

Operational risks are inherent in the RBS Group's operations

The RBS Group's operations are dependent on the ability to process a very large number of transactions efficiently and accurately while complying with applicable laws and regulations where it does business. The RBS Group has complex and geographically diverse operations and operational risk and losses can result from internal and external fraud, errors by employees or third parties, failure to document transactions properly or to obtain proper authorisation, failure to comply with applicable regulatory requirements and conduct of business rules (including those arising out of anti-money laundering and anti-terrorism legislation, as well as the provisions of applicable sanctions programmes), equipment failures, natural disasters or the inadequacy or failure of systems and controls, including those of the RBS Group's suppliers or counterparties. Although the RBS Group has implemented risk controls and loss mitigation actions, and substantial resources are devoted to developing efficient procedures, to identify and rectify weaknesses in existing procedures and to train staff, it is not possible to be certain that such actions have been or will be effective in controlling each of the operational risks faced by the RBS Group. Any weakness in these systems or controls, or any breaches or alleged breaches of applicable laws or regulations, could have a materially negative impact on the RBS Group's business, reputation and results of operations and the price of any Securities. Notwithstanding anything contained in this risk factor, it should not be taken as implying that the company will be unable to comply with its obligations as a company with securities admitted to the Official List of the United Kingdom Listing Authority nor that it, or its relevant subsidiaries, will be unable to comply with its or their obligations as supervised firms regulated by the FSA.

The RBS Group is exposed to the risk of changes in tax legislation and its interpretation and to increases in the rate of corporate and other taxes in the jurisdictions in which it operates.

The RBS Group's activities are subject to tax at various rates around the world computed in accordance with local legislation and practice. Action by governments to increase tax rates or to impose additional taxes or to restrict the tax reliefs currently available to the RBS Group would reduce the RBS Group's profitability. Revisions to tax legislation or to its interpretation might also affect the RBS Group's results in the future.

HM Treasury (or UKFI on its behalf) may be able to exercise a significant degree of influence over the RBS Group.

UKFI manages HM Treasury's shareholder relationship with the company. Although HM Treasury has indicated that it intends to respect the commercial decisions of the RBS Group and that the RBS Group will continue to have its own independent board of directors and management team determining its own strategy, should its current intentions change, HM Treasury's position as a majority shareholder (and UKFI's position as manager of this shareholding) means that HM Treasury or UKFI may be able to exercise a significant degree of influence over, among other things, the election of directors and the appointment of senior management. In addition, as the provider of the APS, HM Treasury has a range of rights that other shareholders do not have. These include rights under the terms of the APS over the RBS Group's remuneration policy and practice. The manner in which HM Treasury or UKFI exercises HM Treasury's rights as majority shareholder or in which HM Treasury exercises its rights under the APS could give rise to conflict between the interests of HM Treasury and the interests of other shareholders. The Board has a duty to promote the success of the company for the benefit of its members as a whole.

The RBS Group's operations have inherent reputational risk.

Reputational risk, meaning the risk to earnings and capital from negative public opinion, is inherent in the RBS Group's business. Negative public opinion can result from the actual or perceived manner in which the RBS Group conducts its business activities, from the RBS Group's financial performance, from the level of direct and indirect government support or from actual or perceived practices in the banking and financial industry. Negative public opinion may adversely affect the RBS Group's ability to keep and attract customers and, in particular, corporate and retail depositors. The RBS Group cannot ensure that it will be successful in avoiding damage to its business from reputational risk.

In the United Kingdom and in other jurisdictions, the RBS Group is responsible for contributing to compensation schemes in respect of banks and other authorised financial services firms that are unable to meet their obligations to customers.

In the United Kingdom, the Financial Services Compensation Scheme (the "Compensation Scheme") was established under the FSMA and is the United Kingdom's statutory fund of last resort for customers of authorised financial services firms. The Compensation Scheme can pay compensation to customers if a firm is unable, or likely to be unable, to pay claims against it and may be required to make payments either in connection with the exercise of a stabilisation power or in exercise of the bank insolvency procedures under the Banking Act. The Compensation Scheme is funded by levies on firms authorised by the FSA, including the RBS Group. In the event that the Compensation Scheme raises funds from the authorised firms, raises those funds more frequently or significantly increases the levies to be paid by such firms, the associated costs to the RBS Group may have a material impact on its results of operations and financial condition. As at 31 December 2009, the RBS Group has a provision of £135 million for its share of Compensation Scheme management expenses levies for the 2009/10 and 2010/11 Compensation Scheme years.

In addition, to the extent that other jurisdictions where the RBS Group operates have introduced or plan to introduce similar compensation, contributory or reimbursement schemes (such as in the United States with the Federal Deposit Insurance Corporation), the RBS Group may make further provisions and may incur additional costs and liabilities, which may negatively impact its financial condition and results of operations or result in a loss of value in the Securities.

The RBS Group's business and earnings may be affected by geopolitical conditions.

The performance of the RBS Group is significantly influenced by the geopolitical and economic conditions prevailing at any given time in the countries in which it operates, particularly the United Kingdom, the United States and other countries in Europe and Asia. For example, the RBS Group has a presence in countries where businesses could be exposed to the risk of business interruption and economic slowdown following the outbreak of a pandemic, or the risk of sovereign default following the assumption by governments of the obligations of private sector institutions. Similarly, the RBS Group faces the heightened risk of trade barriers, exchange controls and other measures taken by sovereign governments which may impact a borrower's ability to repay. Terrorist acts and threats and the response to them of governments in any of these countries could also adversely affect levels of economic activity and have an adverse effect upon the RBS Group's business.

The restructuring proposals for ABN AMRO are complex and may not realise the anticipated benefits for the RBS Group.

The restructuring plan in place for the integration and separation of ABN AMRO into and among the businesses and operations of the Consortium Members is complex, involving substantial reorganisation of ABN AMRO's operations and legal structure. The restructuring plan is being implemented and significant elements have been completed within the planned timescales and the integration of the RBS Group's businesses continues. As part of this reorganisation, on 6 February 2010, the businesses of ABN AMRO acquired by the Dutch State were legally demerged from the ABN AMRO businesses acquired by the RBS Group and were transferred into a newly established holding company, ABN AMRO Bank N.V. This holding company remains within the ABN AMRO Group until it is transferred to a new holding company that is to be established by the Dutch State, which is expected to take place in the first half of 2010 and is subject to the approval of the Dutch Central Bank.

The RBS Group may not realise the benefits of the acquisition or the restructuring when expected or to the extent projected. The occurrence of any of these events, including as a result of staff losses or performance issues, or as a result of further disposals or restructurings by the RBS Group, may have a negative impact on the RBS Group's financial condition and results of operations. It is not expected that the Dutch State's acquisition of Fortis Bank Nederland's shares in RFS Holdings B.V. will materially affect the integration benefits envisaged by the RBS Group.

The recoverability and regulatory capital treatment of certain deferred tax assets recognised by the RBS Group depends on the RBS Group's ability to generate sufficient future taxable profits and there being no adverse changes to tax legislation, regulatory requirements or accounting standards.

In accordance with IFRS, the RBS Group has recognised deferred tax assets on losses available to relieve future profits from tax only to the extent that it is probable that they will be recovered. The deferred tax assets are quantified on the basis of current tax legislation and accounting standards and are subject to change in respect of the future rates of tax or the rules for computing taxable profits and allowable losses. Failure to generate sufficient future taxable profits or changes in tax legislation or accounting standards may reduce the recoverable amount of the recognised deferred tax assets.

There is currently no restriction in respect of deferred tax assets recognised by the RBS Group for regulatory purposes. Changes in regulatory rules may restrict the amount of deferred tax assets that can be recognised and such changes could lead to a reduction in the RBS Group's Core Tier 1 capital ratio. In particular, on 17 December 2009, the Basel Committee published a consultative document setting out certain proposed changes to capital requirements (see risk factor above headed "The RBS Group's business performance could be adversely affected if its capital is not managed effectively or if there are changes to capital adequacy and liquidity requirements"). Those proposals included a requirement that deferred tax assets which rely on future profitability of the RBS Group to be realised should be deducted from the common equity component of Tier 1 and therefore not count towards Tier 1 capital.

Risks relating to the RBS Group's participation in the Asset Protection Scheme, the B shares, the Contingent B shares and the Dividend Access Share.

Owing to the complexity, scale and unique nature of the APS and the uncertainty surrounding the duration and severity of the recent economic recession, there may be unforeseen issues and risks that are relevant in the context of the RBS Group's participation in the APS and in the impact of the APS on the RBS Group's business, operations and financial condition. In addition, the assets or exposures to be covered by the APS may not be those with the greatest future losses or with the greatest need for protection.

Since the APS is a unique form of credit protection over a complex range of diversified assets and exposures (the "Covered Assets") in a number of jurisdictions and there is significant uncertainty about the duration and severity of the recent economic recession, there may be unforeseen issues and risks that may arise as a result of the RBS Group's participation in the APS and the impact of the APS on the RBS Group's business, operations and financial condition cannot be predicted with certainty. Such issues or risks may have a material adverse effect on the RBS Group. Moreover, the RBS Group's choice of assets or exposures to be covered by the APS was based on predictions at the time of its accession to the APS regarding the performance of counterparties and assumptions about market dynamics and asset and liability pricing, all or some of which may prove to be inaccurate. There is, therefore, a risk that the Covered Assets will not be those with the greatest future losses or with the greatest need for protection and, as a result, the RBS Group's financial condition, income from operations and the value of any Securities may still suffer due to further impairments and credit write-downs.

There is no assurance that the RBS Group's participation in the APS and the issue of £25.5 billion of B shares and, if required, the £8 billion Contingent B shares will achieve the RBS Group's goals of improving and maintaining the RBS Group's capital ratios in the event of further losses. Accordingly, the RBS Group's participation in the APS and the issue of £25.5 billion of B shares and, if required, the £8 billion Contingent B shares may not improve market confidence in the RBS Group and the RBS Group may still face the risk of full nationalisation or other resolution procedures under the Banking Act.

The RBS Group's participation in the APS, together with the issue of £25.5 billion of B shares in December 2009 and, if required, the £8 billion Contingent B shares, has improved its consolidated capital ratios. In the event that the RBS Group's Core Tier 1 capital ratio declines to below 5 per cent., and if certain conditions are met, HM Treasury is committed to subscribe (the "Contingent Subscription") for up to an additional £8 billion of B shares (the "Contingent B shares") and, in connection with such subscription, would receive further enhanced dividend rights under the associated series 1 dividend access share in the capital of the company (the "Dividend Access Share"). However, notwithstanding the RBS Group's participation in the APS and the issue of the £25.5 billion of B shares and, if required, the issue of the £8 billion Contingent B, the RBS Group remains exposed to a substantial first loss amount of £60 billion in respect of the Covered Assets and for 10 per cent. of Covered Assets losses after the first loss amount. In addition, as mentioned in the previous risk factor, the assets or exposures covered by the APS may not be those with the greatest future losses or with the greatest need for protection. Moreover, the RBS Group continues to carry the risk of losses, impairments and write-downs with respect to assets not covered by the APS. Therefore, there can be no assurance that any regulatory capital benefits and the additional Core Tier 1 capital will be sufficient to maintain the RBS Group's capital ratios at the requisite levels in the event of further losses (even with the £8 billion Contingent B shares). If the RBS Group is unable to improve its capital ratios sufficiently or to maintain its capital ratios in the event of further losses, its business, results of operations and financial condition will suffer, its credit ratings may fall, its ability to lend and access funding will be further limited and its cost of funding may increase. The occurrence of any or all of such events may cause the price of its securities to decline substantially and may result in intervention by the Authorities, which could include full nationalisation or other resolution procedures under the Banking Act. Any compensation payable to holders of its securities would be subject to the provisions of the Banking Act, and investors may receive no value for their Securities.

In the event that the RBS Group's Core Tier 1 capital ratio declines to below 5 per cent., HM Treasury is committed to subscribe for up to an additional £8 billion of Contingent B shares if certain conditions are met. If such conditions are not met, and the RBS Group is unable to issue the £8 billion Contingent B shares, the RBS Group may be unable to find alternative methods of obtaining protection for stressed losses against severe or prolonged recessionary periods in the economic cycle and improving its capital ratios, with the result that the RBS Group may face increased risk of full nationalisation or other resolution procedures under the Banking Act.

In the event that the RBS Group's Core Tier 1 capital ratio declines to below 5 per cent., HM Treasury is committed to subscribe for up to an additional £8 billion of Contingent B shares if certain conditions are met. Such conditions include that the European Commission's decision that the State aid is compatible with article 87 of the consolidated version of the Treaty establishing the European Community continues to be in force, that the European Commission has not opened a formal investigation under article 88(2) of such Treaty in relation to the possible misuse of State aid, that there has been no breach by the company of the State Aid Commitment Deed and that no 'Termination Event' has occurred.

If such conditions are not met, and the RBS Group is unable to issue the £8 billion Contingent B shares, the RBS Group may be unable to find alternative methods of obtaining protection for stressed losses against severe or prolonged recessionary periods in the economic cycle and improving its capital ratios, with the result that the RBS Group may face increased risk of full nationalisation or other resolution procedures under the Banking Act.

In these circumstances, if the RBS Group is unable to issue the £8 billion Contingent B shares, the RBS Group will need to assess its strategic and operational position and will be required to find alternative methods for achieving the requisite capital ratios. Such methods could include an accelerated reduction in risk-weighted assets, disposals of certain businesses, increased issuance of Tier 1 capital securities, increased reliance on alternative government-supported liquidity schemes and other forms of government assistance. There can be no assurance that any of these alternative methods will be available or would be successful in increasing the RBS Group's capital ratios to the desired or requisite levels. If the RBS Group is unable to issue the £8 billion Contingent B shares, the RBS Group's business, results of operations, financial condition and capital position and ratios will suffer, its credit ratings may drop, its ability to lend and access funding will be further limited and its cost of funding may increase. The occurrence of any or all of such events may cause the price of its securities to decline substantially and may result in intervention by the Authorities or other regulatory bodies in the other jurisdictions in which the Royal Bank and its subsidiaries operate, which could include full nationalisation, other resolution procedures under the Banking Act or revocation of permits and licences necessary to conduct the RBS Group's businesses. Any compensation payable to holders of Securities would be subject to the provisions of the Banking Act, and investors may receive no value for their Securities (see the risk factor headed "The company and its United Kingdom bank subsidiaries may face the risk of full nationalisation or other resolution procedures under the Banking Act 2009").

The RBS Group may have included Covered Assets that are ineligible (or that later become ineligible) for protection under the APS. Protection under the APS may be limited or may cease to be available where Covered Assets are not correctly or sufficiently logged or described, where a Covered Asset is disposed of (in whole or in part) prior to a Trigger, where the terms of the APS do not apply or are uncertain in their application, where the terms of the protection itself potentially give rise to legal uncertainty, where certain criminal conduct has or may have occurred or where a breach of bank secrecy, confidentiality, data protection or similar laws may occur. In addition, certain assets included in the APS do not satisfy the eligibility requirements of the Scheme Documents. In each case this would reduce the anticipated benefits to the RBS Group of the APS.

The Covered Assets comprise a wide variety and a very large number of complex assets and exposures. As a result of the significant volume, variety and complexity of assets and exposures and the resulting complexity of the Scheme Documents, there is a risk that the RBS Group may have included assets or exposures within the Covered Assets that are not eligible for protection under the APS, with the result that such assets or exposures may not be protected by the APS. Furthermore, if Covered Assets are not correctly or sufficiently logged or described for the purposes of the APS, protection under the APS may, in certain circumstances and subject to certain conditions, not be available or may be limited, including by potentially being limited to the terms of the assets "as logged". If a Covered Asset is disposed of prior to the occurrence of a failure to pay, a bankruptcy or a restructuring, as described in the UK Asset Protection Scheme Terms and Conditions (the "Scheme Conditions") (a "Trigger") in respect of that Covered Asset, the RBS Group will also lose protection under the APS in respect of that disposed asset or, if the Covered Asset is disposed of in part, in respect of that disposed part of the Covered Asset or in some circumstances all of the Covered Asset, in each case with no rebate of the fee payable to HM Treasury, unless an agreement otherwise is reached with HM Treasury at the relevant time. Moreover, since the terms of the credit protection available under the APS are broad and general (given the scale and purpose of the APS and the wide variety and very large number of complex assets and exposures intended to be included as Covered Assets) and also very complex and in some instances operationally restrictive, certain Scheme Conditions may not apply to particular assets, exposures or operational scenarios or their applicability may be uncertain (for example, in respect of overdrafts). In addition, many of these provisions apply from 31 December 2008 and therefore may not have been complied with between this date and the date of the RBS Group's accession to the APS on 22 December 2009. In each case this may result in a loss or reduction of protection. There are certain limited terms and conditions of the Scheme Conditions which are framed in such a way that may give rise to lack of legal certainty. Furthermore, if a member of the RBS Group becomes aware after due and reasonable enquiry that there has been any material or systemic criminal conduct on the part of the RBS Group (including its directors, officers and employees) relating to or affecting any of the Covered Assets, some or all of those assets may cease to be protected by the APS. HM Treasury may also require the withdrawal or the company may itself consider it necessary to withdraw Covered Assets held in certain jurisdictions where disclosure of certain information to HM Treasury may result in a breach of banking secrecy, confidentiality, data protection or similar laws. In addition, at the time of accession to the APS, approximately £3 billion of derivative and structured finance assets were identified as having been included in the APS which, for technical reasons, did not or which were anticipated at some stage not to, satisfy the eligibility requirements specified in the Scheme Documents. HM Treasury and the company agreed to negotiate in good faith to establish as soon as practicable whether (and if so, to what extent) coverage should extend to these derivative assets. These negotiations remain ongoing. The £3 billion of derivative and structured finance assets referred to above were in addition to approximately £1.2 billion of Covered Assets across a broad range of asset classes which were withdrawn from the APS at the time of accession.

The effect of (i) failures to be eligible and/or to log or correctly describe Covered Assets, (ii) disposals of Covered Assets prior to a Trigger, (iii) the uncertainty of certain Scheme Conditions and the exclusion of certain assets and exposures from the APS and potential lack of legal certainty, (iv) the occurrence of material or systemic criminal conduct on the part of the company or its representatives relating to or affecting Covered Assets or breach of banking secrecy, confidentiality, data protection or similar laws and (v) failure or potential failure of HM Treasury and the company to reach agreement in respect of whether (and if so, to what extent) cover should extend to certain ineligible assets, may (or, in respect of assets which HM Treasury and the company have agreed are ineligible, will) impact the enforceability and/or level of protection available to the RBS Group and may materially reduce the protection anticipated by the RBS Group for its stressed losses. Further, there is no ability to nominate additional or alternative assets or exposures in place of those which turn out not to be covered under the APS. If the RBS Group is then unable to find alternative methods for improving and maintaining its capital ratios, its business, results of operations and financial condition will suffer, its credit ratings may drop, its ability to lend and access funding will be further limited and its cost of funding may increase. The occurrence of any or all of such events may cause the price of its securities to decline substantially and may result in intervention by the Authorities, which could include full nationalisation or other resolution procedures under the Banking Act. Any compensation payable to holders of Securities would be subject to the provisions of the Banking Act, and investors may receive no value for their Securities.

During the life of the APS, certain or all of the Covered Assets may cease to be protected due to a failure to comply with continuing obligations under the APS, reducing the benefit of the APS to the RBS Group.

The RBS Group is subject to limitations on actions it can take in respect of the Covered Assets and certain related assets and to extensive continuing obligations under the Scheme Conditions relating to governance, asset management, audit and reporting. The RBS Group's compliance with the Scheme Conditions is dependent on its ability to (i) implement efficiently and accurately new approval processes and reporting, governance and management systems in accordance with the Scheme Conditions and (ii) comply with applicable laws and regulations where it does business. The RBS Group has complex and geographically diverse operations, and operational risk in the context of the APS may result from errors by employees or third-parties, failure to document transactions or procedures properly or to obtain proper authorisations in accordance with the Scheme Conditions, equipment failures or the inadequacy or failure of systems and controls. Although the RBS Group has devoted substantial financial and operational resources, and intends to devote further substantial resources, to developing efficient procedures to deal with the requirements of the APS and to training staff, it is not possible to be certain that such actions will be effective to control each of the operational risks faced by the RBS Group or to provide the necessary information in the necessary time periods in the context of the APS. Since the RBS Group's operational systems were not originally designed to facilitate compliance with these extensive continuing obligations, there is a risk that the RBS Group will fail to comply with a number of these obligations. This risk is particularly acute in the period immediately following the APS becoming effective. Certain of the reporting requirements, in particular, are broad in their required scope and challenging in their required timing. There is, as a result, a real possibility that the RBS Group, at least initially, will not be able to achieve full compliance. Where the RBS Group is in breach of its continuing obligations under the Scheme Conditions in respect of any of the Covered Assets, related assets or other obligations, or otherwise unable to provide or verify information required under the APS within the requisite time periods, recovery of losses under the APS may be adversely impacted, may lead to an indemnity claim and HM Treasury may in addition have the right to exercise certain step-in rights, including the right to require the RBS Group to appoint a step-in manager who may exercise oversight, direct management rights and certain other rights including the right to modify certain of the RBS Group's strategies, policies or systems. Therefore, there is a risk that Covered Assets in relation to which the RBS Group has failed to comply with its continuing obligations under the Scheme Conditions, will not be protected or fully protected by the APS. As there is no ability to nominate additional or alternative assets or exposures for cover under the APS, the effect of such failures will impact the level of protection available to the RBS Group and may reduce or eliminate in its entirety the protection anticipated by the RBS Group for its stressed losses, in which case its business, results of operations and financial condition will suffer, its credit ratings may drop, its ability to lend and access funding will be further limited and its cost of funding may increase. The occurrence of any or all of such events may cause the price of its securities to decline substantially and may result in intervention by the Authorities, which could include full nationalisation or other resolution procedures under the Banking Act. Any compensation payable to holders of Securities would be subject to the provisions of the Banking Act, and investors may receive no value for their Securities.

The Scheme Conditions may be modified by HM Treasury in certain prescribed circumstances, which could result in a loss or reduction in the protection provided under the APS in relation to certain Covered Assets, increased costs to the RBS Group in respect of the APS or limitations on the RBS Group's operations.

HM Treasury may, following consultation with the RBS Group, modify or replace certain of the Scheme Conditions in such a manner as it considers necessary (acting reasonably) to:

- remove or reduce (or remedy the effects of) any conflict between: (i) the operation, interpretation or application of certain Scheme Conditions; and (ii) any of the overarching principles governing the APS herein (the "Scheme Principles");
- correct any manifest error contained in certain Scheme Conditions; or
- take account of any change in law.

HM Treasury can only effect a modification or replacement of a Scheme Condition if (i) it is consistent with each of the Scheme Principles, (ii) there has been no formal notification from the FSA that such modification would result in any protection provided to the RBS Group under the APS ceasing to satisfy certain requirements for eligible credit risk mitigation and (iii) HM Treasury has considered in good faith and had regard to any submissions, communications or representations of or made by the RBS Group regarding the anticipated impact of the proposed modification under any non-United Kingdom capital adequacy regime which is binding on the company or a Covered Entity (as defined in the accession agreement between HM Treasury and the company which incorporates the Scheme Conditions and sets out certain other terms and conditions applicable to the company's participation in the APS (the "Accession Agreement")).

Such modifications or replacements may be retrospective and may result in a loss of or reduction in the protection expected by the RBS Group under the APS in relation to certain Covered Assets, an increase in the risk weightings of the Covered Assets (either in the United Kingdom or overseas), a material increase in the continuing reporting obligations or asset management conditions applicable to the RBS Group under the Scheme Conditions or a material increase in the expenses incurred or costs payable by the RBS Group under the APS. Modifications by HM Treasury of the Scheme Conditions could result in restrictions or limitations on the RBS Group's operations. The consequences of any such modifications by HM Treasury are impossible to quantify and are difficult to predict and may have a material adverse effect on the RBS Group's financial condition and results of operations.

Owing to the complexity of the APS and possible regulatory capital developments, the operation of the APS and the issue of £25.5 billion of B shares and, if required, the £8 billion Contingent B shares may fail to achieve the desired effect on the RBS Group's regulatory capital position. This may mean the RBS Group's participation in the APS and the issuance of £25.5 billion of B shares and, if required, the £8 billion Contingent B shares does not improve market confidence in the RBS Group sufficiently or at all. This may result in the RBS Group facing the risk of full nationalisation or other resolution procedures under the Banking Act.

One of the key objectives of the APS and the issuance of £25.5 billion of B shares in December 2009 and, if required, the £8 billion Contingent B shares was to improve capital ratios at a consolidated level for the RBS Group and at an individual level for certain relevant Group members. The RBS Group has and may in the future enter into further back-to-back arrangements with RBS Group members holding assets or exposures to be covered by the APS in order to ensure the capital ratios of these entities are also improved by virtue of the APS. As the APS and certain of the associated back-to-back arrangements are a unique form of credit protection over a complex range of diversified Covered Assets in a number of jurisdictions, there is a risk that the interpretation of the relevant regulatory capital requirements by one or more of the relevant regulatory authorities may differ from that assumed by the RBS Group, with the result that the anticipated improvement to the RBS Group's capital ratios will not be fully achieved. There is a further risk that, given that the current regulatory capital requirements and the regulatory bodies governing these requirements are subject to unprecedented levels of review and scrutiny both globally and locally, regulatory capital treatment that differs from that assumed by the RBS Group in respect of the APS, the treatment of the B share issuance or the back-to-back arrangement may also occur because of changes in law or regulation, regulatory bodies or interpretation of the regulatory capital regimes applicable to the RBS Group and/or the APS and/or the B shares and/or the back-to-back arrangements described above. If participation in the APS and the issuance of £25.5 billion of B shares and, if required, the £8 billion Contingent B shares are not sufficient to maintain the RBS Group's capital ratios, this could cause the RBS Group's business, results of operations and financial condition to suffer, its credit rating to drop, its ability to lend and access to funding to be further limited and its cost of funding to increase. The occurrence of any or all of such events may cause the price of its securities to decline substantially and may result in intervention by the Authorities, which could include full nationalisation or other resolution procedures under the Banking Act. Any compensation payable to holders of Securities would be subject to the provisions of the Banking Act and investors may receive no value for their Securities.

The costs of the RBS Group's participation in the APS may be greater than the amounts received thereunder.

The costs of participating in the APS incurred by the RBS Group to HM Treasury include a fee of £700 million per annum, payable in advance for the first three years of the APS and £500 million per annum thereafter until the earlier of (i) the date of termination of the APS and (ii) 31 December 2099. The fee may be paid in cash or, subject to HM Treasury consent, by the waiver of certain United Kingdom tax reliefs that are treated as deferred tax assets (pursuant to three agreements which provide the right, at the company's option, subject to HM Treasury consent, to satisfy all or part of the annual fee in respect of the APS and £8 billion of Contingent B shares , and the exit fee payable in connection with any termination of the RBS Group's participation in the APS, by waiving the right to certain United Kingdom tax reliefs that are treated as deferred tax assets ("Tax Loss Waiver")) or be funded by a further issue of B shares to HM Treasury. The RBS Group has paid in cash the fee of £1.4 billion in respect of 2009 and 2010. On termination of the RBS Group's participation in the APS, the fees described in the risk factor below headed "The RBS Group may have to repay any net pay-outs made by HM Treasury under the APS in order to terminate its participation in the APS" will apply. Furthermore, the RBS Group may be subject to additional liabilities in connection with the associated intra group arrangements. Significant costs either have been or will also be incurred in (i) establishing the APS (including a portion of HM Treasury's costs attributed to the RBS Group by HM Treasury), (ii) implementing the APS, including the RBS Group's internal systems building and as a consequence of its on-going management and administration obligations under the Scheme Conditions, such as complying with (a) the extensive governance, reporting, auditing and other continuing obligations of the APS and (b) the asset management objective which is generally applied at all times to the Covered Assets and will require increased lending in certain circumstances and (iii) paying the five-year annual fee for the £8 billion of Contingent B shares of £320 million less 4 per cent. of: (a) the value of any B shares subscribed for under the Contingent Subscription; and (b) the amount by which the Contingent Subscription has been reduced pursuant to any exercise by the company of a partial termination of the Contingent Subscription (payable in cash or, with HM Treasury's consent, by waiving certain United Kingdom tax reliefs that are treated as deferred tax assets (pursuant to the Tax Loss Waiver), or funded by a further issue of B shares to HM Treasury). In addition, there will be ongoing expenses associated with compliance with the Scheme Conditions, including the company's and HM Treasury's professional advisers' costs and expenses. These expenses are expected to be significant due to the complexity of the APS, the need to enhance the RBS Group's existing systems in order to comply with reporting obligations required by the APS and the RBS Group's obligations under the Scheme Conditions to pay HM Treasury's and its advisers' costs in relation to the APS. In addition, the RBS Group has certain other financial exposures in connection with the APS including (i) an obligation to indemnify HM Treasury, any governmental entity or their representatives and (ii) for the minimum two-year period from a Trigger until payment is made by HM Treasury under the APS, exposure to the funding costs of retaining assets and exposures on its balance sheet whilst receiving interest based on the "Sterling General Collateral Repo Rate" as displayed on the Bloomberg service, or such other rate as may be notified by HM Treasury from time to time as reflecting its costs of funds.

The aggregate effect of the joining, establishment and operational costs of the APS and the on-going costs and expenses, including professional advisers' costs, may significantly reduce or even eliminate the anticipated amounts to be received by the RBS Group under the APS.

The amounts received under the APS (which amounts are difficult to quantify precisely may be less than the costs of participation, as described above. There are other, non-cash, anticipated benefits of the RBS Group's participation, which include the regulatory capital benefits referred to above and the potential protection from future losses, which are themselves also difficult to quantify.

The RBS Group may have to repay any net pay-outs made by HM Treasury under the APS in order to terminate its participation in the APS.

During its participation in the APS, RBS will pay an annual participation fee to HM Treasury. The annual fee, which is payable in advance, is £700 million per annum for the first three years of the RBS Group's participation in the APS and £500 million per annum thereafter until the earlier of (i) the date of termination of the APS and (ii) 31 December 2099. The RBS Group has paid in cash the fee of £1.4 billion in respect of 2009 and 2010. Pursuant to the Accession Agreement and the Tax Loss Waiver, subject to HM Treasury consent, all or part of the exit fee (but not the refund of the net payments the RBS Group has received from HM Treasury under the APS) may be paid by the waiver of certain United Kingdom tax reliefs that are treated as deferred tax assets (pursuant to the Tax Loss Waiver). The directors of the company may, in the future, conclude that the cost of this annual fee, in combination with the other costs of the RBS Group's participation in the APS, outweighs the benefits of the RBS Group's continued participation and therefore that the RBS Group's participation in the APS should be terminated. However, in order to terminate the RBS Group's participation in the APS, the RBS Group must have FSA approval and pay an exit fee which is an amount equal to (a) the larger of (i) the cumulative aggregate fee of £2.5 billion and (ii) 10 per cent. of the annual aggregate reduction in Pillar I capital requirements in respect of the assets covered by the APS up to the time of exit less (b) the aggregate of the annual fees paid up to the date of exit. In the event that the RBS Group has received payments from HM Treasury under the APS in respect of losses on any Covered Assets in respect of which a Trigger occurs ("Triggered Assets"), it must either negotiate a satisfactory exit payment to exit the APS, or absent such agreement, refund to HM Treasury any net payments made by HM Treasury under the APS in respect of losses on the Triggered Assets.

The effect of the payment of the exit fee and potentially the refund of the net pay-outs it has received from HM Treasury under the APS may significantly reduce or even eliminate the anticipated further regulatory capital benefits to the RBS Group of its participation in the APS or if FSA approval for the proposed termination is not obtained and could have an adverse impact on the RBS Group's financial condition and results of operation or result in a loss of value in the Securities. Alternatively, if the RBS Group is unable to repay to HM Treasury in full the exit fee and potentially the net pay-outs it has received under the APS and, therefore, unable to terminate its participation in the APS, the RBS Group will be required under the Scheme Conditions to continue to pay the annual fee to HM Treasury until 31 December 2099, which could have an adverse impact on the RBS Group's financial condition and results of operation or result in a loss of value in the Securities.

Under certain circumstances, the RBS Group cannot be assured that assets of ABN AMRO (and certain other entities) will continue to be covered under the APS, either as a result of a withdrawal of such assets or as a result of a breach of the relevant obligations.

If HM Treasury seeks to exercise its right to appoint one or more step-in managers in relation to the management and administration of Covered Assets held by ABN AMRO or its wholly-owned subsidiaries, ABN AMRO will, in certain circumstances, need to seek consent from the Dutch Central Bank to allow it to comply with such step-in. If this consent is not obtained by the date (which will fall no less than 10 business days after the notice from HM Treasury) on which the step-in rights must be effective, and other options to effect compliance are not possible (at all or because the costs involved prove prohibitive), those assets would need to be withdrawn by the RBS Group from the APS where permissible under the Scheme Conditions or, otherwise, with HM Treasury consent. If the RBS Group cannot withdraw such Covered Assets from the APS, it would be likely to lose protection in respect of these assets under the APS and/or may be liable under its indemnity to HM Treasury. If the RBS Group loses cover under the APS in respect of any Covered Asset held by ABN AMRO or its wholly-owned subsidiaries, any losses incurred on such asset will continue to be borne fully by the RBS Group and may have a material adverse impact on its financial condition, profitability and capital ratios. Similar issues apply in certain other jurisdictions but the relevant Covered Assets are of a lower quantum.

The extensive governance, asset management and information requirements under the Scheme Conditions and HM Treasury's step-in rights may serve to limit materially the RBS Group's operations. In addition, the market's reaction to such controls and limitations may have an adverse impact on the price of the Securities.

Under the Scheme Conditions, the RBS Group has extensive governance, asset management, audit and information obligations aimed at ensuring (amongst other things) that (i) there is no prejudice to, discrimination against, or disproportionate adverse effect on the management and administration of Covered Assets when compared with the management and administration of other assets of the RBS Group that are outside of the APS and (ii) HM Treasury is able to manage and assess its exposure under the APS, perform any other functions within HM Treasury's responsibilities or protect or enhance the stability of the United Kingdom financial system. Any information obtained by HM Treasury through its information rights under the APS may be further disclosed by HM Treasury to other government agencies, the United Kingdom Parliament, the European Commission, and more widely if HM Treasury determines that doing so is required, for example, to protect the stability of the United Kingdom financial system.

Moreover, HM Treasury has the right under the Scheme Conditions to appoint one or more step-in managers (identified or agreed to by HM Treasury) to exercise certain step-in rights upon the occurrence of certain specified events. The step-in rights are extensive and include certain oversight, investigation, approval and other rights, the right to require the modification or replacement of any of the systems, controls, processes and practices of the RBS Group and extensive rights in relation to the direct management and administration of the Covered Assets. If the RBS Group does not comply with the instructions of the step-in manager, once appointed, the RBS Group may lose protection under the APS in respect of all or some of the Covered Assets. The step-in manager may be a person identified by HM Treasury and not by the RBS Group.

The payment obligations of HM Treasury under the Scheme Documents are capable of being transferred to any third party (provided the transfer does not affect the risk weightings the RBS Group is entitled to apply to its exposures to Covered Assets). The step-in rights, together with all other monitoring, administration and enforcement rights, powers and discretions of HM Treasury under the Scheme Documents, are capable of being transferred to any government entity.

The obligations of the RBS Group and the rights of HM Treasury may, individually or in the aggregate, impact the way the RBS Group runs its business and may serve to limit the RBS Group's operations with the result that the RBS Group's business, results of operations and financial condition will suffer.

Any conversion of the B shares, in combination with any future purchase by HM Treasury of ordinary shares, would increase HM Treasury's ownership interest in the company, and could result in the delisting of the company's Securities.

On 22 December 2009, the company issued £25.5 billion of B shares to HM Treasury. The B shares are convertible, at the option of the holder at any time, into ordinary shares at an initial conversion price of £0.50 per ordinary share. Although HM Treasury has agreed not to convert any B shares it holds if, as a result of such conversion, it would hold more than 75 per cent. of the ordinary shares, if HM Treasury were to acquire additional ordinary shares otherwise than through the conversion of the B shares, such additional acquisitions could significantly increase HM Treasury's ownership interest in the company to above 75 per cent. of the company's ordinary issued share capital, which would put the company in breach of the FSA's Listing Rules requirement that at least 25 per cent. of its issued ordinary share capital must be in public hands. Although the company may apply to the UK Listing Authority for a waiver in such circumstances, there is no guarantee that such a waiver would be granted, the result of which could be the delisting of the company from the Official List and potentially other exchanges where its Securities are currently listed and traded. In addition, HM Treasury will not be entitled to vote in respect of the B shares or in respect of the Dividend Access Share to the extent, but only to the extent, that votes cast on such B shares and/or on such Dividend Access Share, together with any other votes which HM Treasury is entitled to cast in respect of any other ordinary shares held by or on behalf of HM Treasury, would exceed 75 per cent. of the total votes eligible to be cast on a resolution presented at a general meeting of the company. In addition, holders of the B shares will only be entitled to receive notice of and to attend any general meeting of the company and to speak to or vote upon any resolution proposed at such meeting if a resolution is proposed which either varies or abrogates any of the rights and restrictions attached to the B shares or proposes the winding up of the company (and then in each such case only to speak and vote upon any such resolution).

A significant proportion of senior management's time and resources will have to be committed to the APS, which may have a material adverse effect on the rest of the RBS Group's business.

The RBS Group expects that significant senior management and key employee time and resources will have to be committed to the ongoing operation of the APS, including governance, asset management and reporting and generally to ensure compliance with the Scheme Conditions. The time and resources required to be committed to the APS by the RBS Group's senior management and other key employees is likely to place significant additional demands on senior management in addition to the time and resources required to be dedicated to the rest of the RBS Group's business. In addition, and separately from the RBS Group's participation in the APS, significant headcount reductions are being introduced at all levels of management in the context of a restructuring of the RBS Group. The RBS Group's ability to implement its overall strategy depends on the availability of its senior management and other key employees. If the RBS Group is unable to dedicate sufficient senior management resources to the RBS Group's business outside the APS, its business, results of operations and financial condition will suffer.

The cost of the Tax Loss Waiver and related undertakings is uncertain and the RBS Group may be subject to additional tax liabilities in connection with the APS.

It is difficult to value accurately the cost to the RBS Group if it opts, subject to HM Treasury consent, to satisfy the annual fee in respect of both the APS and the Contingent Subscription and any exit fee (payable to terminate the RBS Group's participation in the APS) by waiving certain United Kingdom tax reliefs that are treated as deferred tax assets pursuant to the Tax Loss Waiver. The cost will depend on unascertainable factors including the extent of future losses, the extent to which the RBS Group regains profitability and any changes in tax law. In addition to suffering greater tax liabilities in future years as a result of the Tax Loss Waiver, the RBS Group may also be subject to further tax liabilities in the United Kingdom and overseas in connection with the APS and the associated intra-group arrangements which would not otherwise have arisen. The Tax Loss Waiver provides that the RBS Group will not be permitted to enter into arrangements which have a main purpose of reducing the net cost of the Tax Loss Waiver. It is unclear precisely how these restrictions will apply, but it is possible that they may limit the operations and future post-tax profitability of the RBS Group.

In order to fulfil its disclosure obligations under the APS, the RBS Group may incur the risk of civil suits, criminal liability or regulatory actions

The Scheme Conditions require that certain information in relation to the Covered Assets be disclosed to HM Treasury to enable HM Treasury to quantify, manage and assess its exposure under the APS. The FSA has issued notices to the RBS Group requiring the information that HM Treasury required under the Scheme Documents prior to the RBS Group's accession to and participation in the APS (and certain other information which HM Treasury requires under the Scheme Documents following the RBS Group's accession), be provided to it through its powers under the FSMA and the Banking Act. To the extent regulated by the FSA, the RBS Group has a legal obligation to comply with these disclosure requests from the FSA. However, in complying with these disclosure obligations and providing such information to the FSA, the RBS Group may, in certain jurisdictions, incur the risk of civil suits or regulatory action (which could include fines) to the extent that disclosing information related to the Covered Assets results in the RBS Group breaching common law or statutory confidentiality laws, contractual undertakings, data protection laws, banking secrecy and other laws restricting disclosure. There can be no guarantee that future requests for information will not be made by the FSA in the same manner. Requests made directly by HM Treasury pursuant to the terms of the APS are likely to expose the RBS Group to a greater risk of such suits or regulatory action. Adverse regulatory action or adverse judgments in litigation could result in a material adverse effect on the RBS Group's reputation or results of operations or result in a loss of value in the Securities. Alternatively, in order to avoid the risk of such civil suits or regulatory actions or to avoid the risk of criminal liability, the RBS Group may choose to or (in the case of criminal liability) be required to remove Covered Assets from the APS so as not to be required to disclose to HM Treasury, such information, with the result that such assets will not be protected by the APS. The effect of the removal of such Covered Assets will impact the level of protection available to the RBS Group and may materially reduce the protection anticipated by the RBS Group for its stressed losses, in which case its business, results of operations and financial condition will suffer.

Where the RBS Group discloses information to HM Treasury as set out above, HM Treasury may disclose that information to a number of third parties for certain specified purposes. Such disclosures by HM Treasury may put the RBS Group in breach of common law or statutory confidentiality laws, contractual undertakings, data protection laws, banking secrecy or other laws restricting disclosure.

Risk factor on arrangement with ABN AMRO.

The Bank has also entered into a credit derivative and a financial guarantee contract with ABN AMRO Bank N.V. (ABN AMRO), a fellow subsidiary, under which it has sold credit protection over the exposures held by ABN AMRO and its subsidiaries that are subject to the APS. These agreements may adversely affect the Group's results as: (a) they cover 100% of losses on these assets whilst the APS provides 90% protection and only once losses on the whole APS portfolio exceed the first loss; and (b) the basis of valuation of the APS and the financial guarantee contract are asymmetrical: the one measured at fair value and the other at the higher of cost less amortisation and the amount determined in accordance with IAS 37 'Provisions, Contingent Liabilities and Contingent Assets'.

Financial summary

Summary consolidated income statement for the year ended 31 December 2009

	2009 £m	2008 (1) £m
Net interest income	11,543	13,509
Fees and commissions receivable	7,734	7,483
Fees and commissions payable	(1,972)	(1,733)
Income/(loss) from trading activities	3,007	(5,583)
Gain on redemption of own debt	2,694	—
Other operating income	1,537	2,181
Non-interest income	13,000	2,348
Total income	24,543	15,857
Operating expenses	(12,372)	(20,367)
Profit/(loss) before impairment losses	12,171	(4,510)
Impairment losses	(12,174)	(4,706)
Operating loss before tax	(3)	(9,216)
Tax credit	523	505
Profit/(loss) for the year	520	(8,711)
Minority interests	(235)	(208)
Preference shares and other dividends	(523)	(638)
Loss attributable to ordinary shareholders	(238)	(9,557)

at 31 December	2009 £m	2008 £m
Total assets	1,332,981	1,877,930
Loans and advances to customers	536,169	619,503
Deposits	569,440	635,111
Owners' equity	55,051	45,958

Note:

(1) Restated for the amendment to IFRS 2 'Share-based Payment'.

Operating loss

Operating loss before tax was £3 million compared with £9,216 million in 2008. The results reflect an improvement in income from trading activities, gain on redemption of own debt, a sharp reduction in operating expenses offset by a significant increase in impairment losses, reflecting the continuing deterioration in economic conditions.

Total income

Total income was up 55% to £24,543 million, benefiting from favourable trading conditions, principally in the Global Banking & Markets (GBM) division.

Net interest income decreased by 15% to £11,543 million primarily reflecting the pressure on liability margins, with rates on many deposit products at floors in the low interest rate environment and strong competition, particularly for longer term deposits and the build up of the Group's liquidity portfolio.

Non-interest income increased to £13,000 million from £2,348 million in 2008 largely reflecting the sharp improvement in income from trading activities, as improved asset valuations led to lower credit market losses and GBM benefited from the restructuring of its business to focus on core customer franchises. The Group also recorded a gain of £2,694 million on a liability management exercise to redeem a number of Tier 1 and upper Tier 2 securities.

Operating expenses

Operating expenses were £12,372 million compared with £20,367 million in 2008, which included the write-down of goodwill of £8,144 million (2009 – £118 million). Integration and restructuring costs were £859 million compared with £647 million in 2008. Pension curtailment gains of £2,148 million were recognised in 2009 arising from changes to prospective pension benefits in the defined benefit scheme and certain other subsidiary schemes.

Impairment losses

Impairment losses were £12,174 million, compared with £4,706 million in 2008, with Core bank impairments rising by £2,157 million and Non-Core by £5,311 million. In the Core business, the biggest increases were in UK Retail, UK Corporate and Ulster Bank, reflecting the difficult economic environment. Non-Core impairment losses increased substantially, particularly across the corporate and property sectors.

Balance sheet

Total assets were £1,333.0 billion at 31 December 2009, 29% lower than total assets of £1,877.9 billion at 31 December 2008.

Lending to customers, excluding reverse repurchase agreements and stock borrowing, decreased in 2009 by 28% or £89.2 billion to £502.3 billion. Customer deposits, excluding repurchase agreements and stock lending, decreased by 3% or £11.8 billion to £387.3 billion.

Divisional performance

The results of each division are set out below. The results are stated before amortisation of purchased intangible assets, integration and restructuring costs, gain on redemption of own debt, gains on pension curtailment, bonus tax, strategic disposals and write-down of goodwill and other assets.

Business Services directly attributable costs have been allocated to the operating divisions, based on their service usage. Where services span more than one division an appropriate measure is used to allocate the costs on a basis which management considers reasonable. Business Services costs are fully allocated and there are no residual unallocated costs.

	2009 £m	2008 £m
UK Retail	561	1,118
UK Corporate	1,452	2,056
Wealth	364	472
Global Banking & Markets	5,453	39
Global Transaction Services	831	863
Ulster Bank	(282)	331
US Retail & Commercial	94	682
Central items	(2,600)	(856)
Core	5,873	4,705
Non-Core	(9,509)	(5,472)
Operating loss	(3,636)	(767)
Amortisation of purchased intangible assets	(81)	(100)
Integration and restructuring costs	(859)	(647)
Gain on redemption of own debt	2,694	—
Gains on pensions curtailment	2,148	—
Bonus tax	(151)	—
Strategic disposals	—	442
Write-down of goodwill and other assets	(118)	(8,144)
Operating loss before tax	(3)	(9,216)

The performance of each of the divisions is reviewed on pages 26 to 35.

UK Retail

	2009 £m	2008 £m
Net interest income	3,644	3,367
Net fees and commissions	1,285	1,539
Other non-interest income	4	7
Non-interest income	1,289	1,546
Total income	4,933	4,913
Direct expenses		
– staff costs	(784)	(804)
– other	(330)	(336)
Indirect expenses	(1,579)	(1,636)
	(2,693)	(2,776)
Operating profit before impairment losses	2,240	2,137
Impairment losses	(1,679)	(1,019)
Operating profit	561	1,118

	£bn	£bn
Capital and balance sheet		
Loans and advances to customers – gross		
– mortgages	83.2	72.2
– personal	13.6	15.3
– cards	6.2	6.3
Customer deposits (excluding Bancassurance)	87.2	78.9
Assets under management (excluding deposits)	5.3	5.7

2009 compared with 2008

Operating profit of £561 million was £557 million lower than in 2008. Profit before impairments was up £103 million or 5%, but impairments rose by £660 million as the economic environment deteriorated, albeit with signs of conditions stabilising in the second half of the year.

The division has focused in 2009 on growing secured lending to meet its Government targets while at the same time building customer deposits, thereby reducing the Group's reliance on wholesale funding. Loans and advances to customers grew 10%, with a change in mix from unsecured to secured as the Group sought actively to reduce its risk profile, with 15% growth in mortgage lending and an 8% reduction in unsecured lending.

- Mortgage growth was due to good retention of existing customers and new business sourced predominantly from the existing customer base. Gross mortgage lending market share increased to 12% from 7% in 2008, with the RBS Group on track to exceed its Government targets on net lending by £3 billion.

- Customer deposits grew 11% on 2008 reflecting the strength of the UK Retail customer franchise, which outperformed the market in an increasingly competitive environment. Savings balances grew by £6 billion or 11% and account acquisition saw a 20% increase, with 2.2 million accounts opened. Personal current account balances increased by 12% on 2008 with a 3% growth in accounts to 12.8 million.

Net interest income increased significantly by 8% to £3,644 million, driven by strong balance sheet growth. Net interest margin was flat at 3.79%, with decreasing liability margins in the face of stiff competition for deposits offsetting wider asset margins. The growth in mortgages and the reduction in higher margin unsecured balances also had a negative impact on the blended net interest margin.

Non-interest income declined 17% to £1,289 million, principally reflecting the withdrawal of the single premium payment protection insurance product and the restructuring of current account overdraft fees in the final quarter of 2009, with the annualised impact of the overdraft fee restructuring further affecting income in 2010. The weak economic environment presented little opportunity in 2009 to grow credit card, private banking and bancassurance fees.

Expenses decreased by 3%, with the cost:income ratio improving from 56.5% to 54.6%.

- Direct staff costs declined by 2%, as the division benefited from strong cost control, a focus on process re-engineering and a 10% reduction in headcount.

- RBS continues to progress towards a more convenient, lower cost operating model, with over 4 million active users of online banking and a record share of new sales achieved through direct channels. More than 5.5 million accounts have switched to paperless statements and 254 branches now utilise automated cash deposit machines.

Impairment losses increased 65% to £1,679 million reflecting the deterioration in the economic environment, and its impact on customer finances.

- The mortgage impairment charge was £124 million (2008 – £31 million) on a total book of £83.2 billion. Mortgage arrears rates stabilised in the second half of 2009 and remain well below the industry average, as reported by the Council of Mortgage Lenders. Repossessions show only a small increase on 2008, as the Group continues to support customers facing financial difficulties.

- The unsecured lending impairment charge was £1,555 million (2008 – £988 million) on a book of £19.8 billion. Industry benchmarks for cards arrears showed a slightly improving trend in the final quarter of 2009, which is consistent with the Group's experience. RBS continues to perform better than the market on arrears.

UK Corporate

	2009 £m	2008 £m
Net interest income	2,544	2,655
Net fees and commissions	857	828
Other non-interest income	433	460
Non-interest income	1,290	1,288
Total income	3,834	3,943
Direct expenses		
– staff costs	(753)	(801)
– other	(267)	(318)
Indirect expenses	(435)	(449)
	(1,455)	(1,568)
Operating profit before impairment losses	2,379	2,375
Impairment losses	(927)	(319)
Operating profit	1,452	2,056

	£bn	£bn
Capital and balance sheet		
Loans and advances to customers – gross	111.3	116.4
Customer deposits	87.8	82.0

2009 compared with 2008

Operating profit of £1,452 million was £604 million lower than in 2008, largely due to an increase of £608 million in impairments.

Net interest margin levels were rebuilt during the second half as asset pricing was amended to reflect increased funding and credit costs. For the year as a whole, net interest margin was 18 basis points lower than in 2008, reflecting higher funding costs and continued competitive pricing for deposits.

Gross new lending to customers remained resilient in 2009, with a noticeable acceleration of lending activity in the second half of the year. However, as customers have deleveraged and turned increasingly to capital markets, repayments have accelerated even more sharply. Loans and advances to customers, therefore, declined by 4% to £111.3 billion.

Initiatives aimed at increasing customer deposits have been successful, with balance growth of 7%, although margins declined as a result of increased competition for balances.

Non-interest income was flat, with stable fee income from refinancing and structuring activity.

A reduction in costs of 7% was driven by lower staff expenses as a result of the RBS Group's restructuring programme, together with restraint on discretionary spending levels.

Impairment losses increased substantially reflecting both a rise in the number of corporate delinquencies requiring a specific impairment and a higher charge to recognise losses not yet specifically identified.

Wealth

	2009 £m	2008 £m
Net interest income	565	661
Net fees and commissions	362	404
Other non-interest income	83	75
Non-interest income	445	479
Total income	1,010	1,140
Direct expenses		
– staff costs	(353)	(375)
– other	(139)	(154)
Indirect expenses	(121)	(123)
	(613)	(652)
Operating profit before impairment losses	397	488
Impairment losses	(33)	(16)
Operating profit	364	472

	£bn	£bn
Capital and balance sheet		
Loans and advances to customers – gross		
– mortgages	6.5	5.3
– personal	4.9	5.0
– other	2.3	2.1
Customer deposits	35.7	34.1
Assets under management (excluding deposits)	30.7	34.7

2009 compared with 2008

Wealth operating profit was down 23% to £364 million, reflecting pressure on liability margins in the current low interest rate environment, and marked decrease in investment income as assets under management fell during 2009.

Total income was down 11%. Net interest income fell 15%, despite an increase in customer deposit balances of 5% over 2008. Non-interest income fell 7% as the value of assets under management decreased by 12% during 2009, with investors turning to more liquid assets and away from longer term investments.

Loans and advances increased by 10% over 2008, primarily in the UK. Lending margins improved, particularly for mortgages, and credit metrics for new business remain satisfactory.

Expenses were down 6% (11% lower on a constant currency basis), reflecting a rigorous focus on cost management, with staff costs decreasing by 6% as a result of planned headcount reduction. The cost:income ratio increased from 57.2% to 60.7%.

Impairments increased by £17 million over 2008 reflecting some isolated difficulties in the UK and offshore mortgage books (representing mortgages for second properties for expatriates). Provisions as a percentage of lending to customers increased slightly to 0.25%.

Global Banking & Markets

	2009 £m	2008 £m
Net interest income	1,280	1,611
Net fees and commissions	891	491
Income from trading activities	6,258	(247)
Other operating income	(66)	21
Non-interest income	7,083	265
Total income	8,363	1,876
Direct expenses		
– staff costs	(1,856)	(989)
– other	(474)	(385)
Indirect expenses	(263)	(226)
	(2,593)	(1,600)
Operating profit before impairment losses	5,770	276
Impairment losses	(317)	(237)
Operating profit	5,453	39

	£bn	£bn
Capital and balance sheet		
Loans and advances (including banks)	94.8	145.7
Reverse repos	63.8	57.6
Securities	86.1	97.7
Cash and eligible bill	46.4	17.0
Other assets	18.6	15.4
Total third party assets (excluding derivatives mark to market)	309.7	333.4
Customer deposits (excluding repos)	51.9	72.8

2009 compared with 2008

Operating profit improved to £5,453 million in 2009, compared with £39 million in 2008. Although the buoyant market conditions experienced in the first quarter levelled off over the course of the year, the refocusing of the business on its core franchises was successful. GBM has tightened its balance sheet management over the course of the year, with disciplined deployment of capital to support its targeted client base.

In an often volatile market environment, GBM responded quickly to its clients' needs to strengthen their balance sheets and to take advantage of the attractive environment for debt issuance.

Income grew significantly, reflecting a very strong first quarter benefiting from market volatility and good client activity in the Rates flow business. Portfolio management and origination grew as financial institutions and corporate clients refinanced through the debt capital markets. The refocused Credit Markets delivered a much improved result from greater liquidity and a more positive trading environment.

Expenses increased 62%, reflecting higher performance-related costs and the impact of adverse exchange rate movements, partly offset by restructuring and efficiency benefits.

Total third party assets, excluding derivatives, were down 7%, compared with 31 December 2008, driven by a reduction in loans and advances as customers took advantage of favourable capital market conditions to raise alternative forms of finance to bank debt. This reduction was partially offset by an increase in liquid assets.

Global Transaction Services

	2009 £m	2008 £m
Net interest income	447	492
Non-interest income	1,292	1,193
Total income	1,739	1,685
Direct expenses		
– staff costs	(277)	(250)
– other	(127)	(113)
Indirect expenses	(488)	(429)
	(892)	(792)
Operating profit before impairment losses	847	893
Impairment losses	(16)	(30)
Operating profit	831	863

	£bn	£bn
Capital and balance sheet		
Total third party assets	10.3	11.9
Loans and advances	6.4	7.5
Customer deposits	38.5	38.7

2009 compared with 2008

Operating profit declined by 4%, largely reflecting pressure on deposit income. The attrition of deposit balances experienced in the first half was reversed in the second, but margins remain compressed due to both a very competitive deposit market as well as the low rate environment.

Customer deposit balances at £38.5 billion were flat on the previous year, with growth in the UK and international business offset by weaker US domestic balances. Loans and advances were down 15% due to reduced overdraft utilisation and lower trade volumes.

At constant exchange rates, international payment fees increased by 11%, while trade finance income increased by 8%, with improved penetration in the Asia-Pacific region. Merchant acquiring income, however, declined by 9% at constant exchange rates, as consumers continued to switch to lower margin debit card transactions in preference to using credit cards.

Expenses were up 13%, as cost savings and efficiencies helped to mitigate the impact of investment in infrastructure. Staff expenses were 11% higher primarily due to the foreign exchange movements, with headcount down 8%. The cost:income ratio was 51.3%, a deterioration of 4.3 percentage points.

Impairment losses were £16 million, down £14 million versus 2008. Overall defaults remain modest at 0.3% of loans and advances.

Ulster Bank

	2009 £m	2008 £m
Net interest income	829	849
Net fees and commissions	228	238
Other non-interest income	26	28
Non-interest income	254	266
Total income	1,083	1,115
Direct expenses		
– staff costs	(325)	(330)
– other	(85)	(93)
Indirect expenses	(306)	(255)
	(716)	(678)
Operating profit before impairment losses	367	437
Impairment losses	(649)	(106)
Operating (loss)/profit	(282)	331

	£bn	£bn
Capital and balance sheet		
Loans and advances to customers – gross		
– mortgages	16.2	18.1
– corporate	21.1	23.8
– other	2.4	2.1
Customer deposits	21.9	24.5

2009 compared with 2008

Operating results were in line with expectations but deteriorated during 2009 as economic conditions across the island of Ireland worsened, with an operating loss for the year of £282 million.

Net interest income declined by 10% in constant currency terms, largely as a result of tightening deposit margins in an increasingly competitive market, partly offset by asset repricing initiatives. Net interest margin for the year at 1.99% only reduced marginally despite the challenging market conditions.

At constant exchange rates loans to customers decreased by 4% from the prior year as new business demand weakened. Customer deposits reduced by 5% in 2009 in constant currency terms, reflecting an increasingly competitive Irish deposit market and reductions in wholesale funding during the first quarter. During the second half of the year the market stabilised and the division recorded strong growth in customer balances resulting in an improved funding profile.

Non-interest income declined by 12% in constant currency terms due to lower fee income driven by reduced activity levels across all business lines.

Total costs for the year were flat on a constant currency basis. Direct expenses were down 12% in constant currency terms during 2009, driven by the bank's restructuring programme, which incorporates the merger of the First Active and Ulster Bank businesses. The rollout of the programme has resulted in a downward trend in direct expenses throughout 2009. The reduction in direct expenses has been offset by a 20% increase in indirect expenses primarily reflecting provisions relating to the bank's own property recognised in the fourth quarter.

Impairment losses increased to £649 million from £106 million driven by the continued deterioration in the Irish economic environment and resultant impact on loan performance across the retail and wholesale portfolios.

Necessary fiscal budgetary action allied to the well-entrenched downturn in property markets in Ireland has fed through to higher loan losses. Mortgage impairments have been driven by rising unemployment and lower incomes. Loans to the property sector experienced a substantial rise in defaults as the Irish property market declined, reflecting the difficult economic backdrop and the uncertainty surrounding the possible effect of the Irish Government's National Asset Management Agency on asset values. Sectors driven by consumer spending have been affected by the double digit decline in 2009 with rising default rates evident.

Customer account numbers increased by 3% during 2009, with growth fuelled by strong current account activity and new-to-bank savings customers.

US Retail & Commercial

	2009 £m	2008 £m
Net interest income	1,907	1,817
Net fees and commissions	714	664
Other non-interest income	235	197
Non-interest income	949	861
Total income	2,856	2,678
Direct expenses		
– staff costs	(776)	(645)
– other	(593)	(354)
Indirect expenses	(691)	(560)
	(2,060)	(1,559)
Operating profit before impairment losses	796	1,119
Impairment losses	(702)	(437)
Operating profit	94	682

	£bn	£bn
Capital and balance sheet		
Loans and advances to customers – gross		
– residential mortgages	6.5	9.7
– home equity	15.4	18.7
– corporate and commercial	19.5	23.7
– other consumer	7.5	9.8
Customer deposits	60.1	63.9

2009 compared with 2008

The recessionary economic environment, historically low interest rates and deteriorating credit conditions resulted in an operating profit of £94 million, down 86%. However, the business has now successfully refocused on its core customer franchises in New England, the Mid-Atlantic region and the Midwest.

The division achieved very strong growth in mortgage origination volumes, with significantly higher penetration through the branch network and improved profitability, particularly on recent origination vintages. Cross-selling of card, deposit and checking account products has increased substantially, with over 65% of new mortgage customers also taking out a checking account. The division has also increased commercial banking market penetration, with lead bank share within its footprint increasing from 6% to 7% in the $5 million to $25 million segment and from 6% to 8% in the $25 million to $500 million segment.

Net interest income was up 5%. Margins have been rebuilt in the second half from the lows experienced in the first half, as the business repriced lending rates and aggressively reduced pricing on term and time deposits.

Expenses increased by 32%, reflecting increased FDIC deposit insurance levies, higher employee benefit costs as well as increased costs relating to loan workout and collection activity.

Impairment losses increased to £702 million as charge-offs climbed to 1.44% of loans, an increase of 73bps compared with 2008.

Loans and advances were down 21%, reflecting subdued customer demand together with movements in foreign exchange rates.

Customer deposits decreased 6% compared with the prior year. The deposit mix improved significantly, with strong growth in checking balances combined with migration away from higher priced term and time deposits as the division adjusted its pricing strategies, more than offset by movements in foreign exchange rates. Over 58,000 consumer checking accounts were added over the course of the year, and more than 13,000 small business checking accounts. Consumer checking balances grew by 8% and small business balances by 12%.

Central items

	2009 £m	2008 £m
Fair value of own debt	(105)	665
Other	(2,495)	(1,521)
Total central items	(2,600)	(856)

2009 compared with 2008

Central items increased by £1,744 million to £2,600 million primarily reflecting movements in the fair value of own debt and lower disposal gains.

The Group's credit spreads have fluctuated over the course of the year but ended the year slightly tighter, resulting in an increase in the carrying value of own debt. Other costs increased by £974 million to £2,495 million, which included the impact of economic hedges that do not qualify for IFRS hedge accounting. 2008's results included some significant disposal gains.

Non-Core

	2009 £m	2008 £m
Net interest income	2,009	1,617
Net fees and commissions	386	589
Loss from trading activities	(3,602)	(4,464)
Other operating income	935	705
Non-interest income	(2,281)	(3,170)
Total income	(272)	(1,553)
Direct expenses		
– staff costs	(579)	(600)
– other	(710)	(664)
Indirect expenses	(97)	(115)
	(1,386)	(1,379)
Operating loss before impairment losses	(1,658)	(2,932)
Impairment losses	(7,851)	(2,540)
Operating loss	(9,509)	(5,472)

	£bn	£bn
Capital and balance sheet		
Total third party assets (including derivatives)	191.7	277.2
Loans and advances to customers – gross	127.8	152.4
Customer deposits	6.0	8.2

2009 compared with 2008

Losses from trading activities have declined significantly as underlying asset prices rallied. Mark to market values for exposures such as monolines, super senior high grade collateralised debt obligations, and many negative basis trade asset classes have risen over the course of 2009. However, the £865 million gain recorded on banking book hedging in 2008 unwound over the course of the year to a loss of £634 million in 2009, as spreads continued to tighten throughout the year, ending almost in line with origination levels.

Impairment losses increased to £7.9 billion, reflecting continued weakness in the economic environment, particularly across the corporate and property sectors. There were signs of a slowdown in the rate of provisioning towards the end of the year.

Staff costs decreased by 4% over the year, due to headcount reductions and business divestments, notably Tesco Personal Finance.

Third party assets, excluding derivatives, decreased by £85.5 billion in the year as the division has run down exposures and pursued opportunities to dispose of loan portfolios.

Consolidated balance sheet at 31 December 2009

	2009 £m	2008 £m
Assets		
Cash and balances at central banks	27,060	6,806
Net loans and advances to banks	37,611	47,951
Reverse repurchase agreements and stock borrowing	30,830	31,436
Loans and advances to banks	68,441	79,387
Net loans and advances to customers	502,357	591,531
Reverse repurchase agreements and stock borrowing	33,812	27,972
Loans and advances to customers	536,169	619,503
Debt securities	185,181	177,766
Equity shares	2,405	2,691
Settlement balances	9,153	10,871
Derivatives	446,353	937,457
Intangible assets	11,814	12,591
Property, plant and equipment	17,309	16,628
Deferred taxation	2,228	2,833
Prepayments, accrued income and other assets	12,665	11,397
Assets of disposal groups	14,203	—
Total assets	1,332,981	1,877,930
Liabilities		
Bank deposits	80,556	115,976
Repurchase agreements and stock lending	35,582	66,006
Deposits by banks	116,138	181,982
Customer deposits	387,277	399,034
Repurchase agreements and stock lending	66,025	54,095
Customer accounts	453,302	453,129
Debt securities in issue	172,413	179,942
Settlement balances and short positions	44,394	45,957
Derivatives	424,544	909,105
Accruals, deferred income and other liabilities	16,474	16,685
Retirement benefit liabilities	2,622	1,446
Deferred taxation	1,187	2,483
Subordinated liabilities	34,717	39,951
Liabilities of disposal groups	10,993	—
Total liabilities	1,276,784	1,830,680
Minority interests	1,146	1,292
Owners' equity	55,051	45,958
Total equity	56,197	47,250
Total liabilities and equity	1,332,981	1,877,930

Commentary on consolidated balance sheet

Total assets of £1,333.0 billion at 31 December 2009 were down £544.9 billion, 29%, compared with 31 December 2008, principally reflecting substantial repayments of customer loans and advances as corporate customer demand fell and corporates looked to deleverage their balance sheets. There were also significant falls in the value of derivative assets, with a corresponding fall in derivative liabilities.

Cash and balances at central banks were up £20.3 billion to £27.1 billion due to the placing of short-term cash surpluses, including the capital contribution received from the parent company in December, with central banks.

Loans and advances to banks decreased by £10.9 billion, 14%, to £68.4 billion reflecting lower reverse repurchase agreements and stock borrowing ('reverse repos'), down by £0.6 billion, 2% to £30.8 billion and lower bank placings, down £10.3 billion, 22%, to £37.6 billion largely as a result of reduced wholesale funding activity.

Loans and advances to customers were down £83.3 billion, 13%, to £536.2 billion. Within this, reverse repos increased by 21%, £5.9 billion to £33.8 billion. Excluding reverse repos, lending decreased by £89.2 billion, 15% to £502.4 billion.

Debt securities increased by £7.4 billion, 4%, to £185.2 billion principally due to growth in Group Treasury, largely offset by lower holdings in Global Banking & Markets and Non-Core.

Settlement balances were down £1.7 billion, 16%, to £9.2 billion as a result of lower customer activity.

Movements in the value of derivative assets, down £491.1 billion, 52%, to £446.4 billion, and liabilities, down £484.6 billion, 53%, to £424.5 billion, reflect the easing of market volatility, the strengthening of sterling and significant tightening in credit spreads in the continuing low interest rate environment.

Increases in assets and liabilities of disposal groups reflect the inclusion of the RBS Sempra Commodities business.

Deposits by banks declined by £65.8 billion, 36% to £116.1 billion due to a decrease in repurchase agreements and stock lending ('repos'), down £30.4 billion, 46%, to £35.6 billion and reduced inter-bank deposits, down £35.4 billion, 31% to £80.5 billion principally in Global Banking & Markets, reflecting reduced reliance on wholesale funding.

Customer accounts were flat at £453.3 billion. Within this, repos increased £11.9 billion, 22% to £66.0 billion. Excluding repos, deposits were down £11.8 billion, 3%, to £387.3 billion primarily due to exchange rate movements and reductions in Global Banking & Markets, Non-Core and Ulster Bank, offset in part by growth across other divisions.

Debt securities in issue were down £7.5 billion, 4% to £172.4 billion mainly as a result of movements in exchange rates, together with reductions in Global Banking & Markets and Non-Core.

Retirement benefit liabilities increased by £1.2 billion, 81%, to £2.6 billion, with net actuarial losses of £3.7 billion, arising from lower discount rates and higher assumed inflation, partially offset by curtailment gains of £2.1 billion due to changes in prospective pension benefits.

Subordinated liabilities were down £5.2 billion, 13% to £34.7 billion, reflecting the issue of dated loan capital of £5.0 billion more than offset by the redemption of £4.5 billion undated loan capital, £2.3 billion dated loan capital and £0.3 billion preference shares, together with the effect of exchange rate movements and other adjustments, £3.1 billion.

Owners' equity increased by £9.1 billion, 20%, to £55.1 billion. The issue of ordinary shares to the parent company raised £8.2 billion in addition to capital contributions of £12.5 billion. Actuarial losses, net of tax, of £2.7 billion; exchange rate movements of £1.5 billion; the payment of ordinary dividends of £2.0 billion; the payment of £0.5 billion of equity preference dividends; and the redemption of preference shares, £7.8 billion were partly offset by the attributable profit for the year, £0.3 billion, increases in available-for-sale reserves, £1.7 billion; and cash flow hedging reserves, £0.6 billion.

Cash flow

	2009 £m	2008 £m
Net cash flows from operating activities	15,144	(11,920)
Net cash flows from investing activities	(8,550)	(16,181)
Net cash flows from financing activities	10,697	8,459
Effects of exchange rate changes on cash and cash equivalents	(4,767)	15,295
Net increase/(decrease) in cash and cash equivalents	12,524	(4,347)

2009

The major factors contributing to the net cash inflow from operating activities of £15,144 million were the increase of £5,498 million in operating liabilities less operating assets, elimination of foreign exchange differences of £5,715 million, other non cash items of £7,252 million, and depreciation and amortisation, £1,587 million. This was partly offset by pension scheme curtailment gains of £2,148 million and gain on redemption of own debt of £2,694 million

Purchase of securities, net of sales and maturities, of £5,488 million, net investments in business interests and intangible assets of £397 million and purchase of property, plant and equipment, net of sales of £2,665 million resulted in the net cash flows from investing activities of £8,550 million.

Net cash flows from financing activities of £10,697 million primarily arose from the capital raised from the issue of ordinary shares of £8,151 million, the capital contribution of £12,500 million and the issue of subordinated liabilities of £5,000 million. This was offset in part by the redemption of preference shares of £7,825 million, the cash outflow on repayment of subordinated liabilities of £3,200 million, interest paid on subordinated liabilities of £1,151 million and dividends paid of £2,784 million.

2008

The major factors contributing to the net cash outflow from operating activities of £11,920 million were the net operating loss before tax of £9,216 million and the elimination of foreign exchange differences of £20,997 million. This was partly offset by goodwill and other asset write-downs of £8,144 million, provision for impairment losses of £4,706 million and the increase of £2,845 million in operating liabilities less operating assets.

Purchase of securities, net of sales and maturities, of £12,483 million, net investment in business interests and intangible assets of £908 million and purchase of property, plant and equipment, net of sales of £2,790 million, resulted in the net cash flows from investing activities of £16,181 million.

Net cash flows from financing activities of £8,459 million primarily arose from the issue of ordinary shares of £10,000 million, the issue of subordinated liabilities of £5,055 million and proceeds of minority interests, £812 million. These were offset in part by the cash outflow on redemption of minority interests of £140 million, repayment of subordinated liabilities of £1,035 million, dividends paid of £4,722 million and interest paid on subordinated liabilities of £1,511 million.

Risk, capital and liquidity management

On pages 39 to 92 of the Financial review certain information has been audited and is part of the Group's financial statements as permitted by IFRS 7. Other disclosures are unaudited and labelled with an asterisk (*).

Risk, capital and liquidity management are conducted on an overall basis within the RBS Group. Therefore the discussion on risk, capital and liquidity management on pages 39 to 92 refers principally to policies and procedures in the RBS Group that also apply to the Group. Data is also provided for the Bank and its subsidiaries ('the Group'), and the Bank.

Risk, capital and liquidity governance*

Risk, capital and liquidity management strategies are owned and set by the RBS Group's Board of Directors, and implemented by executive management led by the Group Chief Executive. There are a number of committees and executives that support the execution of the business plan and strategy, as set out below. Representation by and interaction between the individual risk disciplines is a key feature of this governance structure, with the aim of promoting cross-risk linkages.

Note:
For key changes to the risk, capital and liquidity governance structure, refer to the table overleaf.

*unaudited

Risk, capital and liquidity governance* continued

The role and remit of these committees is as follows:

Committee	Focus	Membership
Group Audit Committee (GAC)	Financial reporting and the application of accounting policies as part of the internal control and risk assessment process. From a historical perspective, GAC monitors the identification, evaluation and management of all significant risks throughout the Group.	Independent non-executive directors
Board Risk Committee (BRC)	A new committee, formed to provide oversight and advice to the Group Board in relation to current and potential future risk exposures of the Group and future risk strategy. Reports to the Group Board, identifying any matters within its remit in respect of which it considers an action or improvement is needed, and making recommendations as to the steps to be taken. Provides quantitative and qualitative advice to the Remuneration Committee upon the Group Remuneration Policy and the implications for risk management.	At least three independent non-executive directors, one of whom is the Chairman of the Group Audit Committee
Executive Credit Group (ECG)	Formed to replace the Advances Committee and the Group Credit Committee, the ECG decides on requests for the extension of existing or new credit limits on behalf of the Board of Directors which exceed the delegated authorities of individuals throughout the Group as determined by the credit approval grid. The Head of Restructuring and Risk or the Group Chief Credit Officer must be present along with at least one other member to ensure the meeting is quorate.	Group Chief Executive Head of Restructuring and Risk Group Chief Risk Officer Group Chief Credit Officer Chief Executive Officer from each division Group Finance Director
Executive Committee (ExCo)	A newly formed committee responsible for managing Group wide issues and those operational issues material to the broader Group.	Group Chief Executive Business and function heads, as determined by the Group Chief Executive/Board Head of Restructuring and Risk Group Finance Director
Group Risk Committee (GRC)	Recommends limits and approves processes and major policies to ensure the effective management of all material risks across the Group.	Head of Restructuring and Risk Group Chief Risk Officer Group Head of each risk function Group Head of Country Risk Global Head of Risk Architecture Deputy Group Finance Director Chief Operating Officer, RBS Risk Management Chief Executive and Chief Risk Officer from each division
Group Asset and Liability Management Committee (GALCO)	Identifies, manages and controls the Group balance sheet risks.	Group Finance Director Deputy Group Finance Director Head of Restructuring and Risk Chief Executive from each division Group Chief Accountant Group Treasurer and Deputy Group Treasurer Chief Financial Officer, ABN AMRO Director, Group Corporate Finance Director, Group Financial Planning & Analysis Head of Balance Sheet Management, Group Treasury
Executive Risk Forum (ERF)	Acts on all strategic risk and control matters across the Group including, but not limited to, credit risk, market risk, operational risk, compliance and regulatory risk, enterprise risk, treasury and liquidity risk, reputational risk, insurance risk and country risk.	Group Chief Executive Head of Restructuring and Risk Group Chief Risk Officer Group Finance Director Chief Executive Officer from each division

Note:
These committees are supported at a divisional level by a risk governance structure embedded in the businesses.

*unaudited

Management responsibilities

All employees have a role to play in the day-to-day management of capital, liquidity and risk which is set and managed by specialist staff in:

- Risk Management: credit risk, market risk, operational risk, regulatory risk, reputational risk, insurance risk and country risk, together with risk analytics; and
- Group Treasury: balance sheet, capital management, intra-group exposure, funding, liquidity and hedging policies.

Independence underpins the approach to risk management, which is reinforced throughout the RBS Group by appropriate reporting lines. Risk Management and Group Treasury functions are independent of the revenue generating business. As part of the move toward greater functional independence, the divisional Chief Risk Officers have a direct reporting line to the Head of Restructuring and Risk as well as to their divisional CEOs.

Group Internal Audit supports the GAC in providing an independent assessment of the design, adequacy and effectiveness of the internal controls relating to risk management.

Risk appetite

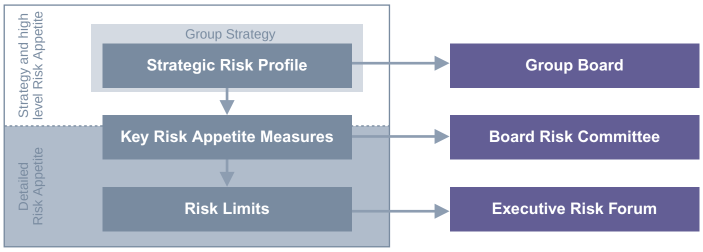
Risk appetite is an expression of the maximum level of risk that the RBS Group is prepared to accept in order to deliver its business objectives. Risk and capital management across the RBS Group is based on the risk appetite set by the Board, who ultimately approve annual plans for each division and regularly reviews and monitors the RBS Group's performance in relation to risk.

Risk appetite is defined in both quantitative and qualitative terms as follows:

- Quantitative: encompassing stress testing, risk concentration, VaR, liquidity and credit related metrics; and
- Qualitative: ensuring that the RBS Group applies the correct principles, policies and procedures.

Different techniques are used to ensure that the RBS Group's risk appetite is achieved. The Board Risk Committee considers and recommends for approval by the Group Board, the RBS Group's risk appetite framework and tolerance for current and future strategy, taking into account the RBS Group's capital adequacy and the external risk environment. The ERF is responsible for ensuring that the implementation of strategy and operations are in line with the risk appetite determined by the Board. This is reinforced through policy and limit frameworks ensuring that all staff within the RBS Group make appropriate risk and reward trade-offs within pre-agreed boundaries.

The annual business planning and performance management processes and associated activities together ensure that the expression of risk appetite remains appropriate. Both GRC and GALCO support this work.



Remuneration responsibilities

In August 2009, the Financial Services Authority (FSA) published its Code of Remuneration Practices (the Code). The Code requires the RBS Group to establish, implement and maintain remuneration policies, procedures and practices that promote and are consistent with effective risk management.

The Risk Management function provides input to the Remuneration Committee on the remuneration policy for the RBS Group. Each division is allocated risk objectives as part of the strategic plan and achievement of these objectives is evaluated as part of the annual performance management process.

During 2009 Risk Management provided formal independent 360° feedback for key individuals, reviewing their capability and performance in relation to managing risk. Individuals selected perform roles of significant influence and their activities have, or could have, a material impact on the RBS Group's risk profile.

An annual report on the risk performance of each division, including both qualitative and quantitative information is provided to the Remuneration Committee to allow consideration of adjustments relating to the compensation for the performance year.

Capital*

All the disclosures in this section (pages 42 and 43) are unaudited and labelled with an asterisk (*).

Capital resources

It is the RBS Group's policy to maintain a strong capital base 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 RBS Group has regard to the supervisory requirements of the 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 (RWAs) (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 2009, the Group's total RAR was 14.8% (2008 – 14.2%) and the Tier 1 RAR was 10.5% (2008 – 8.5%).

As part of the annual planning and budgeting cycle, each division is allocated capital based upon RWAs and associated regulatory deductions. The budgeting process considers risk appetite, available capital resources, stress testing results and business strategy. The budget is agreed by the Board and allocated to divisions to manage their allocated RWAs.

Group Treasury and GALCO monitor available capital and its utilisation across divisions. GALCO makes the necessary decisions around re-allocation of budget and changes in RWA allocations.

Asset Protection Scheme

On 22 December 2009, the RBS Group acceded to the Asset Protection Scheme ('APS' or 'the Scheme'). The key commercial terms and details of the assets covered by the Scheme are set out on page 69.

Following the accession to the APS, HM Treasury provides loss protection against potential losses arising in a pool of assets. HM Treasury also subscribed to £25.5 billion of capital in the form of B shares in the holding company and a Dividend Access Share with a further £8 billion of capital in the form of B shares, potentially available as contingent capital. The RBS Group pays annual fees in respect of the protection and contingent capital. The RBS Group has the option, subject to HM Treasury consent, to pay the annual premium, contingent capital and the exit fee payable in connection with any termination of the RBS Group's participation in the APS in whole or in part, by waiving the entitlements of members of the RBS Group to certain UK tax reliefs.

Following accession to the APS, arrangements were put in place within the Group that extended effective APS protection to all other regulated entities holding assets covered by the APS.

On 19 January 2009, the FSA announced that it expects each bank participating in the UK Government's recapitalisation scheme to have a minimum Core Tier 1 ratio of 4% on a stressed basis. As at 31 December 2009 the Group's Core Tier 1 ratio was 8.6% (2008 – 5.3%).

While the RWA relief from the APS enabled the Group to maintain robust capital ratios, it is clear that the next few years pose continuing challenges in respect of impairment levels, trading performance and the return to profitability, RWA volatility including procyclical effects, and increasing regulatory demands.

The Group's policy will be to continue to maintain a strong capital base, to develop this base as appropriate and to utilise it efficiently throughout the Group's activities in order to optimise shareholder returns while maintaining a prudent relationship between the capital base and the underlying risks of the business.

Regulatory capital impact of the APS

Methodology

The regulatory capital requirements for assets covered by the Scheme are calculated using the securitisation framework under the FSA prudential rules. The calculation is as follows (known as 'the Uncapped Amount'):

- *First Loss –* the residual first loss, after impairments and writedowns, to date, is deducted from the available capital – split equally between Core Tier 1 and Tier 2 capital;

- *HM Treasury share of covered losses –* after the first loss piece has been deducted, the 90% of assets covered by HM Treasury are risk weighted at 0%; and

- *RBS share of covered losses –* the remaining 10% share of loss is borne by RBS and is risk weighted in the normal way.

Should the Uncapped Amount be higher than those of the underlying assets (ignoring the Scheme), the capital requirements for the Scheme are capped at the level of the requirements for the underlying assets ('Capped Amount'). Where capped, the RBS Group apportions the Capped Amount up to the level of the First Loss as calculated above; any unused Capped Amount after the First Loss capital deduction will be taken as RWAs for the RBS Group's share of covered losses.

Adjustments to the regulatory capital calculation can be made for either currency or maturity mismatches. These occur where there is a difference between the currency or maturity of the protection and that of the underlying asset. These mismatches will have an impact upon the timing of the removal of the cap and level of regulatory capital benefit on the Uncapped Amount, but this effect is not material.

Impact at accession

The RBS Group expects initially to calculate its capital requirements in accordance with the Capped basis. Accordingly, the APS itself (viewed separately from the B share issuance) at accession had no impact on the Pillar 1 regulatory capital requirement in respect of the assets covered by the APS. It will, however, improve the total capital ratios, and the Core Tier 1 ratios, of the RBS Group as a whole. It is also expected that the protection afforded by the APS will assist the RBS Group in satisfying the forward looking stress testing framework applied by the FSA.

*unaudited

Risk coverage

The main risks facing the Group are shown below.

Risk type	Definition	Features
Credit risk (including country and political risks)	The risk arising from the possibility that the Group will incur losses owing to the failure of customers to meet their financial obligations to the Group.	Loss characteristics vary materially across portfolios. Significant correlation between losses and the macroeconomic environment. Concentration risk - potential for large material losses.
	The risk arising from country events.	Country risks correlated with macroeconomic developments. Country vulnerabilities changing structurally in the aftermath of the financial crisis.
Funding and liquidity risk	The risk of being unable to meet obligations as they fall due.	Potential to disrupt the business model and stop normal functions of the Group.
Market risk	The risk that the value of an asset or liability may change as a result of a change in market risk factors.	Potential for large, material losses. Significantly correlated with equity risk and the macroeconomic environment. Potential for losses due to stress events.
Operational risk	The risk of financial, customer or reputational loss resulting from inadequate or failed internal processes or systems; from improper behaviour; or from external events.	Frequent small losses. Infrequent material losses.
Regulatory risk	The risks arising from regulatory changes and enforcement.	Risk of regulatory changes. Compliance with regulations. Potential for fines and/or restrictions in business activities.
Other risk	The risks arising from reputation risk.	Additional regulation can be introduced as a result of other risk losses. Failure to meet expectations of stakeholders.
	Pension risk is the risk that the Group may have to make additional contributions to its defined benefit pension schemes.	Pension risk arises because of the uncertainty of future investment returns and the projected value of schemes' liabilities.

Credit risk

Credit risk is the risk arising from the possibility that the RBS Group will incur losses owing to the failure of customers to meet their financial obligations. The quantum and nature of credit risk assumed in the RBS Group's different businesses varies considerably, while the overall credit risk outcome usually exhibits a high degree of correlation to the macroeconomic environment. Certain disclosures in this section (pages 44 to 50) are unaudited and are labelled with an asterisk (*).

Principles for credit risk management

The key principles for credit risk management in the RBS Group are as follows:

- A credit risk assessment of the customer and credit facilities is undertaken prior to approval of credit exposure. Typically, this includes both quantitative and qualitative elements including: the purpose of the credit and sources of repayment; compliance with affordability tests; repayment history; ability to repay; sensitivity to economic and market developments; and risk-adjusted return based on credit risk measures appropriate to the customer and facility type;

- Credit risk authority is specifically granted in writing to individuals involved in the approval of credit extensions. In exercising credit authority, individuals are required to act independently of business considerations and must declare any conflicts of interest;

- Credit exposures, once approved, are monitored, managed and reviewed periodically against approved limits. Lower quality exposures are subject to more frequent analysis and assessment;

- Credit risk management works with business functions on the ongoing management of the credit portfolio, including decisions on mitigating actions taken against individual exposures or broader portfolios;

- Customers with emerging credit problems are identified early and classified accordingly. Remedial actions are implemented promptly and are intended to restore the customer to a satisfactory status and minimise any potential loss to the RBS Group; and

- Stress testing of portfolios is undertaken to assess the potential credit impact of non-systemic scenarios and wider macroeconomic events on the RBS Group's income and capital.

Credit risk organisation

The credit risk function is organised within a divisionally aligned structure to ensure appropriate proximity to the businesses it covers and to develop and provide the specialisation required to manage the associated credit risk. The function comprises a number of activities: credit approval; transaction/customer assessment; policy formulation and development (in the context of the RBS Group-wide policy framework); portfolio reporting; and quantitative portfolio analytics.

In addition to the activities undertaken within divisional functions, a RBS Group-wide credit risk function sets the overall framework and highest level credit risk policy standards; produces RBS Group-wide credit risk portfolio reporting and analysis; and approves credit transactions which exceed divisional credit authority.

The Group Risk Committee (GRC) considers detailed reports of credit risk performance such as monthly risk portfolio performance trend information. The Group Credit Risk Policy Committee, a subcommittee of the GRC, approves material new credit risk policy standards.

For wholesale credit portfolios, an updated RBS Group-wide credit approval and authority framework was introduced in early 2009, replacing the previous structure of credit committees. The authority held by an individual in respect of a particular extension of credit is determined by a RBS Group-wide credit approval grid which links total credit limit amount for a customer group with customer credit quality (expressed as a credit grade) and the individual's credit experience and expertise (which determines the authority level assigned to them). The Executive Credit Group (ECG) considers credit decisions which exceed the delegated authorities of individuals throughout the RBS Group.

Global Restructuring Group (GRG)

GRG manages problem and potential problem exposures in the RBS Group's wholesale credit portfolios. Its primary function is to work closely with the RBS Group's customer facing businesses to support the proactive management of any problem lending. This may include assisting with the restructuring of a customer's business and/or renegotiation of credit.

GRG reports to the Head of Restructuring and Risk and is structured with specialist teams focused on: large corporate cases (higher value, multiple lenders); small and medium size business cases (lower value, bilateral relationships); and recovery/litigations.

Originating business units liaise with GRG upon the emergence of a potentially negative event or trend that may impact a borrower's ability to service its debt. This may be a significant deterioration in some aspect of the borrower's activity, such as trading, where a breach of covenant is likely or where a borrower has missed or is expected to miss a material contractual payment to the RBS Group or another creditor.

On transfer of a relationship to GRG a strategy is devised to:

- Work with the borrower to facilitate changes that will maximise the potential for turnaround of their situation and return them to profitability;

- Define the RBS Group's role in the turnaround situation and assess the risk/return dimension of the RBS Group's participation;

- Return customers to the originating business unit in a sound and stable condition or, if such recovery cannot be achieved, avoid additional losses and maximise recoveries; and

- Ensure key lessons learned are fed back into origination policies and procedures.

Retail collections and recoveries

There are collections and recoveries functions in each of the consumer businesses. Their role is to provide support and assistance to customers who are currently experiencing difficulties meeting their financial obligations. Where possible, the aim of the collections and recoveries teams is to return the customer to a satisfactory position, by working with them to restructure their finances. If this is not possible, the team has the objective of reducing the loss to the RBS Group.

The ongoing investment in collections and recoveries operations has continued in 2009. Investment has increased staffing levels in all collections and recoveries functions, enhanced staff training to improve efficiency and effectiveness as well as upgraded technology and infrastructure.

In the UK and Ireland the RBS Group has introduced new forbearance policies for customers in financial difficulty based on various government sponsored schemes, customer affordability and prospects. In the US there has been an increase in agreed loan modification programmes, including those sponsored by the US government.

Credit risk framework

The approach taken to managing credit risk varies significantly between wholesale portfolios (loans, and other products giving rise to credit risk, to all but the smaller corporate customers, to financial institutions and to government entities) and retail portfolios (secured and unsecured loans and related products to individuals and small businesses).

Wholesale portfolios

Wholesale risk limits are aggregated at the counterparty level to determine the level of credit approval required and to facilitate consolidated credit risk management.

The credit approval process has two stages, assessment and decision. Credit applications for corporate customers are prepared by relationship managers in the units originating the credit exposures or by the relationship management team with lead responsibility for a counterparty where a customer has relationships with different divisions and business units across the RBS Group. This includes the assignment of risk parameter estimates (probability of default, loss given default and exposure at default) using approved models.

Credit approval authority is discharged by way of a framework of individual delegated authorities that 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 under the RBS Group-wide authority grid. The level of authority granted to an individual is dependent on their experience and expertise with only a small number of senior executives holding the highest authority provided under the framework.

Daily monitoring of individual counterparty limits is undertaken. For certain counterparties early warning indicators are also in place to detect deteriorating trends of concern in limit utilisation or account performance. A framework is also in place to monitor changes in credit quality at the portfolio level.

As 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.

Retail portfolios

Retail business operations require a large volume of small scale credit decisions, typically 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 best practice credit and behaviour scoring techniques. Scores and strategies are typically segmented by product, brand and other significant drivers of credit risk. These data driven strategies utilise a wide range of credit information relating to a customer including, where appropriate, information across a customer's holdings.

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 transactions and some residential mortgage applications.

Divisional risk management committees focus on portfolio level decisions which drive credit quality, changes to policy and strategy, and the setting of credit scorecard cut-offs. The divisional risk management committees are also responsible for reviewing ongoing performance of the business and, if necessary, making or recommending adjustments to risk appetite.

Credit risk continued

Credit risk measurement

Credit risk models are used throughout the RBS Group to support the quantitative risk assessment element of the credit approval process, ongoing credit risk management, monitoring and reporting and portfolio analytics. Credit risk models used by the RBS Group can be divided into three categories.

Probability of default/customer credit grade (PD)

These models assess the probability that a customer will fail to make full and timely repayment of their obligations. The probability of a customer failing to do so is measured over a one year period through the economic cycle, although certain retail scorecards use longer periods for business management purposes.

- Wholesale businesses: each counterparty is assigned an internal credit grade which is in turn assigned to a default probability range. There are a number of different credit grading models in use across the RBS Group, each of which considers risk characteristics particular to a type of customer. The credit grading models score a combination of quantitative inputs (for example, recent financial performance) and qualitative inputs (for example, management performance or sector outlook). Scores are then mapped to grades within each model. Grades are calibrated centrally to default probabilities. Obligor grades can, under certain circumstances, be cascaded to other borrowing entities within the obligor group where there is sufficient dependence on the graded entity. The credit grades for sovereign and central bank entities are assigned by a specialist country risk analysis team using a sovereign grading model. This team is independent of the origination function and is comprised of economists. Certain grading models also cover customers or transactions categorised as specialised lending (for example, certain types of investment property and asset finance such as shipping).
- Retail businesses: each customer account is separately scored using models based on the most material drivers of default. In general, scorecards are statistically derived using customer data. Customers are assigned a score which in turn, is mapped to a probability of default. The probability of default is used within the credit approval process and ongoing credit risk management, monitoring and reporting. The probabilities of default are used to group customers into risk pools. Pools are then assigned a weighted average probability of default using regulatory default definitions.

Exposure at default (EAD)

Facility usage models estimate the expected level of utilisation of a credit facility at the time of a borrower's default. For revolving and variable draw down type products which are not fully drawn, the EAD will typically be higher than the current utilisation. The methodologies used in EAD modelling provide a conservative estimate of potential exposure and recognise that customers may make more use of their existing credit facilities as they approach default.

Counterparty credit risk exposure measurement models calculate the market driven credit risk exposure for products where the exposure is not based solely upon principal and interest due. These models are most commonly used for derivative and other traded instruments where the amount of credit risk exposure may be dependent upon one or more underlying market variables such as interest or foreign exchange rates. These models drive internal credit risk activities such as limit and excess management.

Loss given default (LGD)

These models estimate the economic loss that may be experienced – the amount that cannot be recovered – by the RBS Group on a credit facility in the event of default. The RBS Group's LGD models take into account both borrower and facility characteristics for unsecured or partially unsecured facilities, as well as the quality of any risk mitigation that may be in place for secured facilities, plus the cost of collections and a time discount factor for the delay in cash recovery.

Credit risk mitigation
The RBS Group employs a number of structures and techniques to mitigate credit risk:

- Netting of debtor and creditor balances is utilised in accordance with relevant regulatory and internal policies and requires a formal agreement with the customer to net the balances and a legal right of set-off;
- Under market standard documentation net exposure on over-the-counter (OTC) derivative and secured financing transactions is further mitigated by the exchange of financial collateral;
- The RBS Group enhances its position as a lender in a range of transactions, from retail mortgage lending to large wholesale financing, by structuring a security interest in a physical or financial asset;
- Credit derivatives, including credit default swaps, credit linked debt instruments, and securitisation structures are used to mitigate credit risk; and
- Guarantees and similar instruments (for example, credit insurance) from related and third parties 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 RBS Group cover:

- General requirements including acceptable credit risk mitigation types and any conditions or restrictions applicable to those mitigants;
- The maximum loan-to-value (LTV) percentages, minimum haircuts or other volatility adjustments applicable to each type of mitigant including, where appropriate, adjustments for currency mismatch, obsolescence and any time sensitivities on asset values;
- The means by which legal certainty is to be established, including required documentation and all necessary steps required to establish legal rights;
- Acceptable methodologies for the initial and any subsequent valuations of collateral and the frequency with which they are to be revalued (for example, daily in the trading book);
- Actions to be taken in the event the current 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, for example, any situations where customer default materially impacts the value of a mitigant and applying a haircut or recovery value adjustment which reflects the potential correlation risk;
- Management of concentration risks, for example, 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 is legally effective and enforceable.

Credit concentration risk*
The RBS Group defines four key areas of concentration in credit risk that are monitored, reported and managed at both RBS Group and divisional levels. These are single name, industry/sector, country and product/asset class. Frameworks to address single name, industry/sector and country concentrations are established and continue to be enhanced and embedded into business processes across the RBS Group. Aspects of the product/asset class framework are in place whilst others will be developed during the course of 2010.

Under the RBS Group's credit approval framework, the required approval level is linked to the size of exposure with exposures above a certain level requiring the highest level of approval, held by a very small number of executives. In addition, the RBS Group's single name concentration framework includes specific approval requirements; additional reporting and monitoring; and the requirement to develop plans to address and reduce excess exposures.

The RBS Group has also developed a more robust approach and framework for managing sector concentrations, a major outcome of which is the regular review of the most material concentrations at the Executive Risk Forum (ERF). These reviews include an assessment of the RBS Group's franchise in a particular sector, an analysis of the outlook (including downside outcomes), identification of key vulnerabilities and stress/scenario tests. Reviews conclude with specific sector caps and other portfolio strategies to align the RBS Group's exposure profile with its appetite.

Country risk*
Country risk arises from sovereign events (for example, default or restructuring); economic events (for example, contagion of sovereign default to other parts of the economy, cyclical economic shock); political events (for example, convertibility restrictions and expropriation or nationalisation); and natural disaster or conflict. Losses are broadly defined and include credit, market, liquidity, operational and franchise risk related losses.

* unaudited

Credit risk continued

Risk elements and impairments

All the disclosures in this section (pages 48 to 50) are audited. The RBS Group classifies impaired assets as either Risk Elements in Lending (REIL) or Potential Problem Loans (PPL). REIL represents non-accrual loans, loans that are accruing but are past due 90 days and restructured loans. PPL represents impaired assets which are not included in REIL, but where information about possible credit problems cause management to have serious doubts about the future ability of the borrower to comply with loan repayment terms.

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.

The analyses of risk elements in lending and impairments as discussed below, form a key part of the data provided to senior management on the credit performance of the RBS Group's portfolios.

The table below sets out the loans that are classified as REIL and PPL.

	Group		
	2009 £m	2008 £m	2007 £m
Loans accounted for on a non-accrual basis (1)	27,515	13,726	6,667
Accruing loans which are contractually overdue 90 days or more as to principal interest (2)	3,069	1,669	256
Total REIL	30,584	15,395	6,923
PPL (3)	430	226	64
Total REIL and PPL	31,014	15,621	6,987
REIL and PPL as % of customer loans and advances – gross (4)	6.01%	2.60%	1.47%

The sub-categories of REIL and PPL are calculated as described in notes 1 to 4 below.

Notes:

(1) All loans against which an impairment provision is held are reported in the non-accrual category.

(2) Loans where an impairment event has taken place but no impairment recognised. This category is used for fully collateralised non-revolving credit facilities.

(3) Loans for which an impairment event has occurred but no impairment provision is necessary. This category is used for fully collateralised advances and revolving credit facilities where identification as 90 days overdue is not feasible.

(4) Gross of provisions and excluding reverse repurchase agreements.

Impairment loss provision methodology

Provisions for impairment losses are assessed under three categories:

- Individually assessed provisions: provisions required for individually significant impaired assets which are assessed on a case by case basis, taking into account the financial condition of the counterparty and any guarantee and other collateral held after being stressed for downside risk. This incorporates an estimate of the discounted value of any recoveries and realisation of security or collateral. 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 which are assessed on a portfolio basis, to reflect the homogeneous nature of the assets, such as credit cards or personal loans. The provision is determined from a quantitative review of the relevant portfolio, taking account of the level of arrears, security and average loss experience over the recovery period; and

- Latent loss provisions: provisions held against the 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 RBS Group has developed methodologies to estimate latent loss provisions that reflect:

  – Historical loss experience adjusted where appropriate, in the light of current economic and credit conditions; and

  – The period ('emergence period') between an impairment event occurring and a loan being identified and reported as impaired.

Recoverable cash flows are estimated using two parameters: loss given default (LGD) – this is the estimate loss amount, expressed as a percentage, that will be incurred if the borrower defaults; and the probability that the borrower will default (PD).

Emergence periods are estimated at a portfolio level and reflect the portfolio product characteristics such as a coupon period and repayment terms, and the duration of the administrative process required to report and identify an impaired loan as such. Emergence periods vary across different portfolios from two to 225 days. They are based on actual experience within the particular portfolio and are reviewed regularly.

The RBS Group's retail business segment their performing loan books into homogenous portfolios such as mortgages, credit cards or unsecured loans, to reflect their different credit characteristics. Latent provisions are computed by applying portfolio-level LGDs, PDs and emergence periods. The wholesale calculation is based on similar principles but there is no segmentation into portfolios: PDs and LGDs are calculated on an individual basis.

Provision analysis

The RBS 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 RBS Group operates a transparent provisions governance framework, setting thresholds to trigger enhanced oversight and challenge.

Impairment charge

The following table shows impairment losses charged to the income statement.

	Group		
	2009 £m	2008 £m	2007 £m
New impairment losses	12,481	4,917	2,110
less: recoveries of amounts previously written-off	(307)	(211)	(245)
Charge to income statement	12,174	4,706	1,865
Comprising:			
Loan impairment losses	11,373	4,555	1,843
Impairment losses on available-for-sale securities	801	151	22
Charge to income statement	12,174	4,706	1,865

Analysis of loan impairment charge

	Group		
	2009 £m	2008 £m	2007 £m
Latent loss	1,110	582	2
Collectively assessed	3,921	2,183	1,644
Individually assessed (1)	6,334	1,709	197
Charge to income statement (2)	11,365	4,474	1,843
Charge as a % of customer loans and advances – gross (3)	2.21%	0.75%	0.39%

Notes:

(1) Excludes loan impairment charge against loans and advances to banks of £8 million (2008 – £81 million; 2007 – nil).

(2) Excludes impairment of available-for-sale securities of £801 million (2008 – £151 million; 2007 – £22 million).

(3) Gross of provisions and excluding reverse repurchase agreements.

Analysis of loan impairment provisions on loans to customers

	Group		
	2009 £m	2008 £m	2007 £m
Latent loss	2,361	1,328	600
Collectively assessed	4,654	3,380	2,996
Individually assessed (1)	4,915	1,864	637
	11,930	6,572	4,233
Total provision as a % of customer loans and advances – gross (2)	2.32%	1.10%	0.89%

Notes:

(1) Excludes provisions of £90 million relating to loans and advances to banks (2008 – £83 million; 2007 – £2 million).

(2) Gross of provisions and excluding reverse repurchase agreements.

Credit risk continued

Provisions coverage

The provision coverage ratios are shown in the table below.

	Group 2009 £m	2008 £m	2007 £m
Total provision expressed as a:			
% of REIL	39%	43%	61%
% of REIL and PPL	39%	43%	61%

Movement in loan impairment provisions

The following table shows the movement in the provision for impairment losses for loans and advances.

2009	Group Individually assessed £m	Collectively assessed £m	Latent £m	Total 2009 £m	2008 £m	2007 £m
At 1 January	1,947	3,380	1,328	6,655	4,235	3,929
Currency translation and other adjustments	(187)	21	(77)	(243)	453	30
(Disposals)/acquisitions	—	—	—	—	(178)	6
Amounts written-off	(2,932)	(2,784)	—	(5,716)	(2,447)	(1,652)
Recoveries of amounts previously written-off	29	278	—	307	211	245
Charged to the income statement (1)	6,342	3,921	1,110	11,373	4,555	1,843
Unwind of discount	(194)	(162)	—	(356)	(174)	(166)
At 31 December (2)	5,005	4,654	2,361	12,020	6,655	4,235

Notes:

(1) Includes charge relating to loans and advances to banks of £8 million (2008 – £81 million; 2007 – nil).

(2) The provision for impairment losses at 31 December 2009 includes £90 million relating to loans and advances to banks (2008 – £83 million; 2007 – £2 million).

Balance sheet analysis

All the disclosures in this section (pages 51 to 58) are audited. The following tables provide an analysis of the credit quality and distribution of financial assets by the RBS Group's internal credit quality gradings, geography and industry sector.

Credit quality

	Group								
2009	Cash and balances at central banks £m	Loans and advances to banks (1) £m	Loans and advances to customers £m	Settlement balances £m	Derivatives £m	Other financial instruments £m	Commitments £m	Contingent liabilities £m	Total £m
AQ1	27,033	56,548	98,079	3,721	372,642	26	56,560	6,617	621,226
AQ2	—	897	8,631	306	10,574	—	22,770	1,134	44,312
AQ3	1	1,932	26,617	199	10,287	—	23,500	2,671	65,207
AQ4	23	860	88,922	605	5,697	—	37,342	4,302	137,751
AQ5	2	48	109,383	149	5,895	7	38,399	3,987	157,870
AQ6	1	96	90,661	40	2,286	—	29,758	1,682	124,524
AQ7	—	37	43,128	33	1,931	—	25,410	1,429	71,968
AQ8	—	13	19,179	—	1,247	—	11,330	180	31,949
AQ9	—	—	12,181	—	1,788	—	3,691	260	17,920
AQ10	—	216	7,975	3	1,946	—	3,135	167	13,442
Balances with Group companies	—	5,274	1,949	—	32,020	—	42	20,680	59,965
Accruing past due	—	36	13,979	3,910	39	—	—	—	17,964
Non-accrual	—	100	27,415	187	1	—	—	—	27,703
Impairment provision	—	(90)	(11,930)	—	—	—	—	—	(12,020)
	27,060	65,967	536,169	9,153	446,353	33	251,937	43,109	1,379,781

2008	Cash and balances at central banks £m	Loans and advances to banks (1) £m	Loans and advances to customers £m	Settlement balances £m	Derivatives £m	Other financial instruments £m	Commitments £m	Contingent liabilities £m	Total £m
AQ1	6,803	64,770	118,092	4,997	793,789	32	105,383	11,731	1,105,597
AQ2	3	1,296	13,797	535	16,098	—	19,780	2,092	53,601
AQ3	—	2,389	52,948	550	13,501	—	19,600	2,771	91,759
AQ4	—	495	109,234	34	22,616	—	52,494	7,477	192,350
AQ5	—	91	136,652	252	23,051	—	56,715	4,625	221,386
AQ6	—	31	83,157	217	3,808	—	15,132	1,875	104,220
AQ7	—	11	50,343	248	3,719	—	16,059	1,865	72,245
AQ8	—	—	18,823	—	364	—	11,618	233	31,038
AQ9	—	51	7,701	9	1,024	—	3,312	125	12,222
AQ10	—	177	4,404	—	3,052	—	993	123	8,749
Balances with Group companies	—	7,297	4,484	—	56,424	—	51	—	68,256
Accruing past due	—	—	12,797	4,029	11	—	—	—	16,837
Non-accrual	—	83	13,643	—	—	—	—	—	13,726
Impairment provision	—	(83)	(6,572)	—	—	—	—	—	(6,655)
	6,806	76,608	619,503	10,871	937,457	32	301,137	32,917	1,985,331

Note:

(1) Excluding items in the course of collection of £2,474 million (2008 – £2,779 million).

Balance sheet analysis continued

Credit quality continued

The following tables show 2008 and 2007 data based on the old AQ1-5 bands for the Group and the Bank.

	Group								
2008	Cash and balances at central banks £m	Loans and advances to banks (1) £m	Loans and advances to customers £m	Settlement balances £m	Derivatives £m	Other financial instruments £m	Commitments £m	Contingent liabilities £m	Total £m
AQ1	6,806	68,885	231,688	5,651	812,895	32	173,350	20,946	1,320,253
AQ2	—	91	108,005	516	33,632	—	44,710	5,976	192,930
AQ3	—	77	144,408	290	24,984	—	43,765	2,989	216,513
AQ4	—	28	74,314	129	4,077	—	20,983	2,519	102,050
AQ5	—	230	36,736	256	5,434	—	18,278	487	61,421
Balances with Group companies	—	7,297	4,484	—	56,424	—	51	—	68,256
Accruing past due	—	—	12,797	4,029	11	—	—	—	16,837
Non-accrual	—	83	13,643	—	—	—	—	—	13,726
Impairment provision	—	(83)	(6,572)	—	—	—	—	—	(6,655)
	6,806	76,608	619,503	10,871	937,457	32	301,137	32,917	1,985,331

2007									
AQ1	5,559	89,357	191,451	3,228	175,770	19	95,664	7,658	568,706
AQ2	—	1,772	109,460	98	21,166	—	73,221	7,915	213,632
AQ3	—	426	163,792	344	4,801	—	60,895	4,989	235,247
AQ4	—	94	46,293	21	894	—	19,797	1,214	68,313
AQ5	—	2	19,850	68	394	—	12,177	1,100	33,591
Balances with Group companies	—	1,966	9,088	—	2,950	—	—	—	14,004
Accruing past due	—	—	9,083	1,567	—	—	—	—	10,650
Non-accrual	—	2	6,665	—	—	—	—	—	6,667
Impairment provision	—	(2)	(4,233)	—	—	—	—	—	(4,235)
	5,559	93,617	551,449	5,326	205,975	19	261,754	22,876	1,146,575

Note:

(1) Excluding items in the course of collection of £2,779 million (2007 – £2,729 million).

	Bank							
2009	Cash and balances at central banks £m	Loans and advances to banks (1) £m	Loans and advances to customers £m	Settlement balances £m	Derivatives £m	Commitments £m	Contingent liabilities £m	Total £m
AQ1	21,099	39,939	45,138	2,656	371,762	45,312	5,443	531,349
AQ2	—	888	5,019	42	10,456	21,579	911	38,895
AQ3	—	1,492	16,075	—	10,196	20,316	2,205	50,284
AQ4	—	623	41,900	50	5,389	25,436	2,349	75,747
AQ5	—	36	50,851	35	5,399	17,115	2,255	75,691
AQ6	—	93	35,739	40	1,922	10,969	446	49,209
AQ7	—	23	14,182	33	1,746	10,594	592	27,170
AQ8	—	9	5,350	—	1,168	3,753	20	10,300
AQ9	—	—	6,177	—	1,753	1,621	108	9,659
AQ10	—	216	4,707	3	1,850	2,015	92	8,883
Balances with Group companies	—	33,610	102,853	—	39,233	329	20,680	196,705
Accruing past due	—	—	3,431	1,113	39	—	—	4,583
Non-accrual	—	90	11,696	187	—	—	—	11,973
Impairment provision	—	(80)	(4,570)	—	—	—	—	(4,650)
	21,099	76,939	338,548	4,159	450,913	159,039	35,101	1,085,798
2008								
AQ1	3,714	51,140	68,437	3,580	788,754	80,882	10,351	1,006,858
AQ2	—	1,031	10,060	51	14,547	16,710	1,611	44,010
AQ3	—	1,991	27,679	497	13,040	15,078	1,869	60,154
AQ4	—	303	44,559	—	21,820	34,726	4,737	106,145
AQ5	—	52	60,333	71	21,519	22,763	2,026	106,764
AQ6	—	10	37,114	100	3,104	5,303	568	46,199
AQ7	—	—	19,886	24	2,615	5,349	971	28,845
AQ8	—	—	5,021	—	285	4,284	21	9,611
AQ9	—	48	2,099	2	942	1,656	82	4,829
AQ10	—	177	1,774	—	3,008	310	79	5,348
Balances with Group companies	—	36,481	44,368	—	68,860	346	—	150,055
Accruing past due	—	—	2,482	1,010	11	—	—	3,503
Non-accrual	—	81	5,622	—	—	—	—	5,703
Impairment provision	—	(81)	(2,394)	—	—	—	—	(2,475)
	3,714	91,233	327,040	5,335	938,505	187,407	22,315	1,575,549

Note:
(1) Excluding items in the course of collection of £426 million (2008 – £484 million).

Balance sheet analysis continued

Credit quality continued

The following tables show 2008 and 2007 data based on the old AQ1-5 bands.

	Bank							
2008	Cash and balances at central banks £m	Loans and advances to banks (1) £m	Loans and advances to customers £m	Settlement balances £m	Derivatives £m	Commitments £m	Contingent liabilities £m	Total £m
AQ1	3,714	54,403	127,883	4,051	807,283	131,942	16,804	1,146,080
AQ2	—	66	50,267	120	31,173	23,847	3,093	108,566
AQ3	—	50	60,255	129	23,224	17,102	1,155	101,915
AQ4	—	8	28,830	—	3,367	6,659	1,081	39,945
AQ5	—	225	9,727	25	4,587	7,511	182	22,257
Balances with Group companies	—	36,481	44,368	—	68,860	346	—	150,055
Accruing past due	—	—	2,482	1,010	11	—	—	3,503
Non-accrual	—	81	5,622	—	—	—	—	5,703
Impairment provision	—	(81)	(2,394)	—	—	—	—	(2,475)
	3,714	91,233	327,040	5,335	938,505	187,407	22,315	1,575,549

2007								
AQ1	3,333	66,418	97,715	1,273	174,288	61,866	5,876	410,769
AQ2	—	574	59,825	89	20,879	39,825	5,187	126,379
AQ3	—	275	75,432	130	4,575	31,604	2,962	114,978
AQ4	—	70	12,645	—	795	6,478	278	20,266
AQ5	—	—	5,874	39	367	5,784	703	12,767
Balances with Group companies	—	24,115	74,340	—	7,009	258	—	105,722
Accruing past due	—	—	2,501	515	—	—	—	3,016
Non-accrual	—	—	2,088	—	—	—	—	2,088
Impairment provision	—	—	(1,273)	—	—	—	—	(1,273)
	3,333	91,452	329,147	2,046	207,913	145,815	15,006	794,712

Note:

(1) Excluding items in the course of collection of £484 million (2007 – £530 million).

Debt securities

The tables below analyse debt securities by external ratings for the Group and the Bank, mapped onto the Standard & Poor's rating scale.

	Group						
2009	UK and US government £m	Other-government £m	Bank and building society £m	Asset backed securities £m	Corporate £m	Other £m	Total £m
AAA	44,491	29,421	2,857	44,101	1,376	—	122,246
BBB– and above	—	27,184	6,007	16,064	2,990	—	52,245
Non-investment grade	—	181	156	3,469	1,401	—	5,207
Unrated	—	43	231	2,021	1,513	802	4,610
	44,491	56,829	9,251	65,655	7,280	802	184,308
Balances with Group companies	—	—	—	—	873	—	873
	44,491	56,829	9,251	65,655	8,153	802	185,181
2008							
AAA	29,632	28,311	6,019	64,622	2,543	—	131,127
BBB– and above	—	7,676	10,678	10,390	5,538	—	34,282
Non-investment grade	—	31	—	2,793	1,459	—	4,283
Unrated	—	1	1,335	1,934	4,064	740	8,074
	29,632	36,019	18,032	79,739	13,604	740	177,766

	Bank						
2009	UK and US government £m	Other-government £m	Bank and building society £m	Asset backed securities £m	Corporate £m	Other £m	Total £m
AAA	34,588	28,424	2,433	13,710	741	—	79,896
BBB– and above	—	22,120	5,495	13,174	2,133	—	42,922
Non-investment grade	—	160	180	2,304	1,006	—	3,650
Unrated	—	38	230	2,004	2,112	736	5,120
	34,588	50,742	8,338	31,192	5,992	736	131,588
Balances with Group companies	—	—	—	81,492	1,518	—	83,010
	34,588	50,742	8,338	112,684	7,510	736	214,598
2008							
AAA	18,534	27,016	5,772	62,026	2,725	—	116,073
BBB– and above	—	4,098	10,205	8,421	3,452	—	26,176
Non-investment grade	—	31	—	2,604	1,321	—	3,956
Unrated	—	—	1,490	5,842	4,785	668	12,785
	18,534	31,145	17,467	78,893	12,283	668	158,990
Balances with Group companies	—	—	—	—	708	—	708
	18,534	31,145	17,467	78,893	12,991	668	159,698

Balance sheet analysis continued

Industry risk – geographical analysis

The tables below analyse financial assets by location of office and by industry type.

	Group					
2009	Loans and advances to banks and customers £m	Securities £m	Derivatives £m	Other(1) £m	Total £m	Netting offset(2) £m
UK	416,071	120,612	287,881	3,062	827,626	245,861
US	98,893	55,826	131,546	5,592	291,857	113,670
Europe	78,056	1,541	515	60	80,172	—
Rest of the World	23,610	10,382	26,411	472	60,875	19,725
	616,630	188,361	446,353	9,186	1,260,530	379,256
Central and local government	6,676	110,601	6,924	172	124,373	1,723
Manufacturing	31,017	567	2,900	14	34,498	3,120
Construction	13,948	227	908	45	15,128	1,450
Finance	149,250	65,367	420,806	8,946	644,369	365,912
Service industry and business activities	112,497	6,391	10,570	1	129,459	5,833
Agriculture, forestry and fishing	4,031	2	44	—	4,077	76
Property	98,131	4,085	4,136	1	106,353	1,114
Individuals:						
Home mortgages	140,199	64	11	—	140,274	7
Other	39,340	1	38	7	39,386	21
Finance lease and instalment credit	20,086	285	16	—	20,387	—
Interest accruals	1,455	771	—	—	2,226	—
	616,630	188,361	446,353	9,186	1,260,530	379,256

2008						
UK	469,902	107,079	523,749	4,100	1,104,830	442,335
US	121,276	62,963	375,155	6,520	565,914	326,473
Europe	91,465	1,842	763	116	94,186	7
Rest of the World	22,902	8,715	37,790	167	69,574	31,262
	705,545	180,599	937,457	10,903	1,834,504	800,077
Central and local government	7,661	66,225	4,319	181	78,386	1,636
Manufacturing	46,415	521	7,863	184	54,983	4,029
Construction	19,032	96	925	6	20,059	1,485
Finance	183,541	103,694	896,458	9,034	1,192,727	781,701
Service industry and business activities	133,414	6,498	22,228	1,494	163,634	10,056
Agriculture, forestry and fishing	4,258	1	48	2	4,309	87
Property	100,676	2,072	5,522	2	108,272	1,026
Individuals:						
Home mortgages	138,747	—	14	—	138,761	52
Other	45,949	248	55	—	46,252	5
Finance leases and instalment credit	22,246	3	25	—	22,274	—
Interest accruals	3,606	1,241	—	—	4,847	—
	705,545	180,599	937,457	10,903	1,834,504	800,077

For the notes to the above table refer to page 57.

2007	Group Loans and advances to banks and customers £m	Securities £m	Derivatives £m	Other(1) £m	Total £m	Netting offset (2) £m
UK	459,650	96,608	194,942	1,685	752,885	206,396
US	95,495	61,924	9,703	3,012	170,134	7,420
Europe	71,156	1,855	1,028	28	74,067	16
Rest of the World	25,729	9,599	302	620	36,250	72
	652,030	169,986	205,975	5,345	1,033,336	213,904
Central and local government	5,859	40,276	1,167	212	47,514	1,531
Manufacturing	31,068	447	1,517	—	33,032	4,031
Construction	17,024	103	741	—	17,868	1,685
Finance	229,623	120,247	196,560	5,081	551,511	197,802
Service industry and business activities	99,759	6,533	4,661	—	110,953	6,709
Agriculture, forestry and fishing	3,183	1	58	—	3,242	104
Property	80,882	722	970	7	82,581	2,033
Individuals:						
Home mortgages	117,361	18	5	—	117,384	—
Other	44,547	260	15	—	44,822	7
Finance leases and instalment credit	19,498	131	281	45	19,955	—
Interest accruals	3,226	1,248	—	—	4,474	2
	652,030	169,986	205,975	5,345	1,033,336	213,904

Notes:

(1) Includes settlement balances of £9,153 million (2008 – £10,871 million; 2007 – £5,326 million)

(2) This column shows 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 to 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 in reverse repurchase agreements. Cash and securities are received as collateral in respect of derivative transactions.

2009	Bank Loans and advances to banks and customers £m	Securities £m	Derivatives £m	Settlement balances £m	Total £m	Netting offset (1) £m
UK	365,599	201,383	292,048	3,059	862,089	236,076
US	16,317	8,617	132,305	1,046	158,285	112,301
Europe	22,355	52	33	—	22,440	—
Rest of the World	16,292	6,245	26,527	54	49,118	19,725
	420,563	216,297	450,913	4,159	1,091,932	368,102
Central and local government	4,183	84,588	6,922	8	95,701	465
Manufacturing	18,989	377	2,747	—	22,113	1,377
Construction	6,600	156	858	45	7,659	477
Finance	219,063	123,185	427,134	4,105	773,487	364,293
Service industry and business activities	68,851	2,845	9,501	—	81,197	1,046
Agriculture, forestry and fishing	846	—	35	—	881	61
Property	49,819	4,639	3,668	1	58,127	356
Individuals:						
Home mortgages	43,769	—	3	—	43,772	7
Other	6,979	—	29	—	7,008	20
Finance leases and instalment credit	428	56	16	—	500	—
Interest accruals	1,036	451	—	—	1,487	—
	420,563	216,297	450,913	4,159	1,091,932	368,102

For the note to the above table refer to page 58.

Balance sheet analysis continued

Industry risk – geographical analysis continued

2008	Bank Loans and advances to banks and customers £m	Securities £m	Derivatives £m	Settlement balances £m	Total £m	Netting and offset(1) £m
UK	346,498	142,892	529,349	3,959	1,022,698	431,609
US	25,540	12,368	370,988	1,376	410,272	320,611
Europe	29,381	60	8	—	29,449	7
Rest of the World	19,813	5,444	38,160	—	63,417	31,262
	421,232	160,764	938,505	5,335	1,525,836	783,489
Central and local government	4,766	35,040	4,324	4	44,134	352
Manufacturing	29,710	462	6,918	20	37,110	1,904
Construction	8,269	36	812	—	9,117	405
Finance	186,154	116,257	905,622	4,776	1,212,809	777,831
Service industries and business activities	86,726	5,453	16,101	532	108,812	2,441
Agriculture, forestry and fishing	853	—	33	1	887	71
Property	53,270	2,693	4,659	2	60,624	433
Individuals:						
Home mortgages	39,852	—	5	—	39,857	52
Other	7,861	—	6	—	7,867	—
Finance leases and instalment credit	1,009	—	25	—	1,034	—
Interest accruals	2,762	823	—	—	3,585	—
	421,232	160,764	938,505	5,335	1,525,836	783,489

2007	Loans and advances to banks and customers £m	Securities £m	Derivatives £m	Settlement balances £m	Total £m	Netting and offset(1) £m
UK	321,793	94,118	197,214	1,680	614,805	195,696
US	41,931	13,504	10,400	321	66,156	4,932
Europe	35,945	38	10	—	35,993	—
Rest of the World	22,733	3,609	289	45	26,676	72
	422,402	111,269	207,913	2,046	743,630	200,700
Central and local government	3,097	16,324	1,168	—	20,589	387
Manufacturing	17,901	333	1,416	—	19,650	1,775
Construction	7,124	51	716	—	7,891	769
Finance	235,715	86,656	199,164	1,994	523,529	194,949
Service industries and business activities	69,728	6,268	4,238	—	80,234	2,145
Agriculture, forestry and fishing	811	—	56	—	867	87
Property	41,154	571	867	7	42,599	588
Individuals:						
Home mortgages	35,993	—	1	—	35,994	—
Other	8,217	—	6	—	8,223	—
Finance leases and instalment credit	875	128	281	45	1,329	—
Interest accruals	1,787	938	—	—	2,725	—
	422,402	111,269	207,913	2,046	743,630	200,700

Note:

(1) This column shows the amount by which the Bank's credit risk exposure is reduced through arrangements, such as master netting agreements, which give the Bank a legal right to set-off the financial asset against a financial liability due to the same counterparty. In addition, the Bank holds collateral in respect of individual loans and advances to banks and to 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 Bank obtains collateral in the form of securities in reverse repurchase agreements. Cash and securities are received as collateral in respect of derivative transactions.

Funding and liquidity risk

All the disclosures in this section (pages 59 to 63) are audited unless indicated otherwise with an asterisk (*).

The RBS Group's liquidity policy is designed to ensure that the RBS Group can at all times meet its obligations as they fall due.

Liquidity management within the RBS Group addresses the overall balance sheet structure and the control, within prudent limits, of risk arising from the mismatch of maturities across the balance sheet and from exposure to undrawn commitments and other contingent obligations.

Following a difficult first quarter of 2009, most indicators of stress in financial markets are close to or better than in late 2008. Liquidity conditions in money and debt markets have improved significantly since the beginning of the second quarter of 2009. Contributing to the improvement has been a combination of ongoing central bank and other official liquidity support schemes, guarantee schemes and rate cuts. Signs of underlying macroeconomic trends, such as stabilisation of the UK economy, also helped to sustain a recovery in debt markets.

Liquidity risk framework and governance

The RBS Group has an approved risk appetite supported by explicit targets and metrics to control the size and extent of both short-term and long-term liquidity risk. These metrics are reviewed by the Board and Group Asset and Liability Management Committee (GALCO) on a regular basis. The RBS Group uses stress tests to refine and update the risk appetite in light of changing conditions.

The GALCO, chaired by the Group Finance Director, has the responsibility to set RBS Group policy and ensure that it is cascaded and communicated to the business divisions. Group Treasury is the functional area with responsibility for monitoring and control of the RBS Group's funding and liquidity positions.

Group Treasury is supported by a governance process that includes a Liquidity Risk Forum comprising functional areas across the organisation that are responsible for liquidity management, including monitoring through divisional and regional asset and liability committees.

The RBS Group uses funds transfer pricing to ensure the costs of liquidity as well as funding are integrated into the business decision making process.

The RBS Group continues to improve and augment funding and liquidity risk management practices in light of experience of the market over the last two years and of emerging regulatory and industry standards such as the FSA policy statement on strengthening liquidity standards.

Structural management

The RBS Group regularly evaluates its structural liquidity risk and applies a variety of balance sheet management and term funding strategies to maintain this risk within its policy parameters. The degree of maturity mismatch within the overall long-term structure of the RBS Group's assets and liabilities are managed within internal policy guidelines, aimed at ensuring term asset commitments are funded on an economic basis over their life. In managing its overall term structure, the RBS Group analyses and takes into account the effect of retail and corporate customer behaviour on actual asset and liability maturities where they differ materially from the underlying contractual maturities.

The RBS Group targets diversification in its funding sources to reduce funding risk. A key source of funds for the RBS Group is its core customer deposits gathered by its retail banking, private client, corporate and Small and Medium Enterprises (SME) franchises. The RBS Group's multi-brand offering and strong client focus is a key part of the funding strategy and continues to benefit the RBS Group's funding position.

The RBS Group also accesses the wholesale funding market to provide additional flexibility in funding sources. The RBS Group has actively sought to manage its liquidity position through increasing the duration of short-term wholesale funding, continued diversification of wholesale debt investors and depositors, supplemented by long-term issuance, government guaranteed debt, and a programme of ensuring that assets held are eligible as collateral to access central bank liquidity schemes.

Cash flow management

The short-term maturity structure of the RBS Group's assets and liabilities is managed daily to ensure that all material or potential cash flow, undrawn commitments and other contingent obligations can be met. The primary focus of the daily management activity is to ensure access to sufficient liquidity to meet cash flow obligations within key time horizons, including out to one month ahead and FSA target horizons such as 90 days.

Potential sources of liquidity include cash inflows from maturing assets, new borrowings or the sale of various debt securities held. Short-term liquidity risk is generally managed on a consolidated basis with liquidity mismatch limits in place for subsidiaries and non-UK branches which have material local treasury activities, thereby assuring that the daily maintenance of the RBS Group's overall liquidity risk position is not compromised.

Volume management

The RBS Group also actively monitors and manages future business volumes to assess funding and liquidity requirements and ensure that the RBS Group operates within the within the risk appetite and metrics set by the Board. This includes management of undrawn commitments, conduits and liquidity facilities within acceptable levels.

Liquidity reserves

The RBS Group has built up a diversified stock of highly marketable liquid assets including highly rated central government debt that can be used as a buffer against unforeseen impacts on cash flow or in stressed environments. The make up of this portfolio of assets is sub-divided into tiers on the basis of asset liquidity, with haircuts applied to ensure that realistic liquidation values are used in key metrics. This portfolio includes a centrally held buffer against severe liquidity stresses and locally held buffers to meet self sufficiency needs.

Funding and liquidity risk continued

Stress testing

The RBS Group performs stress tests to simulate how events may impact its funding and liquidity capabilities. Such tests assist in the planning of the overall balance sheet structure, help define suitable limits for control of the risk arising from the mismatch of maturities across the balance sheet and from undrawn commitments and other contingent obligations, and feed into the risk appetite and contingency funding plans. The form and content of stress tests are updated where required as market conditions evolve. These stresses include the following scenarios:

- Idiosyncratic stress: an unforeseen, name-specific, liquidity stress, with the initial short-term period of stress lasting for at least two weeks;
- Market stress: an unforeseen, market-wide liquidity stress of three months duration;
- Idiosyncratic and market stress: a combination of idiosyncratic and market stress;
- Rating downgrade: one and two notch long-term credit rating downgrade scenarios; and
- Daily market lockout: no access to unsecured funding and no funding rollovers are possible.

Contingency planning

Contingency funding plans have been developed which incorporate early warning indicators to monitor market conditions. The RBS Group reviews its contingency funding plans in the light of evolving market conditions and stress test results. The contingency funding plan covers: the available sources of contingent funding to supplement cash flow shortages; the lead times to obtain such funding; the roles and responsibilities of those involved in the contingency plans; the communication and escalation requirements when early warning indicators signal deteriorating market conditions; and the ability and circumstances within which the RBS Group accesses central bank liquidity.

Monitoring

Liquidity risk is constantly monitored to evaluate the RBS Group's position having regard to its risk appetite and key metrics. Daily, weekly and monthly monitoring and control processes are in place, which allow management to take appropriate action. Actions taken to improve the liquidity risk include a focus on improving the loan to deposit ratio, issuing longer-term wholesale funding, both guaranteed and unguaranteed, and the size of the conduit commitments. Metrics include, but are not limited to;

Wholesale funding > one year: As the wholesale funding markets have improved over the course of 2009 the RBS Group has been better able to manage both its short and longer term funding requirements and has significantly reduced its reliance on central bank funding.

Loan to deposit ratio: The RBS Group monitors the loan to deposit ratio as a key metric.

Undrawn commitments: The RBS Group has been actively managing down the amount of undrawn commitments that it is exposed to.

Liquidity reserves: The total stock of liquid assets has increased during 2009.

Conduit commitments: The RBS Group has taken additional measures to improve the balance sheet structure. One area of focus has been reducing the size of the multi-seller conduits business which relies upon funding assets through the issuance of short-term asset-backed commercial papers.

Funding profile

The contractual maturity of on balance sheet assets and liabilities, shown in the tables below, highlight the maturity transformation which underpins the role of banks to lend longer-term but funded predominantly by short-term liabilities such as customer deposits. This is achieved through the diversified funding franchise of the RBS Group across an extensive retail, wealth and SME customer base, and across a wide geographic network. In practice, the behavioural profile of many asset and liabilities exhibit greater stability and longer maturity than the contractual maturity. The RBS Group models the behavioural maturity of liabilities so that it can target a diversified and stable funding base.

The table below analyses the contractual undiscounted cash flows receivable and payable up to a period of twenty years including future receipts and payments of interest of the on balance sheet assets by contractual maturity.

	Group					
2009	0-3 months £m	3-12 months £m	1-3 years £m	3-5 years £m	5-10 years £m	10-20 years £m
Assets by contractual maturity						
Cash and balances at central banks	27,053	—	—	1	—	—
Loans and advances to banks	16,795	1,252	491	38	211	290
Debt securities	14,823	5,056	17,063	13,042	21,473	15,954
Settlement balances	9,148	5	—	—	—	—
Other financial assets	—	7	—	17	9	—
Total maturing assets	67,819	6,320	17,554	13,098	21,693	16,244
Loans and advances to customers	79,143	56,308	109,649	86,842	110,926	120,046
Derivatives held for hedging	317	1,008	1,105	231	252	83
Total assets	147,279	63,636	128,308	100,171	132,871	136,373
Liabilities by contractual maturity						
Deposits by banks	44,112	7,622	2,959	1,371	135	11
Debt securities in issue	75,943	28,689	43,068	8,806	7,095	1,599
Subordinated liabilities	2,231	2,291	4,607	5,107	13,678	2,523
Settlement balances and other liabilities	9,817	39	93	91	233	83
Total maturing liabilities	132,103	38,641	50,727	15,375	21,141	4,216
Customer accounts	379,452	9,988	3,784	2,387	3,277	2,011
Derivatives held for hedging	391	1,008	1,174	173	14	19
Total liabilities	511,946	49,637	55,685	17,935	24,432	6,246
Maturity gap	(64,284)	(32,321)	(33,173)	(2,277)	552	12,028
Cumulative maturity gap	(64,284)	(96,605)	(129,778)	(132,055)	(131,503)	(119,475)
Guarantees and commitments notional amount						
Guarantees (1, 2)	11,202	—	—	—	—	—
Commitments (3)	248,529	—	—	—	—	—
2008						
Assets by contractual maturity						
Cash and balances at central banks	6,804	—	—	—	2	—
Loans and advances to banks	14,356	3,037	650	343	156	1
Debt securities	21,104	4,785	14,647	7,983	16,509	23,742
Settlement balances	10,869	—	—	—	2	—
Other financial assets	2	—	—	10	20	—
Total maturing assets	53,135	7,822	15,297	8,336	16,689	23,743
Loans and advances to customers	112,181	63,785	117,538	106,942	137,546	129,999
Derivatives held for hedging	5	734	1,842	911	876	268
Total assets	165,321	72,341	134,677	116,189	155,111	154,010
Liabilities by contractual maturity						
Deposits by banks	83,879	5,938	3,114	1,758	662	34
Debt securities in issue	110,728	30,213	22,461	3,581	5,600	4,038
Subordinated liabilities	972	2,659	5,113	5,583	17,213	13,287
Settlement balances and other liabilities	10,407	5	7	4	7	6
Total maturing liabilities	205,986	38,815	30,695	10,926	23,482	17,365
Customer accounts	368,115	18,634	2,313	2,811	4,105	2,718
Derivatives held for hedging	67	755	1,926	674	597	317
Total liabilities	574,168	58,204	34,934	14,411	28,184	20,400
Maturity gap	(152,851)	(30,993)	(15,398)	(2,590)	(6,793)	6,378
Cumulative maturity gap	(152,851)	(183,844)	(199,242)	(201,832)	(208,625)	(202,247)

Notes:

(1) The Group is only called upon to satisfy a guarantee when the guaranteed party fails to meet its obligations. The Group expects most guarantees it provides to expire unused.

(2) Guarantees exclude the Asset Protection Scheme related financial guarantee contract of £20,680 million between the Bank and a fellow subsidiary.

(3) The Group has given commitments to provide funds to customers under undrawn formal facilities, credit lines and other commitments to lend subject to certain conditions being met by the counterparty. The Group does not expect all facilities to be drawn, and some may lapse before drawdown.

Funding and liquidity risk continued

Other contractual cash obligations

The table below summarises other contractual cash obligations by payment date.

	Group					
2009	0-3 months £m	3-12 months £m	1-3 years £m	3-5 years £m	5-10 years £m	10-20 years £m
Operating leases	111	288	718	583	1,048	1,681
Contractual obligations to purchase goods or services	171	270	153	16	—	1
	282	558	871	599	1,048	1,682
2008						
Operating leases	103	304	743	611	1,174	1,836
Contractual obligations to purchase goods or services	176	696	262	22	—	1
	279	1,000	1,005	633	1,174	1,837

	Bank					
2009	0-3 months £m	3-12 months £m	1-3 years £m	3-5 years £m	5-10 years £m	10-20 years £m
Operating leases	47	118	320	292	576	1,098
Contractual obligations to purchase goods or services	66	173	147	16	—	—
	113	291	467	308	576	1,098
2008						
Operating leases	41	118	299	287	599	1,209
Contractual obligations to purchase goods or services	65	170	162	22	—	—
	106	288	461	309	599	1,209

Undrawn formal facilities, credit lines and other commitments to lend were £248,529 million (2008 – £294,349 million) for the Group and £158,752 million (2008 – £187,041 million) for the Bank. While the Bank and its subsidiaries have given commitments to provide these funds, some facilities may be subject to certain conditions being met by the counterparty. Not all facilities are expected to be drawn, and some may lapse before drawdown.

The tables above show the timing of cash inflows and outflows to settle financial assets and liabilities. They have been prepared on the following basis:

Financial assets have been reflected in the time band of the latest date on which they could be repaid unless earlier repayment can be demanded by the reporting entity; financial liabilities are included at the earliest date on which the counterparty can require repayment regardless of whether or not such early repayment results in a penalty. If the repayment of a financial asset or liability is triggered by, or is subject to, specific criteria such as market price hurdles being reached, the asset is included in the latest date on which it can repay regardless of early repayment whereas the liability is included at the earliest possible date that the conditions could be fulfilled without considering the probability of the conditions being met.

For example, if a structured note is automatically prepaid when an equity index exceeds a certain level, the cash outflow will be included in the less than three months period whatever the level of the index at the year end. The settlement date of debt securities in issue issued by certain securitisation vehicles consolidated by the Group depends on when cash flows are received from the securitised assets. Where these assets are prepayable, the timing of the cash outflow relating to securities assumes that each asset will be prepaid at the earliest possible date. As the repayment of assets and liabilities are linked, the repayment of assets in securitisations are shown on the earliest date that the asset can be prepaid as this is the basis used for liabilities.

Assets and liabilities with a contractual maturity of greater than 20 years – the principal amounts of financial assets and liabilities that are repayable after 20 years or where the counterparty has no right to repayment of the principal are excluded from the table as are interest payments after 20 years.

Held-for-trading assets and liabilities – held-for-trading assets and liabilities amounting to £638.3 billion (assets) and £576 billion (liabilities) (2008 – £1,148.7 billion assets, £1,091.7 billion liabilities) have been excluded from the table in view of their short term nature.

This contractual analysis highlights the maturity transformation of the balance sheet that is fundamental to the structure of banking. In practice, this is not a reflection of the actual behaviour of assets or liabilities. In particular the customer funding of the balance sheet exhibits much greater stability and maturity than the tables indicate. This is because the funding franchise of the Group is diversified across an extensive retail network.

Wholesale funding breakdown

The table below shows the composition of wholesale funding of the Group.

	Group							
	Less than 1 year		1 to 5 years		More than 5 years		Total	
	£m	%	£m	%	£m	%	£m	%
Deposits by banks (1)	75,443	13.9	3,782	5.2	1,331	2.3	80,556	11.9
Debt securities in issue:								
– Commercial paper	23,216	4.3	—	—	—	—	23,216	3.4
– Certificates of deposits	56,056	10.3	529	0.7	—	—	56,585	8.4
– Medium term notes and other bonds	15,847	2.9	51,666	70.9	9,225	16.0	76,738	11.4
– Securitisations	1,613	0.3	142	0.2	14,119	24.5	15,874	2.4
	96,732	17.8	52,337	71.8	23,344	40.5	172,413	25.6
Subordinated debt	1,366	0.3	4,228	5.8	29,123	50.6	34,717	5.1
Total wholesale funding	173,541	32.0	60,347	82.8	53,798	93.4	287,686	42.6
Customer deposits (1)	370,953	68.0	12,528	17.2	3,796	6.6	387,277	57.4
	544,494	100.0	72,875	100.0	57,594	100.0	674,963	100.0

Notes:

(1) Excludes repurchase agreements and stock lending.

Outlook for 2010*

Whilst there have been improvements in the state of the global economy over the course of 2009, the outlook for 2010 remains uncertain. In line with meeting the objectives of the Strategic Plan, the RBS Group is actively focusing on closing the customer funding gap, continuing to exit non-core businesses and focusing on reducing undrawn and contingent commitments. This will reduce the absolute need for wholesale funding. In addition, the RBS Group will continue to make progress in terming out its remaining wholesale funding. The RBS Group will continue to reduce reliance on government supported schemes and the state of the markets and economies that the RBS Group operates in. These strategies will ensure that the RBS Group will be more resilient to any further disruptions in the market and will be better placed to take advantage of favourable trading conditions as they return.

Regulatory environment*

The RBS Group operates in multiple jurisdictions across the globe and is subject to a number of regulatory regimes. The RBS Group's lead regulator is the UK FSA, with other authorities such as the US Federal Reserve Bank playing a key role. The liquidity framework applied by the FSA is the Sterling Stock regime. In line with the FSA policy statement PS09/16, the RBS Group will be subject to a new liquidity risk regulatory framework in the future. The RBS Group has been working towards this new framework and will meet the requirements as they come into force.

In the US the RBS Group is required to meet the liquidity requirements set out by all relevant regulatory authorities, including the Federal Reserve Bank, Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation (FDIC) and Financial Industry Regulatory Authority (FINRA).

Market risk

All the disclosures in this section (pages 63 to 68) are audited, unless indicated otherwise with an asterisk (*).

Market risk arises from changes in interest rates, foreign currency, credit spread, equity prices and risk related factors such as market volatilities. The RBS Group manages market risk centrally within its trading and non-trading portfolios through a comprehensive market risk management framework. This framework includes limits based on, but not limited to VaR, scenario analysis, position and sensitivity analyses.

Measurement

At the RBS Group level, the risk appetite is expressed in the form of a combination of VaR, sensitivity and scenario limits. VaR is a technique that produces estimates of the potential change in the market value of a portfolio over a specified time horizon at given confidence levels. For internal risk management purposes, the RBS Group's VaR assumes a time horizon of one trading day and in June 2009 the RBS Group changed its VaR confidence level from 95% to 99% as it considers this provides greater clarity in respect of more severe potential economic outcomes. The RBS Group's VAR model is based on a historical simulation model utilising data from the previous two years trading results.

The RBS Group continued to update and enhance its market risk management framework during 2009. In addition to the move to a VaR based on a 99% confidence level, the RBS Group has improved and strengthened its market risk limit framework increasing the transparency of market risk taken across the RBS Group's businesses in both the trading and non-trading portfolios.

The RBS Group's market risk appetite is defined within this limit framework which is cascaded down through legal entity, division, business and ultimately trader level market risk limits.

* unaudited

Market risk continued

Measurement continued

The VaR disclosure is broken down into trading and non-trading, where trading VaR relates to the main trading activities of the RBS Group and non-trading reflects the VaR associated with reclassified assets, money market business and the management of internal funds flow within the RBS Group's businesses.

As part of the strategic review, the designation of assets between Core and Non-Core divisions was completed during 2009. As the Non-Core division was not established until conclusion of the strategic review in the first quarter of 2009, constitution of the average, maximum and minimum VaR for Core and Non-Core has been prepared on a best efforts basis as these measures require daily data.

The RBS Group calculates VaR using historical simulation models but does not make any assumption about the nature or type of underlying loss distribution other than implied by history. The methodology uses the previous 500 trading days of market data and calculates both general market risk (the risk due to movement in general market benchmarks) and idiosyncratic market risk (the risk due to movements in the value of securities by reference to specific issuers). The Group 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 prediction of the future based on events that occurred in the time series horizon. Therefore, events that are more severe than those in the historical data series cannot be predicted;

- VaR that uses a 99% confidence level does not reflect the extent of potential losses beyond that percentile;

- VaR that uses 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; and

- 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 intra-day profit and losses will be incurred.

A 'Risks not in VaR' framework has been developed to address those market risks not adequately captured by the market standard VaR methodology. Where risks are not included in the model, various non-VaR controls (for example, position monitoring, sensitivity limits, triggers or stress limits) are in place.

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

Traded portfolios

The primary focus of the RBS Group's trading activities is client facilitation. The RBS Group also undertakes activities within the Core division of the wholesale bank, built around clients in chosen markets, including:

- Market making – quoting firm bid (buy) and offer (sell) prices with the intention of profiting from the spread between the quotes.

- Arbitrage – entering into offsetting positions in different, but closely related markets in order to profit from market imperfections.

- Proprietary activity – taking positions in financial instruments as principal in order to take advantage of anticipated market conditions.

Financial instruments held in the RBS Group's trading portfolios include, but are not limited to: debt securities, loans, deposits, equities, securities sale and repurchase agreements and derivative financial instruments (futures, forwards, swaps and options).

The RBS Group participates in exchange traded and over-the-counter (OTC) derivatives markets. The RBS Group buys and sells financial instruments that are traded or cleared on an exchange, including interest rate swaps, futures and options. Holders of exchange traded instruments provide margin daily with cash or other security at the exchange, to which the holders look for ultimate settlement.

The RBS Group also buys and sells financial instruments that are traded OTC, rather than on a recognised exchange. These instruments range from commoditised transactions in derivative markets, to trades where the specific terms are tailored to the requirements of the RBS Group's customers. In many cases, industry standard documentation is used, most commonly in the form of a master agreement, with individual transaction confirmations.

Assets and liabilities in the trading book are measured at their fair value. 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 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 are reviewed and approved by the market risk function. Group Risk provides an independent evaluation of the model for transactions deemed by the Group Model Product Review Committee (GMPRC) to be large, complex and/or innovative. Any profits or losses on the revaluation of positions are recognised in the daily profit and loss.

The VaR for the trading portfolios segregated by type of market risk exposure, including idiosyncratic risk, is presented in the table below.

	Group							
	2009 (99%ile)				2008 (99%ile)			
Trading	Average £m	Period end £m	Maximum £m	Minimum £m	Average £m	Period end £m	Maximum £m	Minimum £m
Interest rate	57.4	50.3	108.2	29.0	35.7	48.1	93.0	15.4
Credit spread	156.2	176.3	249.2	76.7	70.5	73.4	108.7	46.5
Currency	17.2	19.9	33.6	9.8	6.4	13.4	16.3	3.4
Equity	9.5	6.5	18.0	3.7	6.3	5.5	23.0	2.5
Commodity	14.3	8.9	31.9	6.3	9.3	9.0	24.7	—
Diversification		(81.5)				(61.8)		
	164.3	180.4	238.3	73.9	78.6	87.6	125.3	44.9

	Group							
Trading	2007 (scaled to 99%ile)				2007 (95%ile)			
Interest rate	16.5	13.6	24.9	10.7	11.7	9.6	17.6	7.6
Credit spread	25.0	53.6	62.2	17.8	17.7	37.9	44.0	12.6
Currency	3.7	3.7	9.8	1.6	2.6	2.6	6.9	1.1
Equity	3.4	2.7	9.6	2.0	2.4	1.9	6.8	1.4
Commodity	0.3	0.1	2.3	—	0.2	0.1	1.6	—
Diversification		(17.6)				(12.4)		
	28.7	56.1	64.4	18.7	20.3	39.7	45.5	13.2

The average total VaR utilisation increased in 2009 compared with 2008 largely as a result of increased market volatility experienced since the credit crisis began in August 2007 being more fully incorporated into the two year time series used by the VaR model. This increase was off-set by a reduction in trading book exposure throughout the period, due to a reduction in the size of the inventory held on the balance sheet as a result of sales, reclassification of assets to the non-trading book and write-downs.

The 2009 and 2008 data in the table above excludes exposures to super-senior tranches of asset backed CDOs, as VaR no longer produces an appropriate measure of risk for these exposures due to the illiquidity and opaqueness of the pricing of these instruments over an extended period.

The credit spread VaR increased significantly during May 2009 due to the purchasing of additional protection against the risk of counterparty failure on CDPCs exposures. As this counterparty risk is itself not in VaR these hedges have the effect of increasing the reported VaR.

The credit spread VaR decreased significantly at the end of August 2009 due to the positions relating to CDPCs being capitalised under the Pillar II approach and hence excluded from the VaR measure from that date.

The Counterparty Exposure Management (CEM) manages the OTC derivative counterparty credit risk in GBM, by actively controlling risk concentrations and reducing unwanted risk exposures. The hedging transactions CEM enters into are recorded 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.

The non-trading VaR segregated by type of market risk exposure, including idiosyncratic risk is presented below.

	Group							
	2009 (99%ile)				2008 (99%ile)			
Non-trading	Average £m	Period end £m	Maximum £m	Minimum £m	Average £m	Period end £m	Maximum £m	Minimum £m
Interest rate	15.3	14.6	24.3	9.6	9.7	21.7	29.5	4.7
Credit spread	210.6	213.3	270.8	66.3	10.2	65.9	65.9	5.1
Currency	1.2	0.5	5.9	0.2	0.5	2.2	5.7	0.1
Equity	0.3	0.1	1.3	—	0.2	1.2	1.8	—
Commodity	—	—	—	—	—	—	—	—
Diversification		(23.3)				(18.9)		
	206.3	205.2	271.5	73.7	13.6	72.1	72.1	7.2

	Group							
Non-trading	2007 (Scaled to 99%ile)				2007 (95%ile)			
Interest rate	4.3	4.7	6.0	1.8	3.0	3.3	4.2	1.3
Credit spread	2.5	5.8	7.1	0.5	1.8	4.2	5.0	0.4
Currency	0.1	0.1	0.6	—	0.1	0.1	0.5	—
Equity	—	0.1	0.5	—	—	0.1	0.4	—
Diversification		(3.2)				(2.4)		
	5.1	7.5	8.2	1.9	3.6	5.3	5.8	1.3

Non-trading data above reflects the VaR associated with reclassified assets, money market business and the management of internal funds flow within the Group's assets.

The average total non-trading VaR utilisation was higher in 2009 at £206 million, compared with £14 million in 2008. This is primarily due to assets from the Group's now dissolved securitisation arbitrage conduit, which transferred from ABN AMRO to RBS, being included in the Group's VaR measure from January 2009 and the increased market volatility being incorporated into the two year time series as previously noted. If both of these factors are excluded, the non-trading VaR would decrease to reflect actions taken through the course of the year to dynamically reduce the underlying risk sensitivity.

Market risk continued

Backtesting, stress testing and sensitivity analysis

The RBS Group undertakes a programme of daily back-testing, which compares the actual profit or loss realised in trading activity to the VaR estimation. The results of the back-testing process are one of the methods by which the RBS Group monitors the ongoing suitability of its VaR model.

The RBS 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 exceptional, but plausible market events. Stress testing measures the impact of abnormal changes in market rates and prices on the fair value of the RBS Group's trading portfolios. The RBS Group calculates historical stress tests and hypothetical stress tests.

Historical stress tests calculate the loss that would be generated if the market movements that occurred during historical market events were repeated. Hypothetical stress tests calculate the loss that would be generated if a specific set of adverse market movements were to occur.

Stress testing is also undertaken at key trading strategy level, for those strategies where the associated market risks are not adequately captured by VaR. Stress test exposures are discussed with senior management and are reported to GRC, ERF and the Board. Breaches in the RBS Group's market risk stress testing limits are monitored and reported.

In addition to VaR and stress testing, the RBS 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.

Model validation governance

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 all subject to independent review and sign-off. Models are assessed by GMPRC as having either immaterial or material model risk (valuation uncertainty arising from choice of modelling assumptions), the assessment being made on the basis of expert judgement.

Those models assessed by the GMPRC as having material model risk are prioritised for independent quantitative review. Independent quantitative review aims to quantify model risk (i.e. the impact of missing risk factors in the front office model or the possibility that we may be mismarking these products relative to other market participants who may be using an alternative model) by comparing model outputs against alternative independently developed models. The results of independent quantitative review are used by market risk to inform risk limits and by finance to inform reserves. Governance over this process is provided by GMPRC, a forum which brings together front office quantitative analysts, market risk, finance and QuaRC (Quantitative Research Centre, Group Risk's independent quantitative model review function). Risk (market risk, incremental default risk, counterparty credit risk) models are developed both within business units and by Group functions. Risk models are also subject to independent review and sign-off. Meetings are held with the FSA every quarter to discuss the traded market risk, including changes in models, management, back-testing results, other risks not included in the VaR framework and other model performance statistics.

Risk control

All divisions that are exposed to market risk in the course of their business are required to comply with the RBS Group's Market Risk Policy Standards (MRPS). The main risk management tools are delegated authorities, hard limits and discussion triggers, independent model valuation, a robust and efficient risk system and timely and accurate management information.

Limits form part of the dealing authorities and constitute one of the cornerstones of the market risk management framework. Upon notification of a limit breach, the appropriate body must take one of the following actions:

- Instructions can be given to reduce positions so as to bring the RBS Group within the agreed limits;
- A temporary increase in the limit can be granted to pursue an agreed short-term strategy; and
- A permanent increase in the limit can be granted if consistent with strategy and supported by the business and Risk Management.

Non-traded portfolios

Risks in non-traded portfolios mainly arise in retail and commercial banking assets and liabilities and financial investments designated as available-for-sale and held-to-maturity.

Group Treasury is responsible for setting and monitoring the adequacy and effectiveness of management, using a framework that identifies, measures, monitors and controls the underlying risk. GALCO approves the RBS Group's non-traded market risk appetite, expressed as statistical and non-statistical risk limits, which are delegated to the businesses responsible.

Various banking regulators review non-trading market risk as part of their regulatory oversight. As home regulator, the FSA has responsibility for reviewing non-trading market risk at a RBS Group consolidated level.

The RBS Group is exposed to the following non-traded risks:

Interest Rate Risk in the Banking Book (IRRBB) represents exposures to instruments whose values vary with the level or volatility of interest rates. These instruments include, but are not limited to, loans, debt securities, equity shares, deposits, certificates of deposits, loan capital and derivatives. Hedging instruments used to mitigate these risks include related derivatives such as options, futures, forwards and swaps. Interest rate risk arises from the RBS Group's non-trading activities in four principal forms:

- Re-pricing risk – arises from differences in the re-pricing terms of the RBS Group's assets and liabilities.
- Optionality – arises where a customer has an option to exit a deal early.
- Basis risk – arises, for example, where liabilities, the interest on which is linked to LIBOR, is used to fund assets bearing interest linked to the base rate; and.
- Yield curve risk – arises as a result of non-parallel changes in the yield curve.

It is the RBS Group's policy to minimise the sensitivity to changes in interest rates in its retail and commercial businesses and, where interest rate risk is retained, to ensure that appropriate resources, measures and limits are applied.

Non-trading interest rate risk is calculated in each business on the basis of establishing the re-pricing behaviour of each asset, liability and off-balance sheet product. For many retail and commercial products, the actual interest rate re-pricing characteristics differ from the contractual re-pricing. In most cases, the re-pricing maturity is determined by the market interest rate that most closely fits the historical behaviour of the product interest rate. For non-interest bearing current accounts, the re-pricing maturity is determined by the stability of the portfolio. The re-pricing maturities used are approved by Group Treasury and divisional asset and liability committees at least annually. Key conventions are reviewed annually by GALCO.

Non-trading interest rate exposures are controlled by limiting re-pricing mismatches in the individual business balance sheets. Potential exposures to interest rate movements in the medium to long-term are measured and controlled using a version of the same VaR methodology that is used for the RBS Group's trading portfolios. Net accrual income exposures are measured and controlled in terms of sensitivity over time to movements in interest rates.

Risk is managed within VaR limits approved by GALCO, through the execution of cash and derivative instruments. Execution of the hedging is carried out by the relevant division through the RBS Group's treasury functions. The residual risk position is reported to divisional asset and liability committees, GALCO and the Board.

Foreign Exchange Risk in the Banking Book (FXRBB) represents exposures to changes in the values of current holdings and future cash flows denominated in other currencies. Hedging instruments used to mitigate these risks include foreign currency options, currency swaps, futures, forwards and deposits. Foreign exchange risk results from the RBS Group's investments in overseas subsidiaries, associates and branches in three principal forms:

- Structural foreign currency exposures that arise from net investment in overseas subsidiaries, associates and branches;
- Transactional/commercial foreign currency exposures that arise from mismatches in the currency balance sheet; and
- Foreign currency profit streams.

Equity Risk in the Banking Book (ERBB) is defined as the potential variation in the RBS Group's non-trading income and reserves arising from changes in equity prices/income. This risk may crystallise during the course of normal business activities or in stressed market conditions. Equity positions in the RBS Group's banking book are retained to achieve strategic objectives, support venture capital transactions or in respect of customer restructuring arrangements

The commercial decision to invest in equity holdings, including customer restructurings, is taken by authorised persons with delegated authority under the RBS Group credit approval framework. Investments or disposal of a strategic nature are referred to the Group Acquisitions and Disposal Committee (ADCo), Group Executive Committee (ExCo) and where appropriate the Board for approval; those involving the purchase or sale by the RBS Group of subsidiary companies also require Board approval, after consideration by ExCo and ADCo.

Structural interest rate risk

Non-trading interest rate VaR for the RBS Group's retail and commercial banking activities at a 99% confidence level was £166.8 million at 31 December 2009 (2008 – £218.5 million). During 2009, the maximum VaR was £237.1 million (2008 – £268.1 million), the minimum was £133.9 million (2008 – £122.9 million) and the average was £175.8 million (2008 – £185.7 million).

Citizens Economic Value of Equity (EVE)*

Generally, Citizens is the main contributor to overall non-trading interest rate VaR. Citizens aims, through its management of market risk in non-trading portfolios, to mitigate the effect of prospective interest movements which could reduce future net interest income, whilst balancing the cost of such hedging activities on the current net revenue stream. To do so it uses a variety of income simulation and valuation risk measures that more effectively capture the risk to earnings due to mortgage prepayment and competitive deposit pricing behaviour than a VaR-based methodology. IRRBB is managed within approved limits on interest rate risk, liquidity and capitalisation, with a goal of optimising yield.

In addition to net interest income sensitivity Citizens also measures the sensitivity of the value of the net interest margin to changes in interest rates on a monthly basis. This measure is called EVE sensitivity. The table below details this sensitivity at the end of 2009 and the maximum and minimum month-end figures.

	Percent increase/ decrease in CFG EVE (1)	
	2% parallel upward movement in US interest rates	2% parallel downward movement in US interest rates
Period end	(4.3)	(23.4)
Maximum	(4.3)	(23.4)
Minimum	4.6	(18.4)
Average	(0.8)	(22.2)

Notes:

(1) Economic value of equity is the net present value of assets and liabilities calculated by discounting expected cash flows of each instrument over its expected life. Risk to EVE is quantified by calculating the impact of interest rate changes on the net present value of equity and is expressed as a percentage of CFG regulatory capital.

(2) No negative rates allowed.

* unaudited

Market risk continued

Currency risk

The Group does not maintain material non-trading 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 RBS Group's policy in relation to structural positions is to match fund the structural foreign currency exposure arising from net asset value, including goodwill in foreign subsidiaries, equity accounted investments and branches, except where doing so would materially increase the sensitivity of either the RBS Group's or the subsidiary's regulatory capital ratios to currency movements. The policy requires structural foreign exchange positions to be reviewed regularly by the Group Asset and Liability Committee. Foreign exchange differences arising on the translation of foreign operations are recognised directly in equity, together with the effective portion of foreign exchange differences arising on hedging instruments.

Equity classification of foreign currency denominated preference share issuances mean that these shares are held on the balance sheet at historic cost. Consequently, these share issuances have the effect of increasing the Group's structural foreign currency position.

The table below sets out the Group's structural foreign currency exposures.

	2009			2008			2007		
	Net investments in foreign operations £m	Net investment hedges £m	Structural foreign currency exposures £m	Net investments in foreign operations £m	Net investment hedges £m	Structural foreign currency exposures £m	Net investments in foreign operations £m	Net investment hedges £m	Structural foreign currency exposures £m
US dollar	14,904	(3,208)	11,696	16,710	(4,302)	12,408	13,919	(2,437)	11,482
Euro	5,340	(259)	5,081	4,571	(617)	3,954	3,483	—	3,483
Swiss franc	937	(908)	29	912	(912)	—	563	(561)	2
Other non-sterling	870	(853)	17	877	(844)	33	185	(153)	32
	22,051	(5,228)	16,823	23,070	(6,675)	16,395	18,150	(3,151)	14,999

Key points

- Retranslation gains and losses on the Group's consolidated net investments in operations together with those on instruments hedging these investments are recognised directly in equity.

- Changes in foreign currency exchange rates will affect equity in proportion to the structural foreign currency exposure. A 5% strengthening in foreign currencies against sterling would result in a gain of £840 million (2008 – £820 million) recognised in equity, while a 5% weakening in foreign currencies would result in a loss of £800 million (2008 – £780 million) recognised in equity.

- These movements in equity would off-set retranslation effects on the Group's foreign currency denominated RWAs, reducing the sensitivity of the Group's Tier 1 capital ratio to movements in foreign currency exchange rates.

Equity risk

Equity positions are measured at fair value. Fair value calculations are based on available market prices wherever possible. In the event that market prices are not available, fair value is based on appropriate valuation techniques or management estimates.

The types, nature and amounts of exchange-traded exposures, private equity exposures, and other exposures vary significantly. Such 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 and Federal Home Loan Stock.

Asset Protection Scheme*

All the disclosures in this section (pages 69 to 72) are unaudited and indicated with an asterisk (*). References to 'RBS Group' in this section relate to 'RBS Group before RFS Holdings minority interest'.

Key aspects of the Scheme

On 22 December 2009, the RBS Group acceded to the Asset Protection Scheme ('APS' or 'the Scheme') with HM Treasury (HMT) acting on behalf of the UK Government. Under the Scheme, the RBS Group purchased credit protection over a portfolio of specified assets and exposures ("covered assets") from HMT. The portfolio of covered assets had a par value of approximately £282 billion as at 31 December 2008, of which £48.8 billion of assets held by ABN ARMO, a fellow subsidiary, and are not included on the Group's balance sheet. The protection is subject to a first loss of £60 billion and covers 90% of subsequent losses. Once through the first loss, when a covered asset has experienced a trigger event (1) losses and recoveries in respect of that asset are included in the balance receivable under the APS. Receipts from HMT will, over time, amount to 90% of cumulative losses (net of cumulative recoveries) on the portfolio of covered assets less the first loss amount.

The RBS Group has the right to terminate the Scheme at any time provided that the Financial Services Authority has confirmed in writing to HMT that it has no objection to the proposed termination. On termination, the RBS Group is liable to pay HMT a termination fee. The termination fee would be the difference between £2.5 billion (or, if higher, a sum related to the economic benefit of regulatory capital relief obtained as a result of having entered the APS) and the aggregate fees paid. In addition, the RBS Group would have to repay any amounts received from HMT under the terms of the APS (or as otherwise agreed with HMT). In consideration for the protection provided by the APS, the RBS Group paid an initial premium of £1.4 billion on 31 December 2009 for the years 2009 and 2010. A further premium of £700 million is payable on 1 January 2011 and subsequently annual premiums of £500 million until the earlier of 31 December 2099 or the termination of the agreement.

The APS is a single contract providing credit protection in respect of a portfolio of financial assets: the unit of account is the contract as a whole. Under IFRS, credit protection is either treated as a financial guarantee contract ('FGC') or a derivative depending on the terms of the agreement and the nature of the protected assets and exposures. The portfolio contains more than an insignificant element of derivatives and limited recourse assets, and hence the contract does not meet the definition of an FGC. The APS contract is therefore treated as a derivative and is recognised at fair value, with changes in fair value recognised in profit or loss. The APS derivative did not have any effect on the RBS Group's 2009 income statement; however in future period's changes in value of the APS derivative will have an effect on the RBS Group's profit or loss.

There is no change in the recognition and measurement of those covered assets recognised on the RBS Group's balance sheet as a result of the APS. Impairment provisions on covered assets measured at amortised cost are assessed and charged in accordance with the RBS Group's accounting policy; held-for-trading assets, assets designated at fair value and available-for-sale assets within the APS portfolio continue to be measured at fair value with no adjustments to reflect the protection provided by the APS. There is no change in how gains and losses on the covered assets are recognised in the income statement or in other comprehensive income.

The Bank has also entered into two agreements with ABN AMRO under which it has sold credit protection over the exposures held by ABN AMRO and its subsidiaries that are subject to the APS. These agreements cover 100% of losses on these assets. One agreement provides protection over a portfolio that includes significant exposure in the form of derivatives; the other covers assets that are measured at amortised cost. The former agreement is accounted for as a credit derivative. The second agreement meets the definition of a financial guarantee contract and is accounted for as such.

Trigger events (subject to specific rules detailed in the terms of the APS) comprise:

- failure to pay: the counterparty to the covered asset has (subject to specified grace periods) failed to pay an amount due under the terms of its agreement with the Group.

- bankruptcy: the counterparty is subject to a specified insolvency or bankruptcy-related event.

- restructuring: a covered asset which is individually impaired and is subject to a restructuring.

The selection of assets was carried out primarily between February and April 2009 and was driven by three principal criteria:

(1) Risk and degree of impairment in base case and stressed scenarios;

(2) Liquidity of exposure; and

(3) Capital intensity under procyclicality.

* unaudited

Asset Protection Scheme* continued

The approach for high volume commercial and retail exposures was on a portfolio basis. Selection for large corporates and GBM was at the counterparty/asset level. Set out below are the selection criteria for the contributing divisions.

Global Banking Markets (GBM) (1)	Banking book: selection by individual asset pool (corporate loans, real estate finance, and leveraged finance), Global Restructuring Group work-out unit counterparties/assets and high risk counterparties/assets. Additional counterparties/assets were selected through an individual risk review of the total portfolio. Trading book: selection by individual assets (monolines, derivatives, mortgage trading).
UK Corporate (1)	Commercial & corporate real estate: all defaulted assets in the work-out/restructuring unit or in high risk bands. Corporate: all defaulted assets in the work-out/restructuring unit. Corporate banking clients in high risk sectors or with high concentration risk. Business Banking: portfolios in the work out/restructuring unit or in high risk bands.
UK Retail (1)	Mortgages: assets with a higher loan-to-value (LTV) and in higher risk segments (LTV >97% on general book, LTV >85% on buy-to-let book), and those assets in arrears (at 31 December 2008). Loans and overdrafts: higher risk customers based on internal bandings, and those assets in arrears (at 31 December 2008).
Ulster Bank (1) **(Corporate & Retail)**	Mortgages: assets with greater than 85% LTV, broker mortgages and interest only with a higher probability of default. Retail: portfolios of accounts in default, >1 month arrears, <2 years old and a higher probability of default. Corporate: counterparties/assets in work-out/restructuring groups or in high risk bands, and other assets identified as part of an individual review of cases.

Note:
(1) Including assets transferred to Non-Core division.

Covered assets

Roll forward to 31 December 2009

The table below details the movement in covered assets in the year.

	£bn
Covered assets at 31 December 2008 – at accession to the Scheme	282.0
Disposals	(3.0)
Non-contractual early repayments	(8.9)
Amortisations	(9.4)
Maturities	(16.7)
Rollovers and covered amount cap adjustments	(1.7)
Effect of foreign currency movements	(11.8)
Covered assets at 31 December 2009 (1)	230.5

	Group £bn	ABN AMRO £bn	RBS Group £bn
Covered assets at:			
31 December 2009	203.3	27.2	230.5
31 December 2008	233.2	48.8	282.0

ABN AMRO covered assets declined by £21.6 billion due to novations of £6.3 billion, effect of foreign currency movements of £37 billion and other movements (maturities, disposals and amortisation) of £11.6 billion.

Note:
(1) The covered amount at 31 December 2009 above includes approximately £2.1 billion of assets in the derivatives and structured finance asset classes which, for technical reasons, do not currently satisfy, or are anticipated at some stage not to satisfy, the eligibility requirements of the Scheme. HMT and the Group continue to negotiate in good faith whether (and, if so, to what extent) coverage should extend to these assets. Also, the Group and HMT are in discussion over the HMT classifications of some structured credit assets and this may result in adjustments to amounts for some asset classes; however underlying risks will be unchanged.

* unaudited

Key points
- The majority of the reduction (68%) in the covered assets reflects repayments by customers.
- Additionally the RBS Group took advantage of market conditions and executed a number of loan sales.

Credit impairments and write downs
The table below analyses the cumulative credit impairment losses and adjustments to par value (including AFS reserves) relating to covered assets:

	2009			2008		
	Group £m	ABN AMRO £m	RBS Group £m	Group £m	ABN AMRO £m	RBS Group £m
Loans and advances	11,857	2,383	14,240	6,192	1,513	7,705
Debt securities	7,512	304	7,816	5,562	2,380	7,942
Derivatives	4,908	1,926	6,834	3,972	2,603	6,575
	24,277	4,613	28,890	15,726	6,496	22,222
By division:						
UK Retail	2,431	—	2,431	1,492	—	1,492
UK Corporate	1,007	—	1,007	285	—	285
Global Banking & Markets	1,292	336	1,628	1,549	91	1,640
Ulster Bank	486	—	486	234	—	234
Non-Core	19,061	4,277	23,338	12,166	6,405	18,571
	24,277	4,613	28,890	15,726	6,496	22,222

Note:

(1) Total available-for-sale reserves on debt securities of £1,113 million at 31 December 2009 (£1,315 million as at 31 December 2008 was previously included in undrawn commitments and other adjustments).

Key point
- Of the increase in cumulative losses of £6,668 million, the largest was loan impairments in Non-Core.

First loss utilisation
The triggered amount is equivalent to the aggregate outstanding principal amount on the trigger date excluding interest, fees, premium or any other non-principal sum that is accrued or payable, except where it was capitalised on or before 31 December 2008. At the trigger date, in economic terms, there is an exchange of assets, with the RBS Group receiving a two year interest bearing government receivable in exchange for the asset.

APS recoveries include any return of value on a triggered asset, although these are only recognised for Scheme reporting purposes when they are realised in cash. The net triggered amount at any point in time, only takes into account cash recoveries to date. The capturing of triggered amounts has required extensive new processes and controls to be put in place. These continue to be work in progress. Additionally, as with any bespoke and highly complex legal agreement there are various areas of interpretation which still need to be clarified and agreed between the RBS Group and the Asset Protection Agency ('APA'), some of which could have a material impact on the triggered amount identified to date. Also as part of the APS terms and conditions it was agreed to re-characterise certain assets and their closely related hedges under the scheme and the RBS Group continues to negotiate with APA in good faith to finalise this.

The Scheme rules are designed to allow for data correction over the life of the Scheme, and the RBS Group has a grace period during 2010 to implement processes to capture triggers and restate quarterly claims statements to HMT retrospectively.

Asset Protection Scheme* continued

The table below summarises the total triggered amount and related cash recoveries by division at 31 December 2009.

	Triggered amount £m	Cash recoveries to date £m	Net triggered amount £m
UK Retail	3,340	129	3,211
UK Corporate	3,570	604	2,966
Global Banking & Markets	1,748	108	1,640
Ulster Bank	704	47	657
Non-Core	18,905	777	18,128
	28,267	1,665	26,602

£3.4 billion of triggered amount and £0.3 billion of cash recoveries above relate to ABN AMRO.

Note:

(1) The triggered amount on a covered asset is calculated when an asset is triggered (due to bankruptcy, failure to pay after a grace period, and restructuring with an impairment) and is the lower of the covered amount and the outstanding amount for each covered asset. Given the grace period for triggering assets, the Group expects additional assets to trigger based on the current risk rating and level of impairments on covered assets.

Key points

- APS recoveries include almost any return of value on a triggered asset but are only recognised when they are realised in cash, hence there will be a time lag for the realisation of recoveries.
- The RBS Group expects recoveries on triggered amounts to be approximately 45% over the life of the relevant assets.
- On this basis, expected loss on triggered assets at 31 December 2009 is approximately £15 billion (Group – £13 billion, ABN AMRO – £2 billion) or 25% of the £60 billion first loss threshold under the APS.
- In case the net triggered amount exceeds a specified threshold level for each covered asset class, HMT retains step-in rights as defined in the Scheme rules.

Risk-weighted assets

Risk-weighted assets were as follows:

	2009 £bn	2008 £bn
APS	127.6	158.7
Non-APS	438.2	419.1
RBS Group before APS benefit	565.8	577.8

APS RWAs above include £11.2 billion (2008 – £22.9 billion) relating to ABN AMRO.

Risk-weighted assets by division	2009 APS £bn	2009 Non-APS £bn	2009 Total £bn
UK Retail	16.3	35.0	51.3
UK Corporate	31.0	59.2	90.2
Global Banking & Markets	19.9	103.8	123.7
Ulster	8.9	21.0	29.9
Non-Core	51.5	119.8	171.3
Other divisions	n/a	99.4	99.4
RBS Group before APS benefit	127.6	438.2	565.8

Key point

- Over the year RWAs covered by the APS declined overall due to the restructuring of certain exposures, including monoline related assets, and decrease in the covered amount partly off-set by credit downgrade and procyclicality.

* unaudited

Market turmoil exposures

All the disclosures in this section (pages 73 to 92) are audited unless otherwise indicated with an asterisk (*).

Explanatory note

These disclosures provide information on certain elements of the Group's business activities affected by the unprecedented market events of the second half of 2007 and through 2008 and 2009.

Definitions of acronyms used in this section are explained in the Glossary of terms on page 195.

Asset-backed securities

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 at 31 December 2009 was £185.2 billion (2008 – £177.8 billion; 2007 – £164.4 billion). This comprised:

	2009 £bn	2008 £bn	2007 £bn
Securities issued by central and local governments	101.3	65.7	64.8
Asset-backed securities	65.7	79.7	64.9
Securities issued by corporates, US federal agencies and other entities	9.0	14.4	19.4
Securities issued by banks and building societies	9.2	18.0	15.3
Total debt securities	185.2	177.8	164.4

This section focuses on asset-backed securities, an area of interest following the market dislocations in 2007 and 2008. Asset-backed securities (ABS) are securities with 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.

The Group has exposures to ABS which are predominantly debt securities but can also be held in derivative form. These positions had been acquired primarily through the Group's activities in the US leveraged finance market which expanded during 2007. These include residential mortgage backed securities (RMBS), commercial mortgage backed securities (CMBS), ABS collateralised debt obligations (CDOs) and collateralised loan obligations (CLOs) and other ABS. In many cases the risk on these assets is hedged by way of credit derivative protection purchased over the specific asset or relevant ABS indices. The counterparty to some of these hedge transactions are monoline insurers.

The following table summarises the gross and net exposures and carrying values of these securities by geography – US, UK, other Europe and rest of the world (RoW) and by the measurement classification – held-for-trading (HFT), available-for-sale (AFS), loans and receivables (LAR) and designated at fair value through profit or loss (DFV) – of the underlying assets at 31 December 2009.

Market turmoil exposures continued

Asset-backed securities continued

Asset-backed securities by geography and measurement classification

2009	US £m	UK £m	Other Europe (4) £m	RoW £m	Total £m	HFT £m	AFS £m	LAR £m	DFV £m
Gross exposure: (1)									
RMBS: G10 governments (2)	26,645	17	—	—	26,662	13,443	13,219	—	—
RMBS: prime	2,958	4,496	1,737	219	9,410	3,296	5,355	758	1
RMBS: non-conforming	1,341	2,137	128	—	3,606	635	1,497	1,474	—
RMBS: sub-prime	1,668	699	195	553	3,115	1,632	1,012	471	—
CMBS	3,422	1,741	1,345	590	7,098	3,450	1,844	1,604	200
CDOs	12,378	198	358	27	12,961	9,073	3,715	172	1
CLOs	9,092	166	2,160	1,172	12,590	5,346	6,586	658	—
Other ABS	3,587	1,794	2,421	1,544	9,346	2,531	2,918	3,897	—
Total	61,091	11,248	8,344	4,105	84,788	39,406	36,146	9,034	202
Carrying value:									
RMBS: G10 governments (2)	26,985	15	—	—	27,000	13,363	13,637	—	—
RMBS: prime	2,689	3,847	1,459	209	8,204	2,449	5,259	495	1
RMBS: non-conforming	958	1,957	128	—	3,043	389	1,180	1,474	—
RMBS: sub-prime	977	289	146	379	1,791	779	696	316	—
CMBS	3,237	1,264	849	203	5,553	2,438	1,639	1,271	205
CDOs	3,275	114	220	27	3,636	2,063	1,423	149	1
CLOs	6,736	112	1,460	999	9,307	3,298	5,505	504	—
Other ABS	2,886	947	2,127	1,161	7,121	1,467	2,301	3,353	—
Total	47,743	8,545	6,389	2,978	65,655	26,246	31,640	7,562	207
Net exposure: (3)									
RMBS: G10 governments (2)	26,985	15	—	—	27,000	13,363	13,637	—	—
RMBS: prime	2,428	3,013	468	168	6,077	484	5,097	495	1
RMBS: non-conforming	948	1,957	128	—	3,033	379	1,180	1,474	—
RMBS: sub-prime	565	280	137	282	1,264	530	419	315	—
CMBS	2,245	1,187	520	44	3,996	976	1,556	1,270	194
CDOs	743	72	203	26	1,044	521	373	149	1
CLOs	1,636	86	1,094	39	2,855	673	1,678	504	—
Other ABS	2,117	661	2,089	1,119	5,986	466	2,300	3,220	—
Total	37,667	7,271	4,639	1,678	51,255	17,392	26,240	7,427	196

Notes:

(1) Gross exposures represent the principal amounts relating to asset-backed securities.

(2) RMBS: G10 government securities 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 (GSEs);

(b) Guaranteed by the Dutch government; and

(c) Covered bonds, referencing primarily Dutch and Spanish government-backed loans.

(3) Net exposures represent the carrying value after taking account of hedge protection purchased from monoline insurers and other counterparties but exclude the effect of counterparty credit valuation adjustments. The hedges provide credit protection of principal and interest cashflows in the event of default by the counterparty. The value of this protection is based on the underlying instrument being protected.

The table below summarises ABS carrying values and net exposures by geography and measurement classification at 31 December 2008 and 2007.

2008	US £m	UK £m	Other Europe (3) £m	RoW £m	Total £m	HFT £m	AFS £m	LAR £m	DFV £m
Carrying value:									
RMBS: G10 governments (1)	33,458	26	—	—	33,484	18,586	14,898	—	—
RMBS: prime	5,623	4,084	2,725	241	12,673	3,788	8,400	484	1
RMBS: non-conforming	1,112	2,906	—	—	4,018	352	2,184	1,482	—
RMBS: sub-prime	1,822	419	155	363	2,759	1,578	899	282	—
CMBS	1,958	1,371	1,084	107	4,520	2,431	938	1,151	—
CDOs	4,792	128	127	45	5,092	4,183	560	349	—
CLOs	6,094	292	2,463	256	9,105	3,348	4,965	792	—
Other ABS	3,581	1,470	1,625	1,412	8,088	1,505	3,208	3,375	—
Total	58,440	10,696	8,179	2,424	79,739	35,771	36,052	7,915	1
Net exposure: (2)									
RMBS: G10 governments (1)	33,458	26	—	—	33,484	18,586	14,898	—	—
RMBS: prime	5,548	2,998	1,784	210	10,540	1,656	8,399	484	1
RMBS: non-conforming	1,106	2,906	—	—	4,012	346	2,184	1,482	—
RMBS: sub-prime	358	390	136	300	1,184	344	558	282	—
CMBS	1,127	1,200	604	45	2,976	908	917	1,151	—
CDOs	1,761	126	—	—	1,887	978	560	349	—
CLOs	874	227	1,997	171	3,269	812	1,665	792	—
Other ABS	3,507	1,217	825	1,229	6,778	195	3,208	3,375	—
Total	47,739	9,090	5,346	1,955	64,130	23,825	32,389	7,915	1

Notes:

(1) RMBS: G10 government securities comprises securities that are:

(a) Guaranteed or effectively guaranteed by the US government, by way of its support for US federal agencies and GSEs;

(b) Guaranteed by the Dutch government; and

(c) Covered bonds, referencing primarily Dutch and Spanish government-backed loans.

(2) Net exposures represent the carrying value after taking account of hedge protection purchased from monoline insurers and other counterparties but exclude the effect of counterparty credit valuation adjustments. The hedges provide credit protection of principal and interest cashflows in the event of default by the counterparty. The value of this protection is based on the underlying instrument being protected.

Market turmoil exposures continued

Asset-backed securities continued

2007	US £m	UK £m	Other Europe (3) £m	RoW £m	Total £m	HFT £m	AFS £m	LAR £m	DFV £m
Carrying value:									
RMBS: G10 governments (1)	26,005	155	—	—	26,160	15,627	10,533	—	—
RMBS: prime	2,643	2,514	6,059	142	11,358	10,037	1,321	—	—
RMBS: non-conforming	2,800	724	—	—	3,524	2,884	640	—	—
RMBS: sub-prime	3,986	9	3	255	4,253	4,246	7	—	—
CMBS	2,751	747	377	3	3,878	2,969	409	500	—
CDOs	3,254	53	1,100	123	4,530	4,516	—	—	14
CLOs	3,756	571	543	205	5,075	5,052	20	—	3
Other ABS	3,543	1,078	1,082	437	6,140	5,275	679	—	186
	48,738	5,851	9,164	1,165	64,918	50,606	13,609	500	203
Net exposure: (2)									
RMBS: G10 governments (1)	26,005	149	—	—	26,154	15,627	10,527	—	—
RMBS: prime	2,643	2,185	5,787	142	10,757	9,436	1,321	—	—
RMBS: non-conforming	2,800	724	—	—	3,524	2,884	640	—	—
RMBS: sub-prime	2,662	9	—	5	2,676	2,669	7	—	—
CMBS	2,723	737	316	3	3,779	2,870	409	500	—
CDOs	456	52	646	123	1,277	1,264	—	—	13
CLOs	2,354	571	398	158	3,481	3,458	20	—	3
Other ABS	1,482	997	1,014	368	3,861	2,996	679	—	186
	41,125	5,424	8,161	799	55,509	41,204	13,603	500	202

Notes:

(1) RMBS: G10 government securities comprises securities that are:

(a) Guaranteed or effectively guaranteed by the US government, by way of its support for US federal agencies and GSEs;

(b) Guaranteed by the Dutch government; and

(c) Covered bonds, referencing primarily Dutch and Spanish government-backed loans.

(2) Net exposures represent the carrying value after taking account of hedge protection purchased from monoline insurers and other counterparties but exclude the effect of counterparty credit valuation adjustments. The hedges provide credit protection of principal and interest cashflows in the event of default by the counterparty. The value of this protection is based on the underlying instrument being protected.

The table below summarises the ratings of ABS carrying values:

2009	AAA rated (1) £m	BBB- rated and above (1) £m	Non-investment grade £m	Not publicity rated £m	Total £m
	Ratings (1)				
RMBS: G10 governments	27,000	—	—	—	27,000
RMBS: prime	5,941	1,704	558	1	8,204
RMBS: non-conforming	1,980	467	594	2	3,043
RMBS: sub-prime	545	514	579	153	1,791
CMBS	3,367	1,883	152	151	5,553
CDOs	437	2,140	797	262	3,636
CLOs	2,718	5,223	636	730	9,307
Other ABS	2,111	4,136	152	722	7,121
	44,099	16,067	3,468	2,021	65,655
2008					
RMBS: G10 governments	33,475	—	—	9	33,484
RMBS: prime	11,174	1,391	106	2	12,673
RMBS: non-conforming	3,532	338	146	2	4,018
RMBS: sub-prime	1,132	878	749	—	2,759
CMBS	2,928	1,552	39	1	4,520
CDOs	2,367	1,243	1,243	239	5,092
CLOs	6,825	1,567	269	444	9,105
Other ABS	3,189	3,422	241	1,236	8,088
	64,622	10,391	2,793	1,933	79,739
2007					
RMBS: G10 governments	26,034	—	—	126	26,160
RMBS: prime	10,643	557	27	131	11,358
RMBS: non-conforming	2,733	526	146	119	3,524
RMBS: sub-prime	1,191	2,384	589	89	4,253
CMBS	2,820	1,010	35	13	3,878
CDOs	3,556	682	179	113	4,530
CLOs	3,630	670	69	706	5,075
Other ABS	3,324	1,179	104	1,533	6,140
	53,931	7,008	1,149	2,830	64,918

Note:
(1) Credit ratings are based on those from rating agency Standard & Poor's (S&P). Moody's and Fitch have been mapped onto the S&P scale.

Market turmoil exposures continued

Asset-backed securities continued

Key points

- Total asset-backed securities decreased from £79.7 billion at 31 December 2008 to £65.7 billion at 31 December 2009, due principally to exchange rate movements and the significant sell-down activity which took place in the first half of the year. In addition, credit spreads widened in the first half of the year, further reducing carrying values, although this was off-set to some extent by spreads tightening in the second half of the year. Sales have been limited in the second half of the year, however maturities have continued to reduce the balance sheet exposures.

- Life-to-date net valuation losses on ABS held at 31 December 2009, including impairment provisions, were £19.1 billion comprising:

  – RMBS: £2.8 billion, of which £0.7 billion was in US sub-prime and £1.6 billion in European assets;

  – CMBS: £1.5 billion;

  – CDOs: £9.3 billion and CLOs: £3.3 billion, significantly all in Non-Core; and

  – Other ABS: £2.2 billion.

- The majority of the Group's exposure to ABS is through US government-backed securities, comprising mainly current year vintage positions, of £27.0 billion (2008 – £33.5 billion). Due to the US government backing, explicit or implicit, for these securities, the counterparty credit risk exposure is low. The decrease in exposure over the year was due to foreign exchange movements driven by the strengthening of sterling against the US dollar in the first half of the year and a decrease in the balances in the second half of the year.

- CDOs decreased from £5.1 billion at 31 December 2008 to £3.6 billion at 31 December 2009, driven primarily by significant declines in prices, together with foreign exchange movements, in the first half of the year.

- Subprime balances decreased across ratings, geographies and vintages, due to pay-downs, maturities and sales during the year, while non-conforming exposures fell mainly due to UK AAA-rated AFS redemptions. During the third quarter, improved prices off-set the effect of redemptions in some portfolios.

- Many of the assets, primarily CDOs and CLOs, have market hedges in place which gives rise to a significant difference between the carrying value and the net exposure.

- AAA-rated assets decreased from £64.6 billion at 31 December 2008 to £44.1 billion at 31 December 2009 primarily as a result of the sell-down activity of prime and government-backed securities.

- There were significant downgrades of AAA-rated CLOs to BBB during the year.

The remainder of this section provides additional information and analysis of RMBS portfolios.

Residential mortgage-backed securities (RMBS)

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 of the underlying mortgage assets 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 guarantees over the value of the exposures, often provided by monoline insurers.

The main categories of mortgages that serve as collateral to RMBS held by the Group are described below. 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.

RMBS: G10 government securities comprise securities that are:

- Guaranteed or effectively guaranteed by the US government, by way of its support for US federal agencies and GSEs;
- Guaranteed by the Dutch government; and
- Covered bonds, referencing primarily Dutch and Spanish government-backed loans.

Guaranteed or effectively guaranteed mortgages are mortgages that form part of a mortgage backed security issuance by a government agency, or in the US an entity that benefits from a guarantee (direct or indirect) provided by the US government. For US RMBS, this category includes RMBS issued by Ginnie Mae, Freddie Mac and Fannie Mae. European RMBS includes mortgages guaranteed by the Dutch Government.

Covered mortgage bonds are debt instruments that have recourse to a pool of mortgage assets, where investors have a preferred claim if a default occurs. These underlying assets are segregated from the other assets held by the issuing entity.

Prime mortgages are those of a higher credit quality than non-conforming and sub-prime mortgages, and exclude guaranteed and covered bond mortgages.

Non-conforming mortgages (or 'Alt-A' used for US exposure) have a higher credit quality than sub-prime mortgages, but lower than prime borrowers. Within the US mortgage industry, non-conforming mortgages are those that do not meet the lending criteria for US agency mortgages (described below). For non-US mortgages, judgement is applied in identifying loans with similar characteristics to US non-conforming loans and also includes self-certified loans. Alt-A describes a category of mortgages in which lenders consider the risk to be greater than prime mortgages though less than sub-prime. The offered interest rate is usually representative of the associated risk level.

Sub-prime mortgages are loans to sub-prime borrowers typically having weakened credit histories that include payment delinquencies and potentially more severe problems such as court judgements and bankruptcies. They may also display reduced repayment capacity as measured by credit scores, high debt-to-income ratios, or other criteria indicating heightened risk of default.

The table below analyses the vintage of the Group's holdings of RMBS portfolios (carrying value) by geography.

2009	US £m	UK £m	Other Europe £m	RoW £m	Total £m	G10 governments £m	Prime £m	Non-conforming £m	Sub-prime £m
2004 and earlier	8,504	186	150	33	8,873	7,558	893	98	324
2005	4,221	667	338	74	5,300	2,779	1,750	511	260
2006	1,847	2,822	655	182	5,506	885	3,344	690	587
2007 and later	17,037	2,433	590	299	20,359	15,778	2,217	1,744	620
	31,609	6,108	1,733	588	40,038	27,000	8,204	3,043	1,791
2008									
2004 and earlier	6,833	724	293	102	7,952	5,537	1,647	122	646
2005	9,665	1,613	698	64	12,040	6,014	4,306	1,372	348
2006	3,137	2,999	1,483	188	7,807	1,698	4,023	872	1,214
2007 and later	22,380	2,099	406	250	25,135	20,235	2,697	1,652	551
	42,015	7,435	2,880	604	52,934	33,484	12,673	4,018	2,759
2007									
2004 and earlier	3,833	731	698	203	5,465	2,548	1,819	176	922
2005	4,923	391	1,461	169	6,944	3,209	2,185	437	1,113
2006	9,435	999	2,807	25	13,266	5,570	4,787	1,188	1,721
2007 and later	17,243	1,281	1,096	—	19,620	14,833	2,567	1,723	497
	35,434	3,402	6,062	397	45,295	26,160	11,358	3,524	4,253

Key point

- The change in vintage composition is a result of the balance sheet sell-down as well as the US Mortgage trading activity.

Market turmoil exposures continued

Credit valuation adjustments (CVA)

CVA represent an estimate of the adjustment to arrive at fair value that a market participant would make to incorporate the credit risk inherent in counterparty derivative exposures. The Group makes such credit adjustments to derivative exposures it has to counterparties, as well as debit valuation adjustments (DVA) to liabilities issued by the Group. The Group's methodology used for deriving DVA is different to that used for CVA and is discussed within Note 10 Financial Instruments – own credit on page 137.

The Group has purchased protection from monoline insurers ('monolines'), credit derivative product companies (CDPCs) and other counterparties. The Group makes CVA to exposures it has to these counterparties. The CVA at 31 December 2009 are set out below.

	2009 £m	2008 £m	2007 £m
Monoline insurers	1,925	3,289	452
CDPCs	495	746	—
Other counterparties	1,401	1,089	128
Total CVA	3,821	5,124	580

Key points

- During 2009, there was a significant reduction in the level of CVA held against exposures to monoline insurers and CDPCs, primarily driven by a reduction in the gross exposures to these counterparties due to a combination of restructuring certain trades and higher prices of underlying reference instruments.

- The reduction in CVA held against exposures to other counterparties was primarily driven by a reduction in counterparty risk due to credit spreads tightening.

Monoline insurers

The Group has purchased protection from monolines, mainly against specific asset-backed securities. Monolines specialise in providing credit protection against the principal and interest cash flows due to the holders of debt instruments in the event of default by the debt instrument counterparty. This protection is typically held in the form of derivatives such as credit default swaps (CDSs) referencing underlying exposures held directly or synthetically by the Group.

The gross mark-to-market of the monoline protection depends on the value of the instruments against which protection has been bought. A positive fair value, or a valuation gain, in the protection is recognised if the fair value of the instrument it references decreases. For the majority of trades the gross mark-to-market of the monoline protection is determined directly from the fair value price of the underlying reference instrument. For the remainder of the trades the gross mark-to-market is determined using industry standard models.

The methodology employed to calculate the monoline CVA uses CDS spreads and recovery levels to determine the market's implied level of expected loss on monoline exposures of different maturities. CVA is calculated at a trade level by applying the expected loss corresponding to each trade's expected maturity to the gross mark-to-market of the monoline protection. The expected maturity of each trade reflects the scheduled notional amortisation of the underlying reference instruments and whether payments due from the monoline insurer are received at the point of default or over the life of the underlying reference instruments.

The table below summarises the Group's exposure to monolines.

	2009 £m	2008 £m	2007 £m
Gross exposure to monolines	3,582	6,531	2,275
Hedges with financial institutions	(512)	(518)	—
Credit valuation adjustment	(1,925)	(3,289)	(452)
Net exposure to monolines	1,145	2,724	1,823
CVA as a % of gross exposure	54%	50%	20%

Key points

- The exposure to monoline insurers has decreased considerably during 2009 due to a combination of restructuring certain exposures and higher prices of underlying reference instruments. The trades with monoline insurers are predominantly denominated in US dollars, and the strengthening of sterling against the US dollar during 2009 has further reduced the exposure.

- The overall level of CVA has decreased, in line with the reduction in exposure to these counterparties. However, relative to the exposure to monoline counterparties, the CVA has increased from 50% to 54% due to a combination of wider credit spreads and lower recovery rates. These moves have been driven by deterioration in the credit quality of the monoline insurers as evidenced by rating downgrades (as shown in the following table, together with the Group's exposure to monoline insurers by asset category).

Market turmoil exposures continued

Credit valuation adjustments continued

The table below summarises monoline exposures by rating.

2009	Notional amount: protected assets £m	Fair value: protected assets £m	Gross exposure £m	Credit valuation adjustment £m	Hedges £m	Net exposure to monoline insurers £m
AA rated	6,560	5,355	1,205	361	—	844
Sub-investment grade	7,279	4,902	2,377	1,564	512	301
	13,839	10,257	3,582	1,925	512	1,145
Of which:						
CDOs	1,454	624	830	566		
RMBS	82	66	16	2		
CMBS	719	328	392	247		
CLOs	8,844	7,435	1,408	628		
Other ABS	2,304	1,546	758	395		
Other	436	258	178	87		
	13,839	10,257	3,582	1,925		
2008						
AA rated	4,199	3,060	1,139	518	—	621
BBB rated	9,399	4,450	4,949	2,446	518	1,985
Sub-investment grade	1,874	1,431	443	325	—	118
	15,472	8,941	6,531	3,289	518	2,724
Of which:						
CDOs	4,411	964	3,447	1,670		
RMBS	93	65	28	10		
CMBS	662	321	341	194		
CLOs	8,092	5,999	2,093	1,060		
Other ABS	1,792	1,299	493	287		
Other	422	293	129	68		
	15,472	8,941	6,531	3,289		
2007						
AAA rated	11,276	9,468	1,808	92	—	1,716
AA rated	300	193	107	—	—	107
Sub-investment grade	527	167	360	360	—	—
	12,103	9,828	2,275	452	—	1,823
CDOs	3,939	1,966	1,973	373		
RMBS	73	73	—	—		
CMBS	493	475	18	2		
CLOs	6,135	5,993	142	13		
Other ABS	1,105	1,052	53	1		
Other	358	269	89	63		
	12,103	9,828	2,275	452		

Credit ratings are based on those from rating agencies Standard & Poor's (S&P) and Moody's. Where the ratings differ, the lower of the two is taken.

Key points

- The majority of the current gross exposure is to sub-investment grade monoline counterparties. Nearly all such counterparties were down-graded during the year.
- The main exposure relates to CDOs and CLOs prices improved during the year, mostly in the last quarter.

The net income statement effect relating to monoline exposures is shown below.

	£m
Credit valuation adjustment at 1 January 2009	(3,289)
Credit valuation adjustment at 31 December 2009	(1,925)
Decrease in credit valuation adjustment	1,364
Net debit relating to foreign exchange and other movements	(1,478)
Net debit relating to reclassified debt securities	(1,740)
Net debit to income statement	(1,854)

Key point
- Realised losses arising from restructuring certain exposures, together with the impact of the US dollar weakening against sterling, are the primary components of the £1.5 billion above.

The Group also has indirect exposures to monoline insurers through wrapped securities and other assets with credit enhancement provided by monoline insurers. These securities are traded with the benefit of this credit enhancement. Any deterioration in the credit rating of the monoline is reflected in the fair value of these assets.

Credit derivative product companies (CDPCs)
A CDPC is a company that sells protection on credit derivatives. CDPCs are similar to monoline insurers, however, they are not regulated as insurers.

The Group has purchased credit protection from CDPCs through tranched and single name credit derivatives. The Group's exposure to CDPCs is predominantly due to tranched credit derivatives (tranches). A tranche references a portfolio of loans and bonds and provides protection against total portfolio default losses exceeding a certain percentage of the portfolio notional (the attachment point) up to another percentage (the detachment point). The Group has predominantly traded senior tranches with CDPCs, and the majority of the loans and bonds in the reference portfolios are investment grade.

The gross mark-to-market of the CDPC protection is determined using industry standard models. The methodology employed to calculate the CDPC CVA is different to that outlined above for monolines, as there are no market observable credit spreads and recovery levels for these entities. The level of expected loss on CDPC exposures is estimated by analysing the underlying trades and the cost of hedging expected default losses in excess of the capital available in each vehicle.

A summary of the Group's exposure to CDPCs is detailed below:

	2009 £m	2008 £m	2007 £m
Gross exposure to CDPCs	1,264	2,638	90
Credit valuation adjustment	495	746	—
Net exposure to CDPCs	769	1,892	90
CVA as % of gross exposure	39%	28%	0%

Key points
- The exposure to CDPCs reduced significantly during the year mainly due to a combination of tighter credit spreads of the underlying reference loans and bonds, and a decrease in the relative value of senior tranches compared with the underlying reference portfolios. The trades with CDPCs are predominantly US and Canadian dollar denominated, and the strengthening of sterling against the US dollar has further reduced the exposure, partially off-set by the weakening of sterling against the Canadian dollar.

- The overall level of CVA decreased, in line with the reduction in exposure to these counterparties, however on a relative basis the CVA increased from 28% to 39%. This reflects the perceived deterioration of the credit quality of the CDPCs as reflected by ratings down-grades. Further analysis of the Group's exposure to CDPCs by counterparty credit rating is shown in the following table.

Market turmoil exposures continued

Credit valuation adjustments continued

Credit derivative product companies (CDPC) continued

The table below summarises CDPC exposures by rating.

2009	Notional amount: protected assets £m	Fair value: protected reference assets £m	Gross exposure £m	Credit valuation adjustment £m	Net exposure to CDPCs £m
AAA rated	1,658	1,637	21	5	16
BBB rated	1,070	1,043	27	9	18
Sub-investment grade	17,080	16,137	943	373	570
Rating withdrawn	3,926	3,653	273	108	165
	23,734	22,470	1,264	495	769
2008					
AAA rated	959	549	410	82	328
AA rated	11,876	9,886	1,990	581	1,409
A rated	1,351	1,215	136	48	88
BBB rated	356	254	102	35	67
	14,542	11,904	2,638	746	1,892
2007					
AAA rated	1,557	1,467	90	—	90

Key point

- Nearly all of the current exposure is to CDPCs that are either sub-investment grade or have had their rating withdrawn in 2009. The majority of CDPC counterparties suffered rating downgrades during the year.

The net income statement effect arising from CDPC exposures is shown in the table below.

	£m
CVA at 1 January 2009	(746)
CVA at 31 December 2009	(495)
Decrease in credit valuation adjustment	251
Novations from ABN AMRO	449
Net effect of counterparty hedges	(1,705)
Net effect of foreign currency movement	(59)
Net debit to income statement	(1,064)

Key point

- The Group has additional hedges in place which effectively cap the exposure to CDPCs where the Group has significant risk. As the exposure to these CDPCs has reduced, losses have been incurred on the additional hedges.

CVA attributable to other counterparties

The CVA for all other counterparties is calculated on a portfolio basis reflecting an estimate of the amount a third party would charge to assume the credit risk.

Expected losses are determined from market implied probability of defaults and internally assessed recovery levels. The probability of default is calculated with reference to observable credit spreads and observable recovery levels. For counterparties where observable data do not exist, the probability of default is determined from the average credit spreads and recovery levels of baskets of similarly rated entities. A weighting of 50% to 100% is applied to arrive at the CVA. The weighting reflects portfolio churn and varies according to the counterparty credit quality.

Expected losses are applied to estimated potential future exposures which are modelled to reflect the volatility of the market factors which drive the exposures and the correlation between those factors. Potential future exposures arising from vanilla products (including interest rate and foreign exchange derivatives) are modelled jointly using the Group's core counterparty risk systems. At 31 December 2009, over 75% of the Group's CVA held in relation to other counterparties arises on these vanilla products. The exposures arising from all other product types are modelled and assessed individually. The potential future exposure to each counterparty is the aggregate of the exposures arising on the underlying product types.

Correlation between exposure and counterparty risk is also incorporated within the CVA calculation where this risk is considered significant. The risk primarily arises on trades with emerging market counterparties where the gross mark-to-market value of the trade, and therefore the counterparty exposure, increases as the strength of the local currency declines.

Collateral held under a credit support agreement is factored into the CVA calculation. In such cases where the Group holds collateral against counterparty exposures, CVA is held to the extent that residual risk remains.

CVA is held against exposures to all counterparties with the exception of the CDS protection that the Group has purchased from HM Treasury, as part of its participation in the Asset Protection Scheme, due to the unique features of this derivative.

The net income statement effect arising from the change in level of CVA for all other counterparties and related trades is shown in the table below.

	£m
CVA at 1 Jan 2009	(1,089)
CVA at 31 Dec 2009	(1,401)
Increase in CVA	(312)
Novations from ABN AMRO	90
Net effect of counterparty hedges	(341)
Loss on defaults	(49)
Net debit to income statement	(612)

Key points

- Losses arose on trades hedging the CVA held against other counterparties due to credit spreads tightening. These losses, together with realised losses from counterparty defaults, are the primary cause of the loss arising on foreign exchange, hedges, realisations and other movements.

- The net income statement effect was driven by updates to the CVA methodology, hedges and realised defaults off-setting CVA movements.

  — The primary update applied to the CVA methodology reflected a market wide shift in the approach to pricing and managing counterparty risk. The methodology change related to the calculation of the probability of default. The basis for this calculation moved from a blended market implied and historic measure to the market implied methodology set out above. Other updates to the methodology were made to reflect the correlation between exposure and counterparty risk.

  — Prior to the update to the CVA methodology, CVA moves driven by changes to the historic element of the blended measure were not hedged, resulting in losses during the year arising from related CVA increases.

  — The CVA is calculated on a portfolio basis and reflects an estimate of the losses that will arise across the portfolio due to counterparty defaults. It is not possible to perfectly hedge the risks driving the CVA and this leads to differences between CVA and hedge movements. Differences also arise between realised default losses and the proportion of CVA held in relation to individual counterparties.

Market turmoil exposures continued

Leveraged finance

Leveraged finance is commonly employed to facilitate corporate finance transactions, such as acquisitions or buy-outs, and is so called due to the high ratio of debt to equity (leverage) common in such transactions. A bank acting as a lead manager for a leveraged finance transaction will typically underwrite a loan, alone or with others, and then syndicate the loan to other participants. The Group typically held a portion of these loans as part of its long-term portfolio once primary syndication is completed ('hold portfolio'). Most of the leveraged finance loans held as part of syndicated lending portfolio were reclassified from held-for-trading to loans and receivables with effect from 1 July 2008.

Leveraged finance provided by the Group that has been drawn down by the counterparty is reported on the balance sheet in loans and advances. Undrawn amounts of the facility provided to the borrower are reported in memorandum items – commitments to lend.

The table below shows the Group's global markets sponsor-led leveraged finance exposures by industry and geography. The gross exposure represents the total amount of leveraged finance committed by the Group (drawn and undrawn). The net exposure represents the balance sheet carrying values of drawn leveraged finance and the total undrawn amount. The difference between gross and net exposures is principally due to the cumulative effect of impairment provisions and historic write-downs on assets prior to reclassification.

	2009					2008				
	Americas £m	UK £m	Other Europe £m	RoW £m	Total £m	Americas £m	UK £m	Other Europe £m	RoW £m	Total £m
Gross exposure:										
Retail	17	476	705	59	1,257	268	1,285	798	78	2,429
Industrial	593	1,475	1,190	96	3,354	585	1,563	1,295	103	3,545
TMT (2)	1,591	1,656	775	302	4,324	2,297	1,484	1,629	314	5,725
Other	216	1,527	866	184	2,793	472	1,391	944	126	2,933
	2,417	5,134	3,536	641	11,728	3,622	5,723	4,666	621	14,632
Net exposure:										
Retail	17	445	634	56	1,152	223	978	782	78	2,061
Industrial	520	925	1,161	95	2,701	602	1,107	1,281	101	3,091
TMT (2)	1,311	1,532	771	295	3,909	2,037	1,386	1,610	315	5,348
Other	216	1,461	846	184	2,707	469	1,307	942	126	2,844
	2,064	4,363	3,412	630	10,469	3,331	4,778	4,615	620	13,344
Of which:										
Drawn	1,722	3,698	2,640	541	8,601	2,311	4,085	3,817	539	10,752
Undrawn	342	665	772	89	1,868	1,020	693	798	81	2,592
	2,064	4,363	3,412	630	10,469	3,331	4,778	4,615	620	13,344

Notes:

(1) All the above exposures are in Non-Core.

(2) Telecommunications, media and technology.

(3) There were no held-for-trading exposures at 31 December 2009 (2008 – £103 million).

At 31 December 2007 the carrying value of the Group's syndicated loan book was £12,041 million, all of which was classified as held-for-trading. Of this balance, £6,516 million was drawn and £5,525 million was undrawn.

The table below analyses the movements in leveraged finance exposures for the year.

	Drawn £m	Undrawn £m	Total £m
Balance at 1 January 2009	10,752	2,592	13,344
Transfers in (from credit trading business)	506	41	547
Sales	(245)	(145)	(390)
Repayments and facility reductions	(900)	(381)	(1,281)
Funded deals	115	(115)	—
Changes in fair value	(31)	—	(31)
Accretion of interest	100	—	100
Impairment provisions	(1,121)	—	(1,121)
Exchange and other movements	(575)	(124)	(699)
Balance at 31 December 2009	8,601	1,868	10,469

Key points

- Since the beginning of the credit market dislocation in the second half of 2007, investor appetite for leveraged loans and similar risky assets has fallen dramatically, with higher perceived risk of default due to the leverage involved. Furthermore, secondary prices of leveraged loans traded fell due to selling pressure and margins increasing, as well as reduced activity in the primary market.

- During 2009 the Group's sterling exposure has declined, largely as a result of the weakening of the US dollar and euro against sterling during the period.

- There have also been a number of credit impairments and write-offs during 2009, including some names which the Group previously held as part of its syndicate portfolio.

- Early repayments as a result of re-financings have further reduced the exposure.

Not included in the table above are:

- UK Corporate leveraged finance net exposures of £7.1 billion at 31 December 2009 (2008 – £6.9 billion) related to debt and banking facilities provided to UK mid-corporates. Of this, £1.4 billion related to facilities provided to client in the retail sector and £2.1 billion to the industrial sector (2008 – £1.4 billion and £2.5 billion respectively).

- Ulster Bank leveraged finance net exposures of £0.6 billion at 31 December 2009 (2008 – £0.7 billion).

Special purpose entities (SPEs)

The Group arranges securitisations to facilitate client transactions and undertakes securitisations to sell financial assets or to fund specific portfolios of assets. The Group also acts as an underwriter and depositor in securitisation transactions involving both client and proprietary transactions. In a securitisation, assets, or interests in a pool of assets, are transferred generally to a special purpose entity (SPE) which then issues liabilities to third party investors. SPEs are vehicles established for a specific, limited purpose, usually do not carry out a business or trade and typically have no employees. They take a variety of legal forms – trusts, partnerships and companies – and fulfil many different functions. As well as being a key element of securitisations, SPEs are also used in fund management activities to segregate custodial duties from the fund management advice provided by the Group.

It is primarily the extent of risks and rewards assumed that determines whether these entities are consolidated in the Group's financial statements. The following section aims to address the significant exposures which arise from the Group's activities through specific types of SPEs.

The Group sponsors and arranges own-asset securitisations, whereby the sale of assets or interests in a pool of assets into an SPE is financed by the issuance of securities to investors. The pool of assets held by the SPE may be originated by the Group, or (in the case of whole loan programmes) purchased from third parties, and may be of varying credit quality. Investors in the debt securities issued by the SPE are rewarded through credit-linked returns, according to the credit rating of their securities. The majority of securitisations are supported through liquidity facilities, other credit enhancements and derivative hedges extended by financial institutions, some of which offer protection against initial defaults in the pool of assets. Thereafter, losses are absorbed by investors in the lowest ranking notes in the priority of payments. Investors in the most senior ranking debt securities are typically shielded from loss, since any subsequent losses may trigger repayment of their initial principal.

Market turmoil exposures continued

Special purpose entities continued

The Group also employs synthetic structures, where assets are not sold to the SPE, but credit derivatives are used to transfer the credit risk of the assets to an SPE. Securities may then be issued by the SPE to investors, on the back of the credit protection sold to the Group by the SPE.

Residential and commercial mortgages and credit card receivables form the types of assets generally included in cash securitisations, while corporate loans and commercial mortgages typically serve as reference obligations in synthetic securitisations.

The Group sponsors own-asset securitisations as a way of diversifying funding sources, managing specific risk concentrations, and achieving capital efficiency. The Group purchases the securities issued in own-asset securitisations. During 2008, the Group was able to pledge AAA-rated asset-backed securities as collateral for repurchase agreements with major central banks under schemes such as the Bank of England's Special Liquidity Scheme, launched in April 2008, which allowed banks to temporarily swap high-quality mortgage-backed and other securities for liquid UK treasury bills. This practice has contributed to the Group's sources of funding during 2008 and 2009 in the face of the contraction in the UK market for inter-bank lending and the investor base for securitisations.

The Group typically does not retain the majority of risks and rewards of own-asset securitisations set up for the purposes of risk diversification and capital efficiency, where the majority of investors tend to be third parties. Therefore, the Group typically does not consolidate the related SPEs.

The Group has also established whole loan securitisation programmes in the US and UK where assets originated by third parties are warehoused by the Group for securitisation. The majority of these vehicles are not consolidated by the Group, as it is not exposed to the risks and rewards of ownership.

The table below sets out the asset categories together with the carrying amount of the assets and associated liabilities for those securitisations and other asset transfers, other than conduits (discussed below), where the assets continue to be recorded on the Group's balance sheet.

	2009		2008		2007	
	Assets £m	Liabilities £m	Assets £m	Liabilities £m	Assets £m	Liabilities £m
Residential mortgages	68,963	15,749	53,528*	18,613	19,657	19,441
Credit card receivables	2,975	1,592	3,004	3,197	2,948	2,664
Other loans	36,448	1,010	1,679	1,071	1,703	1,149
Finance lease receivables	597	597	1,077	857	1,038	823

* revised

Key points

- The increase in both residential mortgages and other loan assets in the year principally relates to assets securitised to facilitate access to central bank liquidity schemes.
- As all notes issued by own-asset securitisation SPEs are purchased by Group companies, assets are significantly greater than securitised liabilities.

Conduits

The Group sponsors and administers a number of asset-backed commercial paper (ABCP) conduits. A conduit is an SPE that issues commercial paper and uses the proceeds to purchase or fund a pool of assets. The commercial paper is secured on the assets and is redeemed either by further commercial paper issuance, repayment of assets or funding from liquidity facilities. Commercial paper is typically short-dated, usually up to three months.

Group-sponsored conduits can be divided into multi-seller conduits and own-asset conduits. The Group consolidates both types of conduit where the substance of the relationship between the Group and the conduit vehicle is such that the vehicle is controlled by the Group. The total assets held by Group-sponsored conduits were £19.7 billion at 31 December 2009 (2008 – £31.5 billion). Liquidity commitments from the Group to the conduit exceed the nominal amount of assets funded by the conduit as liquidity commitments are sized to cover the funding cost of the related assets.

Group-sponsored multi-seller conduits

The multi-seller conduits were established by the Group for the purpose of providing its clients with access to diversified and flexible funding sources. A multi-seller conduit typically purchases or funds assets originated by the banks' clients. The multi-seller conduits account for 50% of the total liquidity and credit enhancements committed by the Group at 31 December 2009 (2008 – 100%).

The Group sponsors six multi-seller conduits which finance assets from Europe, North America and Asia-Pacific. Assets purchased or financed by the multi-seller conduits include auto loans, residential mortgages, credit card receivables, consumer loans and trade receivables.

The third-party assets financed by the conduits receive credit enhancement from the originators of the assets. This credit enhancement, which is specific to each transaction can take the form of over-collateralisation, excess spread or subordinated loan, and typically ensures the asset acquired by the conduit has a rating equivalent to at least a single-A credit. In addition, in line with general market practice, the Group provides a small second-loss layer of programme-wide protection to the multi-seller conduits. Given the nature and investment grade equivalent quality of the first loss enhancement provided by the originators of the assets, the Group has only a minimal risk of loss on its programme-wide exposure. The issued ABCP is rated A-1/P-1 by Moody's and Standard & Poor's.

The Group provides liquidity back-up facilities to the conduits it sponsors. The conduits are able to draw funding under these facilities in the event of a disruption in the ABCP market, or when certain trigger events prevent the issue of ABCP.

Key points

- The maturity of commercial paper issued by the Group's conduits is managed to mitigate the short-term contingent liquidity risk of providing back-up facilities. The Group's limits sanctioned for such liquidity facilities at 31 December 2009 totalled approximately £25.0 billion (2008 – £40.9 billion). For a very small number of transactions within one multi-seller conduit the liquidity facilities have been provided by third-party banks. This typically occurs on transactions where the third-party bank does not use, or have, its own conduit vehicles.

- The Group's maximum exposure to loss on its multi-seller conduits is £25.2 billion (2008 – £38.8 billion), being the total amount of the Group's liquidity commitments plus the extent of programme-wide credit enhancements of conduit assets for which liquidity facilities were provided by third parties.

- The Group's multi-seller conduits have continued to fund the vast majority of their assets solely through ABCP issuance. There have been no significant systemic failures within the financial markets similar to that experienced in the second half of 2008 following Lehman Brothers bankruptcy filing in September 2008. The improvement in market conditions has allowed these conduits to move towards more normal ABCP funding and reduced the need for backstop funding from the Group.

Group-sponsored own-asset conduits

The Group's own-asset conduit programmes have been established to diversify the Group's funding sources. The conduits allow the Group to access central government funding schemes and the ABCP market.

The Group holds two own-asset conduits which have assets that have previously been funded by the Group. These vehicles represent 50% (2008 – 0%) of the Group's conduit business (as a percentage of the total liquidity and credit enhancements committed by the Group), with nil of ABCP outstanding at 31 December 2009 (2008 – nil). The Group's maximum exposure to loss on its own-asset conduits is £26.3 billion (2008 – nil), being the total drawn and undrawn amount of the Group's liquidity commitments to these conduits. This comprises committed liquidity of $40.8 billion (£25.1 billion) to an own-asset conduit established to access the Bank of England's open market operations and £1.2 billion to other own-asset conduits. As the first of these conduits was established for contingent funding and at 31 December 2009 it had no commercial paper outstanding, the Group's liquidity commitment to this conduit is not included in the table below.

Group exposure to consolidated conduits

The exposure to conduits which are consolidated by the Group is set out below.

	2009 £m	2008 £m	2007 £m
Total assets held by the conduits	19,671	31,473	10,733
Commercial paper issued	17,888	30,833	10,733
Liquidity and credit enhancements:			
Deal specific liquidity:			
drawn	1,797	640	—
undrawn	24,631	38,201	15,272
PWCE (1)	1,508	2,072	552
	27,936	40,913	15,824
Maximum exposure to loss (2)	26,427	38,841	15,272

Notes:
(1) Programme-wide credit enhancement.
(2) Maximum exposure to loss is determined as the Group's total liquidity commitments to the conduits and additionally programme-wide credit support which would absorb first loss on transactions where liquidity support is provided by a third party. Third party maximum exposure to loss is reduced by repo trades conducted with an external counterparty.

Market turmoil exposures continued

Special purpose entities continued

Conduits continued

During the year both multi-seller and own asset conduit assets have been reduced in line with the wider Group balance sheet management.

Collateral analysis, profile, credit ratings and weighted average lives relating to the Group's consolidated conduits are detailed below.

	Funded assets					
2009	Loan £m	Securities £m	Total £m	Undrawn £m	Liquidity for third parties £m	Total exposure £m
Auto loans	4,293	356	4,649	2,526	—	7,175
Corporate loans	106	—	106	7	—	113
Credit card receivables	4,083	—	4,083	1,058	—	5,141
Trade receivables	840	—	840	1,351	—	2,191
Student loans	915	—	915	263	(132)	1,046
Consumer loans	1,652	—	1,652	222	—	1,874
Mortgages:						
Prime	2,739	3	2,742	750	—	3,492
Non-conforming	1,548	—	1,548	193	—	1,741
Commercial	413	458	871	155	(22)	1,004
Other	872	1,393	2,265	232	(12)	2,485
	17,461	2,210	19,671	6,757	(166)	26,262

2008						
Auto loans	9,670	383	10,053	1,871	—	11,924
Corporate loans	430	—	430	31	—	461
Credit card receivables	5,632	—	5,632	918	—	6,550
Trade receivables	2,706	—	2,706	1,432	(71)	4,067
Student loans	2,555	—	2,555	478	(132)	2,901
Consumer loans	2,371	—	2,371	409	—	2,780
Mortgages:						
Prime	1,822	—	1,822	456	—	2,278
Non-conforming	2,181	—	2,181	727	—	2,908
Commercial	1,069	507	1,576	61	(23)	1,614
Other	1,664	483	2,147	985	—	3,132
	30,100	1,373	31,473	7,368	(226)	38,615

2007						
Auto loans	3,119	—	3,119	1,281	— 102	4,298
Credit card receivables	2,123	—	2,123	501	—	2,624
Trade receivables	223	—	223	15	—	238
Student loans	329	—	329	545	— 132	742
Consumer loans	562	—	562	207	—	769
Mortgages:						
Prime	1,663	—	1,663	153	—	1,816
Non-conforming	1,289	—	1,289	633	—	1,922
Commercial	525	503	1,028	65	23	1,070
Other	397	—	397	1,138	—	1,535
	10,230	503	10,733	4,538	257	15,014

Group exposure to consolidated conduits

	CP funded assets										
	Geographic distribution						Credit ratings (S&P equivalent)				
2009	UK £m	Other Europe £m	US £m	RoW £m	Total £m	Weighted average life years	AAA £m	AA £m	A £m	BBB £m	Below BBB £m
Auto loans	476	982	2,621	570	4,649	1.8	2,965	1,547	137	—	—
Corporate loans	—	106	—	—	106	4.2	—	—	106	—	—
Credit card receivables	177	—	3,823	83	4,083	0.8	2,781	759	420	123	—
Trade receivables	—	334	472	34	840	0.7	480	266	60	34	—
Student loans	117	—	798	—	915	0.7	798	117	—	—	—
Consumer loans	733	800	119	—	1,652	1.5	34	50	1,553	15	—
Mortgages:											
Prime	138	—	—	2,604	2,742	3.1	949	1,746	28	3	16
Non-conforming	599	949	—	—	1,548	3.7	1,070	379	99	—	—
Commercial	641	194	—	36	871	14.7	25	3	840	—	3
Other	121	670	298	1,176	2,265	2.3	170	249	950	896	—
	3,002	4,035	8,131	4,503	19,671	2.3	9,272	5,116	4,193	1,071	19
2008											
Auto loans	801	1,706	7,402	144	10,053	1.7	6,075	868	3,110	—	10,053
Corporate loans	320	110	—	—	430	1.7	—	—	430	—	430
Credit card receivables	633	—	4,999	—	5,632	0.7	3,465	62	1,959	146	5,632
Trade receivables	68	922	1,371	345	2,706	0.8	120	1,025	1,561	—	2,706
Student loans	144	—	2,411	—	2,555	0.3	2,296	144	115	—	2,555
Consumer loans	708	1,195	468	—	2,371	1.7	387	993	923	68	2,371
Mortgages:											
Prime	—	—	—	1,822	1,822	3.7	17	1,806	—	—	1,823
Non-conforming	960	1,221	—	—	2,181	4.6	351	368	475	987	2,181
Commercial	713	453	74	336	1,576	12.1	274	518	315	469	1,576
Other	166	1,198	684	99	2,147	2.1	3	601	1,309	233	2,146
	4,513	6,805	17,409	2,746	31,473	2.0	12,988	6,385	10,197	1,903	31,473
2007											
Auto loans	2,071	324	724	—	3,119	1.6	30	1,755	1,334	—	3,119
Credit card receivables	629	—	1,494	—	2,123	0.4	443	—	1,680	—	2,123
Trade receivables	175	—	48	—	223	0.8	—	—	223	—	223
Student loans	140	—	189	—	329	2.4	184	140	5	—	329
Consumer loans	528	—	34	—	562	—	—	229	333	—	562
Mortgages:											—
Prime	—	—	—	1,663	1,663	4.4	26	1,638	—	—	1,664
Non-conforming	1,133	156	—	—	1,289	5.8	93	610	586	—	1,289
Commercial	729	—	28	271	1,028	16.4	271	507	250	—	1,028
Other	122	179	—	96	397	2.7	96	—	300	—	396
	5,527	659	2,517	2,030	10,733	3.7	1,143	4,879	4,711	—	10,733

Market turmoil exposures continued
Special purpose entities continued
Conduits continued

The Group also extends liquidity commitments to multi-seller conduits sponsored by other banks, but typically does not consolidate these entities as the Group does not retain the majority of risks and rewards.

The Group's exposure from third-party conduits is analysed below.

	2009 £m	2008 £m	2007 £m
Liquidity and credit enhancements:			
Deal specific liquidity:			
drawn	243	3,078	2,280
undrawn	244	198	490
	487	3,276	2,770
Maximum exposure to loss (1)	487	3,276	2,770

Note:

(1) Maximum exposure to loss is determined as the Group's total liquidity commitments to the conduits and additionally programme-wide credit support which would absorb first loss on transactions where liquidity support is provided by a third party.

Structured investment vehicles*

The Group does not sponsor any structured investment vehicles.

Investment funds set up and managed by the Group*

The Group has established and manages a number of money market funds for its customers. When a new money market fund is launched, the Group typically provides a limited amount of seed capital to the funds. The Group has investments in these funds of £776 million at 31 December 2009 (2008 – £107 million). The investors in both money market and non-money market funds have recourse to the assets of the funds only. These funds are not consolidated by the Group. At 31 December 2009 the Group had exposure to one fund amounting to £145 million (2008 – £144 million).

Money market funds

The Group's money market funds held assets of £9.6 billion at 31 December 2009 (2008 – £13.6 billion). The sub-categories of money market funds are:

- £8.0 billion (2008 – £8.0 billion) in money market funds managed by the Group denominated in sterling, US dollars and euro. The funds invest in short-dated, highly rated money market securities with the objective of ensuring stability of capital and net asset value per share, appropriate levels of liquid assets, together with an income which is comparable to the short dated money market interest rate in the relevant currency.

- £0.4 billion (2008 – £0.7 billion) in money market 'Plus' funds managed by the Group denominated in sterling, US dollars and euro. The funds invest in longer-dated, highly rated securities with the objective of providing enhanced returns over the average return on comparable cash deposits.

- £1.2 billion (2008 – £4.9 billion) in third party multi-manager money market funds denominated in sterling, US dollars and euro. The funds invest in short dated, highly rated securities with the objective of maximising current income consistent with the preservation of capital and liquidity.

Non-money market funds

The Group has also established a number of non-money market funds to enable investors to invest in a range of assets including bonds, equities, hedge funds, private equity and real estate. The Group's non-money market funds had total assets of £14.9 billion at 31 December 2009 (2008 – £18.7 billion). The sub-categories of non-money market funds are:

- £1.1 billion (2008 – £1.6 billion) in committed capital to generate returns from equity and equity-like investments in private companies.

- £13.4 billion (2008 – £16.0 billion) in third party, multi-manager funds. These funds offer multi-manager and fund of funds' products across bond, equity, hedge fund, private equity and real estate asset classes. In January 2010, the Group entered into a sale agreement with Aberdeen Asset Management plc for assets of £13.3 billion in these funds.

- £0.4 billion (2008 – £1.1 billion) in various derivative instruments with the objective of providing returns linked to the performance of underlying equity indices.

*unaudited

The directors present their report together with the audited accounts for the year ended 31 December 2009.

Business review

Activities

The Royal Bank of Scotland plc (the 'Bank') is a wholly-owned subsidiary of The Royal Bank of Scotland Group plc ('the holding company'), which is incorporated in Great Britain and has its registered office at 36 St Andrew Square, Edinburgh EH2 2YB. The 'Group' comprises the Bank and its subsidiary and associated undertakings. Details of the principal subsidiary undertakings and their activities are shown in Note 15 on the accounts. 'RBS Group' comprises the holding company and its subsidiary and associated undertakings.

The financial statements of The Royal Bank of Scotland Group plc can be obtained from Group Secretariat, RBS Gogarburn, Edinburgh EH12 1HQ, the Registrar of Companies or through the Group's website, www.rbs.com

The Group is engaged principally in providing a wide range of banking and other financial services. Further details of the organisational structure and business overview of the Group, including the products and services provided by each of its divisions and the competitive markets in which they operate, is contained in the Financial review on pages 3 and 4.

Following the conclusion of a strategic review, the RBS Group has realigned its Core divisions, in particular the separation of RBS UK into UK Retail and UK Corporate. A Non-Core division has also been established to manage and run off or dispose of a number of assets and businesses that do not meet the RBS Group's target criteria.

Capital restructuring

Following placing and open offers in December 2008 and April 2009, HM Treasury currently own approximately 70.3% of the enlarged ordinary share capital of the holding company.

In December 2009, the holding company issued £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 one capital.

Following the issuance of B shares, HM Treasury's holding of ordinary shares of the holding company remained at 70.3% although its economic interest rose to 84.4%.

HM Treasury has agreed not to convert its B shares into ordinary shares to the extent that its holding of ordinary shares following the conversion would represent more than 75% of the holding company's issued ordinary share capital.

Following approval at the General Meeting held on 15 December 2009, RBS Group joined the Asset Protection Scheme set up by HM Treasury which provides additional protection to the RBS Group's capital ratio and financial position.

The Bank has entered into agreements with other RBS Group companies under which it has sold credit protection over the exposures held that are subject to the APS.

Risk factors

The Group's future performance and results could be materially different from expected results depending on the outcome of certain potential risks and uncertainties. Details of the principal risk factors the Group faces are given on pages 5 to 23.

The reported results of the Group are sensitive to the accounting policies, assumptions and estimates that underlie the preparation of its financial statements. Details of the Group's critical accounting policies and key sources of accounting judgements are included in the Accounting policies on pages 104 to 114.

The Group's approach to risk management, including its financial risk management objectives and policies and information on the Group's exposure to price, credit, liquidity and cash flow risk is discussed in the risk, capital and liquidity management section of the Financial review on pages 39 to 92.

Financial performance

A review of the Group's performance during the year ended 31 December 2009, including details of each division, and the Group's financial position as at that date is contained in the Financial review on pages 24 to 38.

Employees

Policies and practices in respect of employee issues are managed on a consistent basis across the RBS Group, and the following sections reflect this approach.

As at 31 December 2009, the Bank and its subsidiaries employed 110,900 employees (full time equivalent basis), throughout the world. Details of employee related costs are included in Note 3 on the accounts on page 117.

The RBS Group offers an appropriate remuneration and benefits package to all employees which seeks to balance the interests of employees, shareholders and the long-term needs of the businesses and reflects banking bonus reforms.

The RBS Group is committed to leading the way in implementing reforms to bank remuneration as agreed by the G20 in Pittsburgh and is implementing important enhancements in disclosure, deferral, and clawback of bonus awards with effect from 1 January 2010 for the performance year 2009. A large amount of focus has been placed on achieving compliance with the emerging regulatory developments on a global scale. This has had a large impact on the RBS Group's culture and changes have affected all levels of the organisation.

Employee learning and development

The RBS Group maintains a strong commitment to creating and providing learning opportunities for all its employees through a variety of personal development and training programmes and learning networks. Employees are encouraged to do voluntary work with community partners.

Employee communication
Employee engagement is encouraged through a range of communication channels, at both a divisional and Group level. These channels provide access to news and information in a number of ways, including the intranet, magazines, video, team meetings led by line managers, briefings held by senior managers and regular dialogue with employees and employee representatives.

The Group Chief Executive and other senior Group executives regularly communicate with employees across a range of channels.

Employee consultation
Each year, all RBS Group employees are invited to complete the global employee opinion survey. The survey is confidential and independently managed by Towers Perrin-ISR (now Towers Watson). The survey provides a channel for employees to express their views and opinions about the RBS Group on a range of key issues.

The 2009 survey took place in September 2009 and the final response rate was 87%. This represents over 144,000 employees participating in the survey, from more than 50 countries.

The RBS Group recognises employee representative organisations such as trade unions and work councils in a number of businesses and countries. The RBS Group has two European Employee Forums that provide elected representatives with an opportunity to understand better its European operations. Engagement with its employees and such bodies remains important to the RBS Group.

Diversity and inclusion
The RBS Group renewed its commitment to the principles of diversity and Inclusion during 2009. The RBS Group recognises that the diversity of its workforce is a considerable asset to the business and believes that an inclusive environment will enable all employees to develop to their full potential and enable RBS to attract and retain the best talent.

The RBS Group already has a range of policies and processes that extend through the employee life-cycle including recruitment, flexible working and support for ill-health and disability-related absence. Diversity performance is monitored and reviewed at RBS Group and divisional executive level. This commitment extends beyond the Group as part of the community support and supplier relationships.

Safety, health and wellbeing
The RBS Group recognises that performance in safety, health and wellbeing adds value to employees and to the RBS Group's businesses globally. Industry leading expertise, innovative tools, products and services and a practical approach to implementation are combined to ensure improved performance continues to be delivered.

During 2009, the RBS Group continued to focus on compliance, governance and managing risk across all jurisdictions. Enhanced mechanisms were implemented to support the health and wellbeing of employees, particularly given the impact of the economic environment.

Pre-employment screening
The RBS Group has a comprehensive pre-employment screening process to guard against possible infiltration and employee-related fraud for all direct and non-direct staff engaged on RBS Group business.

Corporate sustainability
Sustainability sits at the heart of how the RBS Group is being re-shaped and RBS maintains a strong commitment to meeting high standards of environmental, social and ethical responsibility.

Corporate sustainability issues are governed by the Group Corporate Sustainability Committee (GCSC), which was established in 2009. The GCSC is supported by the executive-led Environment Working Group which has representatives from across the RBS Group and reports to the GCSC. The Environment Working Group monitors environmental risk, commercial opportunities, operational impacts and communications and engagement.

The Microfinance Advisory Board comprises senior members from a range of stakeholder groups and provides independent oversight and support for the Microfinance and Supporting Enterprise programmes across the RBS Group's international business.

Throughout the development of 'MoneySense' RBS Group has continuously sought independent counsel. This has now been formalised through the formation of the MoneySense Advisory Board which draws on the skills of independent, impartial experts, to provide strategic input to the MoneySense programme.

Further details of the RBS Group's Corporate Sustainability policies are available on www.rbs.com/sustainability and in the annual Corporate Sustainability Report.

Going concern
The Group's business activities and financial position; the factors likely to affect its future development and performance; and its objectives and policies in managing the financial risks to which it is exposed and its capital are discussed on pages 39 to 92 of the Financial review. The risk factors which could materially affect the Group's future results are set out on pages 5 to 23.

Having reviewed the Group's forecasts, projections and other relevant evidence, the directors have a reasonable expectation that the Group and the Bank will continue in operational existence for the foreseeable future. Accordingly, the financial statements of the Group and of the Bank have been prepared on a going concern basis.

Ordinary share capital
Details of the authorised and issued ordinary share capital at 31 December 2009 are shown in Note 25 on the accounts.

Preference share capital
Details of the authorised and issued preference share capital at 31 December 2009 are shown in Note 25 on the accounts.

Directors
The current members of the board of directors are named on page 2.

Colin Buchan, Stephen Hester, Archie Hunter, Joe MacHale and Gordon Pell served throughout the year and to the date of signing of the financial statements.

Philip Hampton was appointed as a director and Chairman-designate on 19 January 2009 and as Chairman on 3 February 2009.

Sir Tom McKillop ceased to be Chairman on 3 February 2009.

Jim Currie, Bill Friedrich, Bud Koch, Janis Kong, Sir Steve Robson, Bob Scott and Peter Sutherland all ceased to be directors on 6 February 2009.

Sandy Crombie was appointed as Senior Independent Director on 1 June 2009.

Guy Whittaker ceased to be a director on 30 September 2009.

Bruce Van Saun was appointed as a director on 1 October 2009.

Philip Scott was appointed as a director on 1 November 2009.

Penny Hughes was appointed as a director on 1 January 2010.

Gordon Pell will retire from the Board on 31 March 2010.

Sandy Crombie, Penny Hughes, Philip Scott and Bruce Van Saun, all of whom have been appointed since the 2009 Annual General Meeting, will offer themselves for election at the forthcoming Annual General Meeting. In addition, Colin Buchan and Joe MacHale will retire and offer themselves for re-election at the Annual General Meeting.

Archie Hunter, who has served as a director since September 2004 and chairman of the Group Audit Committee since April 2005, will retire from the Board at the end of his existing term at the conclusion of the Group's Annual General Meeting in April 2010.

Brendan Nelson will be appointed as a director with effect from 1 April 2010 and will offer himself for election at the forthcoming Annual General Meeting. He will succeed Archie Hunter as chairman of the Group Audit Committee on 28 April 2010.

Group General Counsel and Group Secretary
Miller McLean will retire as Group General Counsel and Group Secretary on 30 April 2010, after 40 years with the Group.

Directors' interests
The interests of the directors in the shares of the holding company at 31 December 2009 are disclosed in the Report and Accounts of that company. None of the directors held an interest in the loan capital of the holding company or in the shares or loan capital of the Bank or any of the subsidiaries of the Bank during the period from 1 January 2009 to 31 March 2010.

Directors' indemnities
In terms of section 236 of the Companies Act 2006, Qualifying Third Party Indemnity Provisions have been issued by the holding company to directors, members of the Executive and Management Committees of the Group and FSA Approved Persons.

In terms of section 236 of the Companies Act 2006, Qualifying Pension Scheme Indemnity Provisions have been issued to all pension trustees of the Group's pension schemes during 2009.

Directors' disclosure to auditors
Each of the directors at the date of approval of this report confirms that:

(a) so far as the director is aware, there is no relevant audit information of which the Bank's auditors are unaware; and

(b) the director has taken all the steps that he/she ought to have taken as a director to make himself/herself aware of any relevant audit information and to establish that the Bank's auditors are aware of that information.

This confirmation is given and should be interpreted in accordance with the provisions of section 418 of the Companies Act 2006.

Post balance sheet events
There have been no significant events between the year end and the date of approval of these accounts which would require a change to or disclosure in the accounts.

Charitable contributions
The total amount given for charitable purposes by the Group during the year ended 31 December 2009 was £34.6 million (2008 – £23.9 million).

Political donations
No EU political donations were made during the year.

Policy and practice on payment of creditors
The Group is committed to maintaining a sound commercial relationship with its suppliers. Consequently, it is the Group's policy to negotiate and agree terms and conditions with its suppliers, which includes the giving of an undertaking to pay suppliers within 30 days of receipt of a correctly prepared invoice submitted in accordance with the terms of the contract or such other payment period as may be agreed.

At 31 December 2009, the Group's trade creditors represented 30 days (2008 – 30 days) of amounts invoiced by suppliers.

Auditors
The auditors, Deloitte LLP, have indicated their willingness to continue in office. A resolution to re-appoint Deloitte LLP as the Bank's auditor will be proposed at the forthcoming Annual General Meeting.

By order of the Board

Miller McLean
Secretary
31 March 2010

The Royal Bank of Scotland plc
is registered in Scotland No. 90312.

Statement of directors' responsibilities

The directors are required by Article 4 of the IAS Regulation (European Commission Regulation No 1606/2002) to prepare Group accounts, and as permitted by the Companies Act 2006 have elected to prepare Bank accounts, for each financial year in accordance with International Financial Reporting Standards as adopted by the European Union. They are responsible for preparing accounts that present fairly the financial position, financial performance and cash flows of the Group and the Bank. In preparing those accounts, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- state whether applicable accounting standards have been followed, subject to any material departures disclosed and explained in the accounts; and
- prepare accounts on the going concern basis unless it is inappropriate to presume that the Bank will continue in business.

The directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the Group and to enable them to ensure that the Annual Report and Accounts complies with the Companies Act 2006. They are also responsible for safeguarding the assets of the Bank and the Group and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

By order of the Board

Miller McLean
Secretary
31 March 2010

We, the directors listed, confirm that to the best of our knowledge:

- the financial statements, prepared in accordance with International Financial Reporting Standards, give a true and fair view of the assets, liabilities, financial position and profit or loss of the Bank and the undertakings included in the consolidation taken as a whole; and
- the Financial review, which is incorporated into the Directors' report, includes a fair review of the development and performance of the business and the position of the Bank and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face.

By order of the Board

Philip Hampton
Chairman

Stephen Hester
Group Chief Executive

Bruce Van Saun
Group Finance Director

31 March 2010

Board of directors

Chairman
Philip Hampton

Executive directors
Stephen Hester
Gordon Pell
Bruce Van Saun

Non-executive directors
Colin Buchan
Sandy Crombie
Penny Hughes
Archie Hunter
Joe MacHale
John McFarlane
Arthur 'Art' Ryan
Philip Scott

Independent auditors' report
to the members of The Royal Bank of Scotland plc

We have audited the financial statements of The Royal Bank of Scotland plc ("the Bank") and its subsidiaries (together the "Group") for the year ended 31 December 2009 which comprise the accounting policies, the balance sheets as at 31 December 2009, the consolidated income statement, the consolidated statement of comprehensive income, the statements of changes in equity and the cash flow statements for the year ended 31 December 2009, the related Notes 1 to 40 and the information identified as 'audited' in the Risk, capital and liquidity management section of the Financial Review. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRS) as adopted by the European Union, as applied in accordance with the provisions of the Companies Act 2006.

This report is made solely to the Bank's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the Bank's members those matters we are required to state to them in an auditors' report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Bank and the Bank's members as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of directors and auditors
As explained more fully in the statement of directors' responsibility, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view.

Our responsibility is to audit the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

Scope of the audit on the financial statements
An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: the reasonableness of significant accounting estimates made by the directors in the preparation of the financial statements; whether the accounting policies are appropriate to the circumstances of the Bank and the Group and have been consistently applied and adequately disclosed; and the overall presentation of the financial statements.

Opinion
In our opinion:
- the financial statements give a true and fair view of the state of the Group's and of the Bank's affairs as at 31 December 2009 and of the Group's profit for the year then ended;
- the Group and Bank's financial statements have been properly prepared in accordance with IFRS as adopted by the European Union; and
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the Group financial statements, Article 4 of the IAS Regulation.

Separate opinion in relation to IFRS as issued by the IASB
As explained in the accounting policies, the Group in addition to complying with its legal obligation to comply with IFRS as adopted by the European Union, has also complied with the IFRS as issued by the International Accounting Standards Board (IASB).

In our opinion the Group financial statements comply with IFRS as issued by the IASB.

Opinion on other matters prescribed by the Companies Act 2006
In our opinion the information given in the directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which we are required to report by exception
We have nothing to report in respect of the following:

Under the Companies Act 2006 we are required to report to you if, in our opinion:

- adequate accounting records have not been kept by the Bank, or returns adequate for our audit have not been received from branches not visited by us; or
- the Bank financial statements are not in agreement with the accounting records and returns; or
- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

Stephen Almond (Senior Statutory Auditor)
for and on behalf of Deloitte LLP
Chartered Accountants and Statutory Auditors
London, United Kingdom
31 March 2010

Consolidated income statement
for the year ended 31 December 2009

	Note	2009 £m	Restated 2008 £m	2007 £m
Interest receivable		21,160	31,413	28,310
Interest payable		(9,617)	(17,904)	(17,194)
Net interest income	1	11,543	13,509	11,116
Fees and commissions receivable		7,734	7,483	7,519
Fees and commissions payable		(1,972)	(1,733)	(1,496)
Income/(loss) from trading activities		3,007	(5,583)	1,142
Gain on redemption of own debt		2,694	—	—
Other operating income		1,537	2,181	4,026
Non-interest income	2	13,000	2,348	11,191
Total income		24,543	15,857	22,307
Staff costs – excluding curtailment gains		(7,738)	(6,142)	(6,181)
– pension schemes curtailment gains		2,148	—	—
Premises and equipment		(1,983)	(1,760)	(1,521)
Other administrative expenses		(3,094)	(2,759)	(2,147)
Depreciation and amortisation		(1,587)	(1,562)	(1,438)
Write-down of goodwill and other intangible assets		(118)	(8,144)	—
Operating expenses	3	(12,372)	(20,367)	(11,287)
Profit/(loss) before impairment losses		12,171	(4,510)	11,020
Impairment losses	11	(12,174)	(4,706)	(1,865)
Operating (loss)/profit before tax		(3)	(9,216)	9,155
Tax credit/(charge)	6	523	505	(1,903)
Profit/(loss) for the year		520	(8,711)	7,252
Profit/(loss) attributable to:				
Minority interests	24	235	208	53
Preference shareholders	7	523	638	331
Ordinary shareholders		(238)	(9,557)	6,868
		520	(8,711)	7,252

The accompanying notes on pages 115 to 194, the accounting policies on pages 104 to 114 and the audited sections of the 'Financial review: Risk, capital and liquidity management' on pages 39 to 92 form an integral part of these financial statements.

Consolidated statement of comprehensive income

for the year ended 31 December 2009

	Note	2009 £m	Restated 2008 £m	2007 £m
Profit/(loss) for the year		520	(8,711)	7,252
Other comprehensive income:				
Available-for-sale financial assets		2,434	(2,596)	46
Cash flow hedges		850	(276)	(549)
Currency translation		(1,584)	4,968	9
Actuarial (losses)/gains on defined benefit plans	4	(3,676)	(1,716)	2,153
Other comprehensive (loss)/income before tax		(1,976)	380	1,659
Tax		30	1,627	(449)
Other comprehensive (loss)/income after tax		(1,946)	2,007	1,210
Total comprehensive (loss)/income for the year		(1,426)	(6,704)	8,462
Total comprehensive (loss)/income recognised in the statement of changes in equity is attributable as follows:				
Minority interests		109	552	42
Preference shareholders		523	638	331
Ordinary shareholders		(2,058)	(7,894)	8,089
		(1,426)	(6,704)	8,462

The accompanying notes on pages 115 to 194, the accounting policies on pages 104 to 114 and the audited sections of the 'Financial review: Risk, capital and liquidity management' on pages 39 to 92 form an integral part of these financial statements.

Balance sheets

at 31 December 2009

		Group			Bank		
	Note	2009 £m	2008 £m	2007 £m	2009 £m	2008 £m	2007 £m
Assets							
Cash and balances at central banks	10	27,060	6,806	5,559	21,099	3,714	3,333
Loans and advances to banks	10	68,441	79,387	96,346	77,365	91,717	91,982
Loans and advances to customers	10	536,169	619,503	551,449	338,548	327,040	329,147
Debt securities subject to repurchase agreements	27	65,589	75,660	75,001	30,070	70,206	30,633
Other debt securities		119,592	102,106	89,431	184,528	89,492	76,617
Debt securities	13	185,181	177,766	164,432	214,598	159,698	107,250
Equity shares	14	2,405	2,691	5,509	1,025	1,020	4,019
Investments in Group undertakings	15	—	—	—	29,385	26,814	22,210
Settlement balances		9,153	10,871	5,326	4,159	5,335	2,046
Derivatives	12	446,353	937,457	205,975	450,913	938,505	207,913
Intangible assets	16	11,814	12,591	17,761	210	136	295
Property, plant and equipment	17	17,309	16,628	13,025	2,447	2,368	2,116
Deferred taxation	22	2,228	2,833	240	1,728	1,323	319
Prepayments, accrued income and other assets	18	12,665	11,397	6,116	9,988	5,930	1,680
Assets of disposal groups	19	14,203	—	—	7,150	—	—
Total assets		1,332,981	1,877,930	1,071,738	1,158,615	1,563,600	772,310
Liabilities							
Deposits by banks	10	116,138	181,982	151,508	188,548	201,266	196,968
Customer accounts	10	453,302	453,129	442,982	289,792	229,266	197,926
Debt securities in issue	10	172,413	179,942	130,132	129,814	115,149	79,877
Settlement balances and short positions	20	44,394	45,957	53,849	28,352	29,361	33,677
Derivatives	12	424,544	909,105	203,072	430,005	911,174	204,234
Accruals, deferred income and other liabilities	21	16,474	16,685	12,167	9,949	9,618	5,783
Retirement benefit liabilities	4	2,622	1,446	334	16	23	11
Deferred taxation	22	1,187	2,483	2,063	—	—	—
Subordinated liabilities	23	34,717	39,951	27,796	30,513	33,698	22,745
Liabilities of disposal groups	19	10,993	—	—	6,108	—	—
Total liabilities		1,276,784	1,830,680	1,023,903	1,113,097	1,529,555	741,221
Minority interests	24	1,146	1,292	152	—	—	—
Equity owners	25	55,051	45,958	47,683	45,518	34,045	31,089
Total equity		56,197	47,250	47,835	45,518	34,045	31,089
Total liabilities and equity		1,332,981	1,877,930	1,071,738	1,158,615	1,563,600	772,310

The accompanying notes on pages 115 to 194, the accounting policies on pages 104 to 114 and the audited sections of the 'Financial review: Risk, capital and liquidity management' on pages 39 to 92 form an integral part of these financial statements.

The accounts were approved by the Board of directors on 31 March 2010 and signed on its behalf by:

Philip Hampton
Chairman

Stephen Hester
Group Chief Executive

Bruce Van Saun
Group Finance Director

The Royal Bank of Scotland plc
Registration No. SC90312

Statements of changes in equity

for the year ended 31 December 2009

	Group			Bank		
	2009 £m	Restated 2008 £m	2007 £m	2009 £m	Restated 2008 £m	2007 £m
Called-up share capital						
At 1 January	6,483	5,483	5,482	6,483	5,483	5,482
Ordinary shares issued during the year	128	1,000	1	128	1,000	1
Preference shares redeemed during the year	(2)	—	—	(2)	—	—
At 31 December	6,609	6,483	5,483	6,609	6,483	5,483
Share premium account						
At 1 January	25,175	16,175	12,526	25,175	16,175	12,526
Ordinary shares issued during the year	8,023	9,000	3,649	8,023	9,000	3,649
Preference shares redeemed during the year	(7,823)	—	—	(7,823)	—	—
At 31 December	25,375	25,175	16,175	25,375	25,175	16,175
Merger reserve						
At 1 January and 31 December	10,881	10,881	10,881	—	—	—
Available-for-sale reserve						
At 1 January	(1,893)	(35)	(65)	(1,755)	72	52
Unrealised gains/(losses) in the year	1,937	(2,585)	511	1,455	(2,592)	249
Realised losses/(gains) in the year	497	(11)	(465)	534	49	(231)
Taxation	(709)	738	(16)	(558)	716	2
At 31 December	(168)	(1,893)	(35)	(324)	(1,755)	72
Cash flow hedging reserve						
At 1 January	(723)	(511)	(142)	683	(211)	(260)
Amount recognised in equity during the year	339	(461)	(408)	(308)	1,292	60
Amount transferred from equity to earnings in the year	511	185	(141)	226	(54)	25
Taxation	(256)	64	180	17	(344)	(36)
At 31 December	(129)	(723)	(511)	618	683	(211)
Foreign exchange reserve						
At 1 January	4,203	(782)	(833)	(328)	3	(2)
Retranslation of net assets	(1,842)	7,254	287	23	(331)	5
Foreign currency gains/(losses) on hedges of net assets	384	(2,630)	(267)	—	—	—
Taxation	(23)	361	31	—	—	—
At 31 December	2,722	4,203	(782)	(305)	(328)	3
Retained earnings						
At 1 January	1,832	16,472	10,087	3,787	9,567	4,633
Profit/(loss) attributable to ordinary and equity preference shareholders	285	(8,919)	7,199	(540)	(1,309)	7,255
Ordinary dividends paid	(2,000)	(4,000)	(2,000)	(2,000)	(4,000)	(2,000)
Equity preference dividends paid	(523)	(638)	(331)	(523)	(638)	(331)
Actuarial (losses)/gains recognised in retirement benefit schemes						
– gross	(3,676)	(1,716)	2,153	(5)	(2)	2
– taxation	1,018	464	(644)	1	—	—
Capital contribution	12,500	—	—	12,500	—	—
Share-based payments						
– gross	325	177	65	325	177	65
– taxation	—	(8)	(57)	—	(8)	(57)
At 31 December	9,761	1,832	16,472	13,545	3,787	9,567
Owners' equity at 31 December	55,051	45,958	47,683	45,518	34,045	31,089

Statements of changes in equity continued

for the year ended 31 December 2009

	Group			Bank		
	2009 £m	Restated 2008 £m	2007 £m	2009 £m	Restated 2008 £m	2007 £m
Minority interests						
At 1 January	1,292	152	396	—	—	—
Currency translation adjustments and other movements	(126)	344	(11)	—	—	—
Profit attributable to minority interests	235	208	53	—	—	—
Dividends paid	(261)	(84)	(31)	—	—	—
Equity raised	9	812	—	—	—	—
Equity withdrawn and disposals	(3)	(140)	(255)	—	—	—
At 31 December	1,146	1,292	152	—	—	—
Total equity at 31 December	56,197	47,250	47,835	45,518	34,045	31,089

Total comprehensive (loss)/income recognised in the statement of changes in equity is attributable as follows:

	Group 2009 £m	Group Restated 2008 £m	Group 2007 £m	Bank 2009 £m	Bank Restated 2008 £m	Bank 2007 £m
Minority interests	109	552	42	—	—	—
Preference shareholders	523	638	331	523	638	331
Ordinary shareholders	(2,058)	(7,894)	8,089	322	(3,213)	7,000
	(1,426)	(6,704)	8,462	845	(2,575)	7,331

The accompanying notes on pages 115 to 194, the accounting policies on pages 104 to 114 and the audited sections of the 'Financial review: Risk, capital and liquidity management' on pages 39 to 92 form an integral part of these financial statements.

Cash flow statements
for the year ended 31 December 2009

		Group			Bank		
	Note	2009 £m	Restated 2008 £m	2007 £m	2009 £m	Restated 2008 £m	2007 £m
Operating activities							
Operating (loss)/profit before tax		(3)	(9,216)	9,155	(1,142)	(2,373)	7,759
Adjustments for:							
Depreciation and amortisation		1,587	1,562	1,438	495	483	485
Write-down of goodwill and other intangible assets		118	8,144	—	—	215	—
Interest on subordinated liabilities		959	1,694	1,452	672	1,487	1,200
Charge for defined benefit pension schemes		389	351	479	(4)	8	5
Pension scheme curtailment gains		(2,148)	—	—	(1,603)	—	—
Cash contribution to defined benefit pension schemes		(744)	(491)	(536)	(1)	(8)	(16)
Gain on redemption of own debt		(2,694)	—	—	(2,255)	—	—
Elimination of foreign exchange differences		5,715	(20,997)	(2,137)	3,623	(16,892)	(2,034)
Other non-cash items		7,252	5,074	(833)	2,700	5,004	(575)
Net cash inflow/(outflow) from trading activities		10,431	(13,879)	9,018	2,485	(12,076)	6,824
Changes in operating assets and liabilities		5,498	2,845	6,869	47,357	41,418	8,578
Net cash flows from operating activities before tax		15,929	(11,034)	15,887	49,842	29,342	15,402
Income taxes (paid)/received		(785)	(886)	(1,802)	2	83	(526)
Net cash flows from operating activities	30	15,144	(11,920)	14,085	49,844	29,425	14,876
Investing activities							
Sale and maturity of securities		62,263	37,877	23,775	55,257	30,455	17,268
Purchase of securities		(67,751)	(50,360)	(26,160)	(104,885)	(80,693)	(20,726)
Sale of property, plant and equipment		1,590	2,363	5,596	77	90	857
Purchase of property, plant and equipment		(4,255)	(5,153)	(3,886)	(385)	(719)	(449)
Net investment in business interests and intangible assets	31	(397)	(908)	(430)	(3,125)	(3,264)	(590)
Net cash flows from investing activities		(8,550)	(16,181)	(1,105)	(53,061)	(54,131)	(3,640)
Financing activities							
Issue of ordinary shares		8,151	10,000	—	8,151	10,000	—
Issue of equity preference shares		—	—	3,650	—	—	3,650
Issue of subordinated liabilities		5,000	5,055	1,018	5,000	5,055	968
Proceeds of minority interests issued		9	812	—	—	—	—
Capital contribution		12,500	—	—	12,500	—	—
Redemption of preference shares		(7,825)	—	—	(7,825)	—	—
Redemption of minority interests		(3)	(140)	(247)	—	—	—
Repayment of subordinated liabilities		(3,200)	(1,035)	(1,708)	(2,235)	(1,035)	(1,288)
Dividends paid		(2,784)	(4,722)	(2,362)	(2,523)	(4,638)	(2,331)
Interest on subordinated liabilities		(1,151)	(1,511)	(1,431)	(822)	(1,325)	(1,173)
Net cash flows from financing activities		10,697	8,459	(1,080)	12,246	8,057	(174)
Effects of exchange rate changes on cash and cash equivalents		(4,767)	15,295	2,714	(3,762)	12,849	2,601
Net increase/(decrease) in cash and cash equivalents		12,524	(4,347)	14,614	5,267	(3,800)	13,663
Cash and cash equivalents at 1 January		80,414	84,761	70,147	73,449	77,249	63,586
Cash and cash equivalents at 31 December	34	92,938	80,414	84,761	78,716	73,449	77,249

The accompanying notes on pages 115 to 194, the accounting policies on pages 104 to 114 and the audited sections of the 'Financial review: Risk, capital and liquidity management' on pages 39 to 92 form an integral part of these financial statements.

Accounting policies

1. Presentation of accounts

The accounts are prepared on a going concern basis (see page 94 of the Report of the directors) and in accordance with International Financial Reporting Standards issued by the International Accounting Standards Board (IASB) and interpretations issued by the International Financial Reporting Interpretations Committee of the IASB as adopted by the European Union (EU) (together IFRS). The EU has not adopted the complete text of IAS 39 ‘Financial Instruments: Recognition and Measurement’; it has relaxed some of the Standard’s hedging requirements. The Group has not taken advantage of this relaxation and has adopted IAS 39 as issued by the IASB: the Group’s financial statements are prepared in accordance with IFRS as issued by the IASB.

IAS 1 (Revised 2007) ‘Presentation of Financial Statements’ has introduced a number of changes in the format and content of the Group’s financial statements including a statement of changes in equity (showing the components of changes in equity for the period) as a primary financial statement and a statement of comprehensive income immediately following the income statement. Additionally, the revised standard has required the Group to present a third balance sheet (31 December 2007) as a result of the restatement of the Group’s 2008 income statement following the amendment to IFRS 2 (see below).

The IASB issued an amendment, 'Vesting Conditions and Cancellations', to IFRS 2 'Share-based Payment' in January 2008 that changed the accounting for share awards that have non-vesting conditions. The fair value of these awards did not take account of the effect of non-vesting conditions and where such conditions were not subsequently met, costs recognised up to the date of cancellation were reversed. The amendment requires costs not recognised up to the date of cancellation to be recognised immediately. Retrospective application of the amendment caused a restatement of 2008 results for the Group and Bank, reducing profit by £169 million with no material effect on earlier periods; there was no effect on the balance sheet.

The Group has adopted ‘Improving Disclosures about Financial Instruments (Amendments to IFRS 7 Financial Instruments: Disclosures)’. These amendments expand the disclosures required about fair value measurement and liquidity risk.

The Bank is incorporated in the UK and registered in Scotland. The accounts are prepared on the historical cost basis except that the following assets and liabilities are stated at their fair value: derivative financial instruments, held-for-trading financial assets and financial liabilities, financial assets and financial liabilities that are designated as at fair value through profit or loss, available-for-sale financial assets and investment property. Recognised financial assets and financial liabilities in fair value hedges are adjusted for changes in fair value in respect of the risk that is hedged.

The Bank accounts are presented in accordance with the Companies Act 2006.

2. Basis of consolidation

The consolidated financial statements incorporate the financial statements of the Bank and entities (including certain special purpose entities) that are controlled by the Group. Control exists where the Group has the power to govern the financial and operating policies of the entity; generally conferred by holding a majority of voting rights. On acquisition of a subsidiary, its identifiable assets, liabilities and contingent liabilities are included in the consolidated accounts at their fair value. Any excess of the cost (the fair value of assets given, liabilities incurred or assumed and equity instruments issued by the Group plus any directly attributable costs) of an acquisition over the fair value of the net assets acquired is recognised as goodwill. The interest of minority shareholders is stated at their share of the fair value of the subsidiary’s net assets.

The results of subsidiaries acquired are included in the consolidated income statement from the date control passes until the Group ceases to control them through a sale or significant change in circumstances.

All intra-group balances, transactions, income and expenses are eliminated on consolidation. The consolidated accounts are prepared using uniform accounting policies.

3. Revenue recognition

Interest income on financial assets that are classified as loans and receivables, available-for-sale or held-to-maturity and interest expense on financial liabilities other than those at fair value through profit or loss are determined using the effective interest method. The effective interest method is a method of calculating the amortised cost of a financial asset or financial liability (or group of financial assets or liabilities) and of allocating the interest income or interest expense over the expected life of the asset or liability. The effective interest rate is the rate that exactly discounts estimated future cash flows to the instrument’s initial carrying amount. Calculation of the effective interest rate takes into account fees payable or receivable, that are an integral part of the instrument’s yield, premiums or discounts on acquisition or issue, early redemption fees and transaction costs. All contractual terms of a financial instrument are considered when estimating future cash flows.

Financial assets and financial liabilities held-for-trading or designated as at fair value through profit or loss are recorded at fair value. Changes in fair value are recognised in profit or loss together with dividends and interest receivable and payable.

Commitment and utilisation fees are determined as a percentage of the outstanding facility. If it is unlikely that a specific lending arrangement will be entered into, such fees are taken to profit or loss over the life of the facility otherwise they are deferred and included in the effective interest rate on the advance.

Fees in respect of services are recognised as the right to consideration accrues through the provision of the service to the customer. The arrangements are generally contractual and the cost of providing the service is incurred as the service is rendered. The price is usually fixed and always determinable. The application of this policy to significant fee types is outlined below.

Payment services: this comprises income received for payment services including cheques cashed, direct debits, Clearing House Automated Payments (the UK electronic settlement system) and BACS payments (the automated clearing house that processes direct debits and direct credits). These are generally charged on a per transaction basis. The income is earned when the payment or transaction occurs. Charges for payment services are usually debited to the customer's account, monthly or quarterly in arrears. Accruals are raised for services provided but not charged at period end.

Card related services: fees from credit card business include:

- Commission received from retailers for processing credit and debit card transactions: income is accrued to the income statement as the service is performed;

- Interchange received: as issuer, the Group receives a fee (interchange) each time a cardholder purchases goods and services. The Group also receives interchange fees from other card issuers for providing cash advances through its branch and Automated Teller Machine networks. These fees are accrued once the transaction has taken place; and

- An annual fee payable by a credit card holder is deferred and taken to profit or loss over the period of the service i.e. 12 months.

Insurance brokerage: this is made up of fees and commissions received from the agency sale of insurance. Commission on the sale of an insurance contract is earned at the inception of the policy, as the insurance has been arranged and placed. However, provision is made where commission is refundable in the event of policy cancellation in line with estimated cancellations.

Investment management fees: fees charged for managing investments are recognised as revenue as the services are provided. Incremental costs that are directly attributable to securing an investment management contract are deferred and charged as expense as the related revenue is recognised.

4. Assets held for sale and discontinued operations

A non-current asset (or disposal group) is classified as held for sale if the Group will recover the carrying amount principally through a sale transaction rather than through continuing use. A non-current asset (or disposal group) classified as held for sale is measured at the lower of its carrying amount and fair value less costs to sell. If the asset (or disposal group) is acquired as part of a business combination it is initially measured at fair value less costs to sell. Assets and liabilities of disposal groups classified as held for sale and non-current assets classified as held for sale are shown separately on the face of the balance sheet.

The results of discontinued operations are shown as a single amount on the face of the income statement comprising the post-tax profit or loss of discontinued operations and the post-tax gain or loss recognised either on measurement to fair value less costs to sell or on the disposal of the discontinued operation. A discontinued operation is a cash-generating unit or a group of cash-generating units that either has been disposed of, or is classified as held for sale, and (a) represents a separate major line of business or geographical area of operations, (b) is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations or (c) is a subsidiary acquired exclusively with a view to resale.

5. Pensions and other post-retirement benefits

The Group provides post-retirement benefits in the form of pensions and healthcare plans to eligible employees.

For defined benefit schemes, scheme liabilities are measured on an actuarial basis using the projected unit credit method and discounted at a rate that reflects the current rate of return on a high quality corporate bond of equivalent term and currency to the scheme liabilities. Scheme assets are measured at their fair value. Any surplus or deficit of scheme assets over liabilities is recognised in the balance sheet as an asset (surplus) or liability (deficit). The current service cost, curtailments and any past service costs together with the expected return on scheme assets less the unwinding of the discount on the scheme liabilities is charged to operating expenses. Actuarial gains and losses are recognised in full in the period in which they occur outside profit or loss and presented in the consolidated statement of comprehensive income. Contributions to defined contribution pension schemes are recognised in the income statement when payable.

6. Intangible assets and goodwill

Intangible assets that are acquired by the Group are stated at cost less accumulated amortisation and impairment losses. Amortisation is charged to profit or loss over the assets' estimated economic lives using methods that best reflect the pattern of economic benefits and is included in depreciation and amortisation. The estimated useful economic lives are as follows:

Core deposit intangibles	6 to 10 years
Other acquired intangibles	5 to 10 years
Computer software	3 to 5 years

Expenditure on internally generated goodwill and brands is written-off as incurred. Direct costs relating to the development of internal-use computer software are capitalised once technical feasibility and economic viability have been established. These costs include payroll, the costs of materials and services, and directly attributable overheads. Capitalisation of costs ceases when the software is capable of operating as intended. During and after development, accumulated costs are reviewed for impairment against the projected benefits that the software is expected to generate. Costs incurred prior to the establishment of technical feasibility and economic viability are expensed as incurred as are all training costs and general overheads. The costs of licences to use computer software that are expected to generate economic benefits beyond one year are also capitalised.

Acquired goodwill, being the excess of the cost of an acquisition over the Group's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities of the subsidiary, associate or joint venture acquired, is initially recognised at cost and subsequently at cost less any accumulated impairment losses. Goodwill arising on the acquisition of subsidiaries and joint ventures is included in the balance sheet category 'Intangible assets' and that on associates within their carrying amounts. The gain or loss on the disposal of a subsidiary, associate or joint venture includes the carrying value of any related goodwill.

7. Property, plant and equipment

Items of property, plant and equipment (except investment property – see accounting policy 9) are stated at cost less accumulated depreciation and impairment losses. Where an item of property, plant and equipment comprises major components having different useful lives, they are accounted for separately.

Depreciation is charged to profit or loss on a straight-line basis so as to write-off the depreciable amount of property, plant and equipment (including assets owned and let on operating leases) over their estimated useful lives.

The depreciable amount is the cost of an asset less its residual value. Land is not depreciated. Estimated useful lives are as follows:

Freehold and long leasehold buildings	50 years
Short leaseholds	unexpired period of the lease
Property adaptation costs	10 to 15 years
Computer equipment	up to 5 years
Other equipment	4 to 15 years

8. Impairment of intangible assets and property, plant and equipment

At each reporting date, the Group assesses whether there is any indication that its intangible assets, or property, plant and equipment are impaired. If any such indication exists, the Group estimates the recoverable amount of the asset and the impairment loss if any. Goodwill is tested for impairment annually or more frequently if events or changes in circumstances indicate that it might be impaired. If an asset does not generate cash flows that are independent from those of other assets or groups of assets, recoverable amount is determined for the cash-generating unit to which the asset belongs. The recoverable amount of an asset is the higher of its fair value less cost to sell and its value in use. Value in use is the present value of future cash flows from the asset or cash-generating unit discounted at a rate that reflects market interest rates adjusted for risks specific to the asset or cash-generating unit that have not been reflected in the estimation of future cash flows. If the recoverable amount of an intangible or tangible asset is less than its carrying value, an impairment loss is recognised immediately in profit or loss and the carrying value of the asset reduced by the amount of the loss. A reversal of an impairment loss on intangible assets (excluding goodwill) or property, plant and equipment is recognised as it arises provided the increased carrying value does not exceed that which it would have been had no impairment loss been recognised. Impairment losses on goodwill are not reversed.

9. Investment property

Investment property comprises freehold and leasehold properties that are held to earn rentals or for capital appreciation or both. It is not depreciated but is stated at fair value based on valuations by independent registered valuers. Fair value is based on current prices for similar properties in the same location and condition. Any gain or loss arising from a change in fair value is recognised in profit or loss. Rental income from investment property is recognised on a straight-line basis over the term of the lease. Lease incentives granted are recognised as an integral part of the total rental income.

10. Foreign currencies

The Group's consolidated financial statements are presented in sterling which is the functional currency of the Bank.

Transactions in foreign currencies are translated into sterling at the foreign exchange rate ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated into sterling at the rates of exchange ruling at the balance sheet date.

Foreign exchange differences arising on translation are reported in income from trading activities except for differences arising on cash flow hedges and hedges of net investments in foreign operations. Non-monetary items denominated in foreign currencies that are stated at fair value are translated into sterling at foreign exchange rates ruling at the dates the values were determined. Translation differences arising on non-monetary items measured at fair value are recognised in profit or loss except for differences arising on available-for-sale non-monetary financial assets, for example equity shares, which are included in the available-for-sale reserve in equity unless the asset is the hedged item in a fair value hedge.

The assets and liabilities of foreign operations, including goodwill and fair value adjustments arising on acquisition, are translated into sterling at foreign exchange rates ruling at the balance sheet date. The revenues and expenses of foreign operations are translated into sterling at average exchange rates unless these do not approximate to the foreign exchange rates ruling at the dates of the transactions. Foreign exchange differences arising on the translation of a foreign operation are recognised directly in equity and included in profit or loss on its disposal.

11. Leases

Contracts to lease assets are classified as finance leases if they transfer substantially all the risks and rewards of ownership of the asset to the customer. Other contracts to lease assets are classified as operating leases.

Finance lease receivables are stated in the balance sheet at the amount of the net investment in the lease being the minimum lease payments and any unguaranteed residual value discounted at the interest rate implicit in the lease. Finance lease income is allocated to accounting periods so as to give a constant periodic rate of return before tax on the net investment. Unguaranteed residual values are subject to regular review to identify potential impairment. If there has been a reduction in the estimated unguaranteed residual value, the income allocation is revised and any reduction in respect of amounts accrued is recognised immediately.

Rental income from operating leases is credited to the income statement on a receivable basis over the term of the lease. Operating lease assets are included within Property, plant and equipment and depreciated over their useful lives (see accounting policy 7).

12. Provisions

The Group recognises a provision for a present obligation resulting from a past event when it is more likely than not that it will be required to transfer economic benefits to settle the obligation and the amount of the obligation can be estimated reliably.

Provision is made for restructuring costs, including the costs of redundancy, when the Group has a constructive obligation to restructure. An obligation exists when the Group has a detailed formal plan for the restructuring and has raised a valid expectation in those affected by starting to implement the plan or announcing its main features.

If the Group has a contract that is onerous, it recognises the present obligation under the contract as a provision. An onerous contract is one where the unavoidable costs of meeting the obligations under it exceed the expected economic benefits. When the Group vacates a leasehold property, a provision is recognised for the costs under the lease less any expected economic benefits (such as rental income).

Contingent liabilities are possible obligations arising from past events whose existence will be confirmed only by uncertain future events or present obligations arising from past events that are not recognised because either an outflow of economic benefits is not probable or the amount of the obligation cannot be reliably measured. Contingent liabilities are not recognised but information about them is disclosed unless the possibility of any outflow of economic benefits in settlement is remote.

13. Taxation

Provision is made for taxation at current enacted rates on taxable profits, arising in income or in equity, taking into account relief for overseas taxation where appropriate. Deferred taxation is accounted for in full for all temporary differences between the carrying amount of an asset or liability for accounting purposes and its carrying amount for tax purposes, except in relation to overseas earnings where remittance is controlled by the Group, and goodwill.

Deferred tax assets are only recognised to the extent that it is probable that they will be recovered.

14. Financial assets

On initial recognition, financial assets are classified into held-to-maturity investments; available-for-sale financial assets; held-for-trading; designated as at fair value through profit or loss; or loans and receivables.

Held-to-maturity investments – a financial asset may be classified as a held-to-maturity investment only if it has fixed or determinable payments, a fixed maturity and the Group has the positive intention and ability to hold to maturity. Held-to-maturity investments are initially recognised at fair value plus directly related transaction costs. They are subsequently measured at amortised cost using the effective interest method (see accounting policy 3) less any impairment losses.

Held-for-trading – a financial asset is classified as held-for-trading if it is acquired principally for sale in the near term, or forms part of a portfolio of financial instruments that are managed together and for which there is evidence of short-term profit taking, or it is a derivative (not in a qualifying hedge relationship). Held-for-trading financial assets are recognised at fair value with transaction costs being recognised in profit or loss. Subsequently they are measured at fair value. Gains and losses on held-for-trading financial assets are recognised in profit or loss as they arise.

Designated as at fair value through profit or loss – financial assets may be designated as at fair value through profit or loss only if such designation (a) eliminates or significantly reduces a measurement or recognition inconsistency; or (b) applies to a group of financial assets, financial liabilities or both that the Group manages and evaluates on a fair value basis; or (c) relates to an instrument that contains an embedded derivative which is not evidently closely related to the host contract.

Financial assets that the Group designates on initial recognition as being at fair value through profit or loss are recognised at fair value, with transaction costs being recognised in profit or loss, and are subsequently measured at fair value. Gains and losses on financial assets that are designated as at fair value through profit or loss are recognised in profit or loss as they arise.

The Group has designated financial assets as at fair value through profit or loss principally: (a) where the assets are economically hedged by derivatives and fair value designation eliminates the measurement inconsistency that would arise if the assets were carried at amortised cost or classified as available-for-sale and (b) financial assets held in the Group's venture capital portfolio managed on a fair value basis.

Loans and receivables – non-derivative financial assets with fixed or determinable repayments that are not quoted in an active market are classified as loans and receivables, except those that are classified as available-for-sale or as held-for-trading, or designated as at fair value through profit or loss. Loans and receivables are initially recognised at fair value plus directly related transaction costs. They are subsequently measured at amortised cost using the effective interest method (see accounting policy 3) less any impairment losses.

Available-for-sale – financial assets that are not classified as held-to-maturity; held-for-trading; designated as at fair value through profit or loss; or loans and receivables, are classified as available-for-sale. Financial assets can be designated as available-for-sale on initial recognition. Available-for-sale financial assets are initially recognised at fair value plus directly related transaction costs. They are subsequently measured at fair value. Unquoted equity investments whose fair value cannot be measured reliably are carried at cost and classified as available-for-sale financial assets. Impairment losses and exchange differences resulting from retranslating the amortised cost of foreign currency monetary available-for-sale financial assets are recognised in profit or loss together with interest calculated using the effective interest method (see accounting policy 3). Other changes in the fair value of available-for-sale financial assets are reported in a separate component of shareholders' equity until disposal, when the cumulative gain or loss is recognised in profit or loss.

Reclassifications – held-for-trading and available-for-sale financial assets that meet the definition of loans and receivables (non-derivative financial assets with fixed or determinable payments that are not quoted in an active market) may be reclassified to loans and receivables if the Group has the intention and ability to hold the financial asset for the foreseeable future or until maturity. The Group typically regards the foreseeable future as twelve months from the date of reclassification. Additionally, held-for-trading financial assets that do not meet the definition of loans and receivables may, in rare circumstances, be transferred to available-for-sale financial assets or to held-to-maturity investments. Reclassifications are made at fair value. This fair value becomes the asset's new cost or amortised cost as appropriate. Gains and losses recognised up to the date of reclassification are not reversed.

Regular way purchases of financial assets classified as loans and receivables are recognised on settlement date; issues of equity or financial liabilities measured at amortised cost are recognised on settlement date; all other regular way transactions in financial instruments are recognised on trade date.

Fair value for a net open position in a financial asset that is quoted in an active market is the current bid price times the number of units of the instrument held. Fair values for financial assets not quoted in an active market are determined using appropriate valuation techniques including discounting future cash flows, option pricing models and other methods that are consistent with accepted economic methodologies for pricing financial assets.

15. Impairment of financial assets

The Group assesses at each balance sheet date whether there is any objective evidence that a financial asset or group of financial assets classified as held-to-maturity, available-for-sale or loans and receivables is impaired. 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 have adversely affected the amount or timing of future cash flows from the asset.

Financial assets carried at amortised cost – if there is objective evidence that an impairment loss on a financial asset or group of financial assets classified as loans and receivables or as held-to-maturity investments has been incurred, the Group measures the amount of the loss as the difference between the carrying amount of the asset or group of assets and the present value of estimated future cash flows from the asset or group of assets discounted at the effective interest rate of the instrument at initial recognition.

Impairment losses are assessed individually for financial assets that are individually significant and individually or collectively for assets that are not individually significant. In making collective assessment of impairment, financial assets are grouped into portfolios on the basis of similar risk characteristics. Future cash flows from these portfolios are estimated on the basis of the contractual cash flows and historical loss experience for assets with similar credit risk characteristics. Historical loss experience is adjusted, on the basis of observable data, to reflect current conditions not affecting the period of historical experience.

Impairment losses are recognised in profit or loss and the carrying amount of the financial asset or group of financial assets reduced by establishing an allowance for impairment losses. If, in a subsequent period, the amount of the impairment loss reduces and the reduction can be ascribed to an event after the impairment was recognised, the previously recognised loss is reversed by adjusting the allowance. Once an impairment loss has been recognised on a financial asset or group of financial assets, interest income is recognised on the carrying amount using the rate of interest at which estimated future cash flows were discounted in measuring impairment.

Impaired loans and receivables are written off, i.e. the impairment provision is applied in writing down the loan's carrying value partially or in full, when the Group concludes that there is no longer any realistic prospect of recovery of part or all of the loan. For portfolios that are collectively assessed for impairment, the timing of write off principally reflects historic recovery experience for each portfolio. For loans that are individually assessed for impairment, the timing of write off is determined on a case-by-case basis. Such loans are reviewed regularly and write offs will be prompted by bankruptcy, insolvency, restructuring and similar events. Amounts recovered after a loan has been written off are credited to the loan impairment charge for the period in which they are received.

Financial assets carried at fair value – when a decline in the fair value of a financial asset classified as available-for-sale has been recognised directly in equity and there is objective evidence that the asset is impaired, the cumulative loss is removed from equity and recognised in profit or loss. The loss is measured as the difference between the amortised cost of the financial asset and its current fair value. Impairment losses on available-for-sale equity instruments are not reversed through profit or loss, but those on available-for-sale debt instruments are reversed, if there is an increase in fair value that is objectively related to a subsequent event.

16. Financial liabilities

On initial recognition financial liabilities are classified into held-for-trading; designated as at fair value through profit or loss; or amortised cost.

Held-for-trading – a financial liability is classified as held-for-trading if it is incurred principally for the repurchase in the near term, or forms part of a portfolio of financial instruments that are managed together and for which there is evidence of short-term profit taking, or it is a derivative (not in a qualifying hedge relationship). Held-for-trading financial liabilities are recognised at fair value with transaction costs being recognised in profit or loss. Subsequently they are measured at fair value. Gains and losses are recognised in profit or loss as they arise.

Designated as at fair value through profit or loss – financial liabilities may be designated as at fair value through profit or loss only if such designation (a) eliminates or significantly reduces a measurement or recognition inconsistency; or (b) applies to a group of financial assets, financial liabilities or both that the Group manages and evaluates on a fair value basis; or (c) relates to an instrument that contains an embedded derivative which is not evidently closely related to the host contract.

Financial liabilities that the Group designates on initial recognition as being at fair value through profit or loss are recognised at fair value, with transaction costs being recognised in profit or loss, and are subsequently measured at fair value. Gains and losses on financial liabilities that are designated as at fair value through profit or loss are recognised in profit or loss as they arise.

The principal categories of financial liabilities designated as at fair value through profit or loss are structured liabilities issued by the Group: designation significantly reduces the measurement inconsistency between these liabilities and the related derivatives carried at fair value.

Amortised cost – all other financial liabilities are measured at amortised cost using the effective interest method (see accounting policy 3).

Fair value for a net open position in a financial liability that is quoted in an active market is the current offer price times the number of units of the instrument held or issued. Fair values for financial liabilities not quoted in an active market are determined using appropriate valuation techniques including discounting future cash flows, option pricing models and other methods that are consistent with accepted economic methodologies for pricing financial liabilities.

17. Financial guarantee contracts

Under a financial guarantee contract, the Group, in return for a fee, undertakes to meet a customer's obligations under the terms of a debt instrument if the customer fails to do so. A financial guarantee is recognised as a liability; initially at fair value and, if not designated as at fair value through profit or loss, subsequently at the higher of its initial value less cumulative amortisation and any provision under the contract measured in accordance with accounting policy 12 Provisions. Amortisation is calculated so as to recognise fees receivable in profit or loss over the period of the guarantee.

18. Loan commitments

Provision is made for loan commitments, other than those classified as held-for-trading, if it is probable that the facility will be drawn and the resulting loan will be recognised at a value less than the cash advanced. Syndicated loan commitments in excess of the level of lending under the commitment approved for retention by the Group are classified as held-for-trading and measured at fair value.

19. Derecognition

A financial asset is derecognised when it has been transferred and the transfer qualifies for derecognition. A transfer requires that the Group either: (a) transfers the contractual rights to receive the asset's cash flows; or (b) retains the right to the asset's cash flows but assumes a contractual obligation to pay those cash flows to a third party. After a transfer, the Group assesses the extent to which it has retained the risks and rewards of ownership of the transferred asset. If substantially all the risks and rewards have been retained, the asset remains on the balance sheet. If substantially all the risks and rewards have been transferred, the asset is derecognised. If substantially all the risks and rewards have been neither retained nor transferred, the Group assesses whether or not it has retained control of the asset. If it has not retained control, the asset is derecognised. Where the Group has retained control of the asset, it continues to recognise the asset to the extent of its continuing involvement.

A financial liability is removed from the balance sheet when the obligation is discharged, or cancelled, or expires. On the redemption or settlement of debt securities (including subordinated liabilities) issued by the Group, the Group derecognises the debt instrument and records a gain or loss being the difference between the debt's carrying amount and the cost of redemption or settlement. The same treatment applies where the debt is exchanged for a new debt issue that has terms substantially different from those of the existing debt. The assessment of whether the terms of the new debt instrument are substantially different takes into account qualitative and quantitative characteristics including a comparison of the discounted present value of the cash flows under the new terms with the discounted present value of the remaining cash flows of the original debt issue.

20. Sale and repurchase transactions

Securities subject to a sale and repurchase agreement under which substantially all the risks and rewards of ownership are retained by the Group continue to be shown on the balance sheet and the sale proceeds recorded as a financial liability. Securities acquired in a reverse sale and repurchase transaction under which the Group is not exposed to substantially all the risks and rewards of ownership are not recognised on the balance sheet and the consideration paid is recorded as a financial asset.

Securities borrowing and lending transactions are usually secured by cash or securities advanced by the borrower. Borrowed securities are not recognised on the balance sheet or lent securities derecognised. Cash collateral received or given is treated as a loan or deposit; collateral in the form of securities is not recognised. However, where securities borrowed are transferred to third parties, a liability for the obligation to return the securities to the stock lending counterparty is recorded.

21. Netting

Financial assets and financial liabilities are offset and the net amount presented in the balance sheet when, and only when, the Group currently has a legally enforceable right to set off the recognised amounts; and it intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously. The Group is party to a number of arrangements, including master netting agreements, that give it the right to offset financial assets and financial liabilities but where it does not intend to settle the amounts net or simultaneously and therefore the assets and liabilities concerned are presented gross.

22. Capital instruments

The Group classifies a financial instrument that it issues as a financial asset, financial liability or an equity instrument in accordance with the substance of the contractual arrangement. An instrument is classified as a liability if it is a contractual obligation to deliver cash or another financial asset, or to exchange financial assets or financial liabilities on potentially unfavourable terms. An instrument is classified as equity if it evidences a residual interest in the assets of the Group after the deduction of liabilities. The components of a compound financial instrument issued by the Group are classified and accounted for separately as financial assets, financial liabilities or equity as appropriate.

23. Derivatives and hedging

Derivative financial instruments are initially recognised, and subsequently measured, at fair value. Derivative fair values are determined from quoted prices in active markets where available. Where there is no active market for an instrument, fair value is derived from prices for the derivative's components using appropriate pricing or valuation models.

A derivative embedded in a contract is accounted for as a stand-alone derivative if its economic characteristics are not closely related to the economic characteristics of the host contract; unless the entire contract is measured at fair value with changes in fair value recognised in profit or loss.

Gains and losses arising from changes in the fair value of a derivative are recognised as they arise in profit or loss unless the derivative is the hedging instrument in a qualifying hedge. The Group enters into three types of hedge relationship: hedges of changes in the fair value of a recognised asset or liability or firm commitment (fair value hedges); hedges of the variability in cash flows from a recognised asset or liability or a highly probable forecast transaction (cash flow hedges); and hedges of the net investment in a foreign operation.

Hedge relationships are formally documented at inception. The documentation identifies the hedged item and the hedging instrument and details the risk that is being hedged and the way in which effectiveness will be assessed at inception and during the period of the hedge. If the hedge is not highly effective in offsetting changes in fair values or cash flows attributable to the hedged risk, consistent with the documented risk management strategy, hedge accounting is discontinued.

Fair value hedge – in a fair value hedge, the gain or loss on the hedging instrument is recognised in profit or loss. The gain or loss on the hedged item attributable to the hedged risk is recognised in profit or loss and adjusts the carrying amount of the hedged item. Hedge accounting is discontinued if the hedge no longer meets the criteria for hedge accounting; or if the hedging instrument expires or is sold, terminated or exercised; or if hedge designation is revoked. If the hedged item is one for which the effective interest rate method is used, any cumulative adjustment is amortised to profit or loss over the life of the hedged item using a recalculated effective interest rate.

Cash flow hedge – in a cash flow hedge, the effective portion of the gain or loss on the hedging instrument is recognised directly in equity and the ineffective portion in profit or loss. When the forecast transaction results in the recognition of a financial asset or financial liability, the cumulative gain or loss is reclassified from equity in the same periods in which the asset or liability affects profit or loss. Otherwise the cumulative gain or loss is removed from equity and recognised in profit or loss at the same time as the hedged transaction. Hedge accounting is discontinued if the hedge no longer meets the criteria for hedge accounting; if the hedging instrument expires or is sold, terminated or exercised; if the forecast transaction is no longer expected to occur; or if hedge designation is revoked. On the discontinuance of hedge accounting (except where a forecast transaction is no longer expected to occur), the cumulative unrealised gain or loss in equity is recognised in profit or loss when the hedged cash flow occurs or, if the forecast transaction results in the recognition of a financial asset or financial liability, in the same periods during which the asset or liability affects profit or loss. Where a forecast transaction is no longer expected to occur, the cumulative unrealised gain or loss in equity is recognised in profit or loss immediately.

Hedge of net investment in a foreign operation – in the hedge of a net investment in a foreign operation, the portion of foreign exchange differences arising on the hedging instrument determined to be an effective hedge is recognised directly in equity. Any ineffective portion is recognised in profit or loss. Non-derivative financial liabilities as well as derivatives may be the hedging instrument in a net investment hedge.

24. Share-based payments

The Group awards shares and options over shares in The Royal Bank of Scotland Group plc to its employees under various share option schemes. The expense for these transactions is measured based on the fair value on the date the awards are granted. The fair value of an option is estimated using valuation techniques which take into account its exercise price, its term, the risk-free interest rate and the expected volatility of the market price of The Royal Bank of Scotland Group plc's shares. Vesting conditions are not taken into account when measuring fair value, but are reflected by adjusting the proportion of awards that actually vest. The fair value is expensed on a straight-line basis over the vesting period. Following an amendment to IFRS 2 for accounting periods starting after 1 January 2009, the cancellation of an award with non-vesting conditions triggers immediate recognition of an expense in respect of any unrecognised element of the fair value of the award.

25. Cash and cash equivalents

Cash and cash equivalents comprises cash and demand deposits with banks together with short-term highly liquid investments that are readily convertible to known amounts of cash and subject to insignificant risk of change in value.

26. Shares in Group entities

The Bank's investments in its subsidiaries are stated at cost less any impairment.

Critical accounting policies and key sources of estimation uncertainty

The reported results of the Group are sensitive to the accounting policies, assumptions and estimates that underlie the preparation of its financial statements. UK company law and IFRS require the directors, in preparing the Group's financial statements, to select suitable accounting policies, apply them consistently and make judgements and estimates that are reasonable and prudent. In the absence of an applicable standard or interpretation, IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors', requires management to develop and apply an accounting policy that results in relevant and reliable information in the light of the requirements and guidance in IFRS dealing with similar and related issues and the IASB's Framework for the Preparation and Presentation of Financial Statements. The judgements and assumptions involved in the Group's accounting policies that are considered by the Board to be the most important to the portrayal of its financial condition are discussed below. The use of estimates, assumptions or models that differ from those adopted by the Group would affect its reported results.

Loan impairment provisions

The Group's loan impairment provisions are established to recognise incurred impairment losses in its portfolio of loans classified as loans and receivables and carried at amortised cost. A loan is impaired when there is objective evidence that events since the loan was granted have affected expected cash flows from the loan. The impairment loss is the difference between the carrying value of the loan and the present value of estimated future cash flows at the loan's original effective interest rate.

At 31 December 2009, gross loans and advances to customers totalled £548,099 million (2008 – £626,075 million; 2007 – £555,682 million) and customer loan impairment provisions amounted to £11,930 million (2008 – £6,572 million; 2007 – £4,233 million).

There are two components to the Group's loan impairment provisions: individual and collective.

Individual component – all impaired loans that exceed specific thresholds are individually assessed for impairment. Individually assessed loans principally comprise the Group's portfolio of commercial loans to medium and large businesses. Impairment losses are recognised as the difference between the carrying value of the loan and the discounted value of management's best estimate of future cash repayments and proceeds from any security held. These estimates take into account the customer's debt capacity and financial flexibility; the level and quality of its earnings; the amount and sources of cash flows; the industry in which the counterparty operates; and the realisable value of any security held. Estimating the quantum and timing of future recoveries involves significant judgement. The size of receipts will depend on the future performance of the borrower and the value of security, both of which will be affected by future economic conditions; additionally, collateral may not be readily marketable. The actual amount of future cash flows and the date they are received may differ from these estimates and consequently actual losses incurred may differ from those recognised in these financial statements.

Collective component – this is made up of two elements: loan impairment provisions for impaired loans that are below individual assessment thresholds (collectively assessed provisions) and for loan losses that have been incurred but have not been separately identified at the balance sheet date (latent loss provisions). Collectively assessed provisions are established on a portfolio basis using a present value methodology taking into account the level of arrears, security, past loss experience, credit scores and defaults based on portfolio trends. The most significant factors in establishing these provisions are the expected loss rates and the related average life. These portfolios include credit card receivables and other personal advances including mortgages. The future credit quality of these portfolios is subject to uncertainties that could cause actual credit losses to differ materially from reported loan impairment provisions. These uncertainties include the economic environment, notably interest rates and their effect on customer spending, the unemployment level, payment behaviour and bankruptcy trends. Latent loss provisions are held against estimated impairment losses in the performing portfolio that have yet to be identified as at the balance sheet date. To assess the latent loss within its portfolios, the Group has developed methodologies to estimate the time that an asset can remain impaired within a performing portfolio before it is identified and reported as such.

Pensions

The Group operates a number of defined benefit pension schemes as described in Note 4 on the accounts. The assets of the schemes are measured at their fair value at the balance sheet date. Scheme liabilities are measured using the projected unit method, which takes account of projected earnings increases, using actuarial assumptions that give the best estimate of the future cash flows that will arise under the scheme liabilities. These cash flows are discounted at the interest rate applicable to high-quality corporate bonds of the same currency and term as the liabilities. Any recognisable surplus or deficit of scheme assets over liabilities is recognised in the balance sheet as an asset (surplus) or liability (deficit). In determining the value of scheme liabilities, assumptions are made as to price inflation, dividend growth, pension increases, earnings growth and employees. There is a range of assumptions that could be adopted in valuing the schemes' liabilities. Different assumptions could significantly alter the amount of the surplus or deficit recognised in the balance sheet and the pension cost charged to the income statement. The assumptions adopted for the Group's pension schemes are set out in Note 4 on the accounts together with the sensitivity of reported amounts to changes in these assumptions. A pension asset of £28 million and a liability of £2,622 million were recognised in the balance sheet at 31 December 2009 (2008: asset – £4 million, liability – £1,446 million; 2007: asset – £566 million, liability – £334 million).

Fair value – financial instruments

Financial instruments classified as held-for-trading or designated as at fair value through profit or loss and financial assets classified as available-for-sale are recognised in the financial statements at fair value. All derivatives are measured at fair value. Gains or losses arising from changes in the fair value of financial instruments classified as held-for-trading or designated as at fair value through profit or loss are included in the income statement. Unrealised gains and losses on available-for-sale financial assets are recognised directly in equity unless an impairment loss is recognised.

Financial instruments measured at fair value include:

Loans and advances (held-for-trading and designated as at fair value though profit or loss) – principally comprise reverse repurchase agreements (reverse repos) and cash collateral.

Debt securities (held-for-trading, designated as at fair value though profit or loss and available-for-sale) – debt securities include those issued by governments, municipal bodies, mortgage agencies and financial institutions as well as corporate bonds, debentures and residual interests in securitisations.

Equity securities (held-for-trading, designated as at fair value though profit or loss and available-for-sale) – comprise equity shares of companies or corporations both listed and unlisted.

Deposits by banks and customer accounts (held-for-trading and designated as at fair value though profit or loss) – deposits measured at fair value principally include repurchase agreements (repos).

Debt securities in issue (held-for-trading and designated as at fair value though profit or loss) – measured at fair value and principally comprise medium term notes.

Short positions (held-for-trading) – arise in dealing and market making activities where debt securities and equity shares are sold which the Group does not currently possess.

Derivatives – these include swaps (currency swaps, interest rate swaps, credit default swaps, total return swaps and equity and equity index swaps), forward foreign exchange contracts, forward rate agreements, futures (currency, interest rate and equity) and options (exchange-traded options on currencies, interest rates and equities and equity indices and OTC currency and equity options, interest rate caps and floors and swaptions).

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. Fair values are determined from quoted prices in active markets for identical financial assets or financial liabilities where these are available. Fair value for a net open position in a financial asset or financial liability in an active market is the current bid or offer price times the number of units of the instrument held. Where a trading portfolio contains both financial assets and financial liabilities which are derivatives of the same underlying instrument, fair value is determined by valuing the gross long and short positions at current mid market prices, with an adjustment at portfolio level to the net open long or short position to amend the valuation to bid or offer as appropriate. Where the market for a financial instrument is not active, fair value is established using a valuation technique. These valuation techniques involve a degree of estimation, the extent of which depends on the instrument's complexity and the availability of market-based data. More details about the Group's valuation methodologies and the sensitivity to reasonably possible alternative assumptions of the fair value of financial instruments valued using techniques where at least one significant input is unobservable are given in Note 11 on pages 148 to 150.

Goodwill
The Group capitalises goodwill arising on the acquisition of businesses, as discussed in accounting policy 6. The carrying value of goodwill as at 31 December 2009 was £11,007 million (2008 – £11,832 million; 2007 – £16,783 million).

Goodwill is the excess of the cost of an acquired business over the fair value of its net assets. The determination of the fair value of assets and liabilities of businesses acquired requires the exercise of management judgement; for example those financial assets and liabilities for which there are no quoted prices, and those non-financial assets where valuations reflect estimates of market conditions such as property. Different fair values would result in changes to the goodwill arising and to the post-acquisition performance of the acquisition. Goodwill is not amortised but is tested for impairment annually or more frequently if events or changes in circumstances indicate that it might be impaired.

For the purposes of impairment testing, goodwill acquired in a business combination is allocated to each of the Group's cash-generating units or groups of cash-generating units expected to benefit from the combination. Goodwill impairment testing involves the comparison of the carrying value of a cash-generating unit or group of cash-generating units with its recoverable amount. The recoverable amount is the higher of the unit's fair value and its value in use. Value in use is the present value of expected future cash flows from the cash-generating unit or group of cash-generating units. Fair value is the amount obtainable for the sale of the cash-generating unit in an arm's length transaction between knowledgeable, willing parties.

Impairment testing inherently involves a number of judgmental areas: the preparation of cash flow forecasts for periods that are beyond the normal requirements of management reporting; the assessment of the discount rate appropriate to the business; estimation of the fair value of cash-generating units; and the valuation of the separable assets of each business whose goodwill is being reviewed. Sensitivity to changes in assumptions is discussed in Note 16 on page 161.

Deferred tax
The Group makes provision for deferred tax on short-term and other temporary differences where tax recognition occurs at a different time from accounting recognition. Deferred tax assets of £2,228 million were recognised as at 31 December 2009 (2008 – £2,833 million; 2007 – £240 million).

The Group has recognised deferred tax assets in respect of losses, principally in the UK, and short-term timing differences. Deferred tax assets are recognised in respect of unused tax losses to the extent that it is probable that there will be future taxable profits against which the losses can be utilised. Business projections prepared for impairment reviews (see Note 16) indicate that sufficient future taxable income will be available against which to offset these recognised deferred tax assets within eight years. The number of years into the future for which forecast profits should be considered when assessing the recoverability of a deferred tax asset is a matter of judgment. A period of eight years is underpinned by the Group's business projections, its history of profitable operation and the continuing strength of its core business franchises. The Group's cumulative losses are principally attributable to the recent unparalleled market conditions. Deferred tax assets of £26 million (2008 – £29 million; 2007 – £34 million) have not been recognised in respect of tax losses carried forward in jurisdictions where doubt exists over the availability of future taxable profits.

Accounting developments

International Financial Reporting Standards

The International Accounting Standards Board (IASB) published a revised IFRS 3 'Business Combinations' and related revisions to IAS 27 'Consolidated and Separate Financial Statements' following the completion in January 2008 of its project on the acquisition and disposal of subsidiaries. The standards improve convergence with US GAAP and provide new guidance on accounting for changes in interests in subsidiaries. The cost of an acquisition will comprise only consideration paid to vendors for equity; other costs will be expensed immediately. Groups will only account for goodwill on acquisition of a subsidiary; subsequent changes in interest will be recognised in equity and only on a loss of control will there be a profit or loss on disposal to be recognised in income. The changes are effective for accounting periods beginning on or after 1 July 2009 but both standards may be adopted together for accounting periods beginning on or after 1 July 2007. These changes will affect the Group's accounting for future acquisitions and disposals of subsidiaries.

The IASB issued amendments to a number of standards in April 2009 as part of its annual improvements project. The amendments are effective for annual periods beginning on or after 1 July 2009 and are not expected to have a material effect on the Group or Bank.

The IASB issued an amendment, 'Group Cash-settled Share-based Payment Transactions', to IFRS 2 'Share-based Payment' in June 2009 that will change the accounting for share awards by permitting accounting for equity settlement only by entities that either grant awards over their own equity or have no obligation to settle a share-based payment transaction. The amendment is effective for annual periods beginning on or after 1 January 2010 and is not expected to have a material effect on the Group or the Bank.

The IASB published an amendment 'Classification of Rights Issues' to IAS 32 'Financial Instruments: Presentation' and consequential revisions to other standards in October 2009 to improve the accounting for issues of equity for consideration fixed other than in the reporting entity's functional currency. The amendment is effective for annual periods beginning on or after 1 February 2010 but it may be adopted earlier. It is not expected to have a material affect on the Group or the Bank.

The IASB reissued IAS 24, 'Related Party Disclosures', in November 2009 clarifying the existing standard and to provide certain exemptions for entities under government control. The revised standard is effective for annual periods beginning on or after 1 January 2011.

The IASB issued IFRS 9 'Financial Instruments' in November 2009 simplifying the classification and measurement requirements in IAS 39 'Financial Instruments: Recognition and Measurement' in respect of financial assets. The standard reduces the measurement categories for financial assets to two: fair value and amortised cost. A financial asset is classified on the basis of the entity's business model for managing the financial asset and the contractual cash flow characteristics of the financial asset. Only assets with contractual terms that give rise to cash flows on specified dates that are solely payments of principal and interest on the principal amount outstanding and which are held within a business model whose objective is to hold assets in order to collect contractual cash flows are classified as amortised cost. All other financial assets are measured at fair value. Changes in the value of financial assets measured at fair value are generally taken to profit or loss. The standard is effective for annual periods beginning on or after 1 January 2013; early application is permitted.

This standard makes major changes to the framework for the classification and measurement of financial assets and will have a significant effect on the Group's financial statements. The Group is assessing this impact which is likely to depend on the outcome of the other phases of IASB's IAS 39 replacement project.

The International Financial Reporting Interpretations Committee (IFRIC) issued interpretation IFRIC 17 'Distributions of Non-Cash Assets to Owners' and the IASB made consequential amendments to IFRS 5 'Non-Current Assets Held for Sale and Discontinued Operations' in December 2008. The interpretation requires distributions to be presented at fair value with any surplus or deficit recognised in income. The amendment to IFRS 5 extends the definition of disposal groups and discontinued operations to disposals by way of distribution. The interpretation is effective for annual periods beginning on or after 1 July 2009, to be adopted at the same time as IFRS 3 'Business Combinations' (revised 2008), and is not expected to have a material effect on the Bank.

The IFRIC issued interpretation IFRIC 18 'Transfers of Assets from Customers' in January 2009. The interpretation addresses the accounting by suppliers for assets received from customers, requiring such assets to be measured at fair value. The interpretation is effective for assets from customers received on or after 1 July 2009 and is not expected to have a material effect on the Group or the Bank.

The IFRIC issued interpretation IFRIC 19 'Extinguishing Financial Liabilities with Equity Instruments' in December 2009. The interpretation clarifies that the profit or loss on extinguishing liabilities by issuing equity instruments should be measured by reference to fair value, preferably of the equity instruments. The interpretation, effective for the Group for annual periods beginning on or after 1 January 2011, is not expected to have a material effect on the Group or the Bank.

1 Net interest income

	Group 2009 £m	2008 £m	2007 £m
Loans and advances to customers	18,176	28,240	25,886
Loans and advances to banks	425	1,302	1,126
Debt securities	2,559	1,871	1,298
Interest receivable	21,160	31,413	28,310
Customer accounts: demand deposits	668	2,970	3,680
Customer accounts: savings deposits	1,474	2,348	2,266
Customer accounts: other time deposits	1,756	5,408	5,848
Deposits by banks	1,533	3,147	2,802
Debt securities in issue	3,509	5,446	4,325
Subordinated liabilities	959	1,694	1,452
Internal funding of trading business	(282)	(3,109)	(3,179)
Interest payable	9,617	17,904	17,194
Net interest income	11,543	13,509	11,116

2 Non-interest income

	Group 2009 £m	2008 £m	2007 £m
Fees and commissions receivable	7,734	7,483	7,519
Fees and commissions payable	(1,972)	(1,733)	(1,496)
Income/(loss) from trading activities (1)			
Foreign exchange	1,118	707	798
Interest rate	3,805	561	1,796
Credit	(2,867)	(7,691)	(1,620)
Equities and commodities	951	840	168
	3,007	(5,583)	1,142
Gain on redemption of own debt (2)	2,694	—	—
Other operating income			
Operating lease and other rental income	1,329	1,232	1,187
Changes in the fair value of own debt	(105)	665	152
Changes in the fair value of securities and other financial assets and liabilities	4	(325)	846
Changes in the fair value of investment properties	(117)	(86)	288
Profit on sale of available-for-sale financial assets	312	174	496
Profit on sale of property, plant and equipment	40	177	672
(Loss)/profit on sale of subsidiaries and associates	(16)	417	67
Dividend income	50	50	70
Share of profits less losses of associates	(19)	(19)	2
Other income (3)	59	(104)	246
	1,537	2,181	4,026

Notes:

(1) The analysis of trading income is based on how the business is organised and the underlying risks managed. Trading income comprises gains and losses on financial instruments held for trading, both realised and unrealised, interest income and dividends and the related funding costs.

The types of instruments include:

– Foreign exchange: spot foreign exchange contracts, currency swaps and options, emerging markets and related hedges and funding.

– Interest rate: interest rate swaps, forward foreign exchange contracts, forward rate agreements, interest rate options, interest rate futures and related hedges and funding.

– Credit: asset-backed securities, corporate bonds, credit derivatives and related hedges and funding.

– Equities and commodities: equities, commodities, equity derivatives, commodity contracts and related hedges and funding.

(2) In April 2009, the Group concluded a series of exchange offers and tender offers with the holders of a number of Tier 1 and Upper Tier 2 securities. The exchanges involving instruments classified as liabilities all met the criteria in IFRS for treatment as the extinguishment of the original liability and the recognition of a new financial liability. Gains on these exchanges, and on the redemption of securities classified as liabilities for cash, totalling £2,694 million were credited to income.

(3) Other income includes contributions attributable to the Group from activities other than banking.

3 Operating expenses

	Group 2009 £m	Restated 2008 £m	2007 £m
Wages, salaries and other staff costs	6,777	5,234	5,249
Social security costs	424	365	357
Shared-based compensation	129	169	65
Pension costs			
– defined benefit schemes (see Note 4)	389	351	479
– curtailment gains (see Note 4)	(2,148)	—	—
– defined contribution schemes	19	23	31
Staff costs	5,590	6,142	6,181
Premises and equipment	1,983	1,760	1,521
Other administrative expenses	3,094	2,759	2,147
Property, plant and equipment (see Note 17)	1,288	1,221	1,021
Intangible assets (see Note 16)	299	341	417
Depreciation and amortisation	1,587	1,562	1,438
Write-down of goodwill and other intangible assets	118	8,144	—
	12,372	20,367	11,287

Integration costs included in operating expenses comprise expenditure incurred in respect of cost reduction and revenue enhancement programmes set in connection with the various acquisitions made by the Group.

	Group 2009 £m	2008 £m	2007 £m
Staff costs	204	246	18
Premises and equipment	78	25	4
Other administrative expenses	157	194	10
Depreciation and amortisation	18	22	60
	457	487	92

Restructuring costs included in operating expenses comprise:

	2009 £m	2008 £m	2007 £m
Staff costs	310	111	—
Premises and equipment	42	15	—
Other administrative expenses	50	34	—
	402	160	—

The average number of persons employed, rounded to the nearest hundred, by the Group during the year, excluding temporary staff, was 121,000 (2008 – 123,000; 2007 – 123,500). The number of persons employed by the Group at 31 December, excluding temporary staff, was as follows:

	Group		
	2009	2008	2007
UK Retail	28,300	31,400	31,200
UK Corporate	12,600	13,500	13,100
Wealth	4,800	5,300	5,400
Global Banking & Markets	9,700	7,800	8,200
Global Transaction Services	2,100	2,400	2,400
Ulster Bank	4,600	5,600	6,100
US Retail & Commercial	16,400	17,300	17,400
Central items	3,200	3,200	3,000
Core	81,700	86,500	86,800
Non-Core	2,900	2,100	2,400
Business Services	32,500	34,200	35,400
Total	117,100	122,800	124,600
UK	81,200	86,600	88,600
USA	25,000	26,000	25,600
Europe	6,800	6,600	7,600
Rest of the World	4,100	3,600	2,800
Total	117,100	122,800	124,600

4 Pension costs

The Group sponsors a number of pension schemes in the UK and overseas, predominantly defined benefit schemes, whose assets are independent of the Group's finances. The Group's defined benefit schemes generally provide a pension of one-sixtieth of final pensionable salary for each year of service prior to retirement up to a maximum of 40 years. Employees do not make contributions for basic pensions but may make voluntary contributions to secure additional benefits on a money-purchase basis. Since October 2006 The Royal Bank of Scotland Group Pension Fund ('Main scheme') has been closed to new entrants.

The Group also provides post-retirement benefits other than pensions, principally through subscriptions to private healthcare schemes in the UK and the US and unfunded post-retirement benefit plans. Provision for the costs of these benefits is charged to the income statement over the average remaining future service lives of eligible employees. The amounts are not material.

There is no contractual agreement or policy on the way that the cost of The Royal Bank of Scotland Group defined benefit pension schemes and healthcare plans are allocated to the Bank. The Bank therefore accounts for the charges it incurs as payments to a defined contribution scheme.

Interim valuations of the Group's schemes under IAS19 'Employee Benefits' were prepared to 31 December with the support of independent actuaries, using the following assumptions:

Principal actuarial assumptions at 31 December (weighted average)	2009	2008	2007
Discount rate	5.9%	6.3%	6.0%
Expected return on plan assets	6.3%	7.1%	6.9%
Rate of increase in salaries	1.8%	3.8%	4.4%
Rate of increase in pensions in payment	3.3%	2.5%	3.1%
Inflation assumption	3.4%	2.6%	3.2%

Major classes of plan assets as a percentage of total plan assets	2009	2008	2007
Equity interests	47.9%	58.2%	61.3%
Index-linked bonds	21.7%	16.7%	16.9%
Government fixed interest bonds	0.9%	2.9%	2.3%
Corporate and other bonds	20.0%	17.9%	14.8%
Property	3.4%	4.1%	4.0%
Cash and other assets	6.1%	0.2%	0.7%

Ordinary shares of the holding company with a fair value of £4 million (2008 – £15 million; 2007 – £69 million) are held by the Group's pension schemes together with holdings of other financial instruments issued by the Group with a value of £192 million (2008 – £421 million; 2007 – £606 million).

The expected return on plan assets at 31 December is based upon the weighted average of the following assumed returns on the major classes of plan assets:

	2009	2008	2007
Equities	8.0%	8.5%	8.1%
Index-linked bonds	4.5%	3.9%	4.5%
Government fixed interest bonds	5.2%	4.4%	4.6%
Corporate and other bonds	5.9%	6.1%	5.5%
Property	6.2%	6.0%	6.3%
Cash and other assets	1.3%	3.4%	4.3%

Post-retirement mortality assumptions (Main scheme)	2009	2008	2007
Longevity at age 60 for current pensioners (years):			
Males	27.1	26.1	26.0
Females	29.5	26.9	26.8
Longevity at age 60 for future pensioners (years):			
Males	29.2	28.1	28.1
Females	30.8	28.2	28.2

The allowance for post-retirement mortality has been updated following an analysis of recent experience of pensioners in the Main scheme.

Changes in value of net pension deficit/(surplus)	Fair value of plan assets £m	Present value of defined benefit obligations £m	Net pension deficit/ (surplus) £m
At 1 January 2008	20,264	20,032	(232)
Currency translation and other adjustments	522	623	101
Income statement:			
Expected return	1,401		(1,401)
Interest cost		1,196	1,196
Current service cost		528	528
Past service cost		28	28
	1,401	1,752	351
Statement of comprehensive income:			
Actuarial gains and losses	(5,318)	(3,602)	1,716
Disposal of subsidiaries	—	(3)	(3)
Contributions by employer	491	—	(491)
Contributions by plan participants	6	6	—
Benefits paid	(689)	(689)	—
Expenses included in service cost	(26)	(26)	—
At 1 January 2009	16,651	18,093	1,442
Currency translation and other adjustments	(100)	(145)	(45)
Income statement:			
Expected return	1,153		(1,153)
Interest cost		1,130	1,130
Current service cost		397	397
Past service cost		15	15
Gains on curtailments		(2,148)	(2,148)
	1,153	(606)	(1,759)
Statement of comprehensive income:			
Actuarial gains and losses	1,157	4,833	3,676
Transfers from fellow subsidiaries	60	84	24
Contributions by employer	744	—	(744)
Contributions by plan participants and other scheme members	11	11	—
Benefits paid	(849)	(849)	—
Expenses included in service cost	(22)	(22)	—
At 31 December 2009	18,805	21,399	2,594

Net pension deficit/(surplus) comprises:	2009 £m	2008 £m	2007 £m
Net assets of schemes in surplus (included in Prepayments, accrued income and other assets, Note 18)	(28)	(4)	(566)
Net liabilities of schemes in deficit	2,622	1,446	334
	2,594	1,442	(232)

4 Pension costs continued

Curtailment gains of £2,148 million have been recognised in 2009 arising from changes to pension benefits in the Main scheme and certain other subsidiaries schemes due to the capping of future salary increases that will count for pension purposes to the lower of 2% or the rate of inflation in any year.

The Group expects to contribute £494 million to its defined benefit pension schemes in 2010. Of the net liabilities of schemes in deficit, £146 million (2008 – £118 million; 2007 – £94 million) relates to unfunded schemes.

The most recent funding valuation of the main UK scheme, as at 31 March 2007, showed a surplus of assets over liabilities of £0.7 billion. The next valuation is due as at 31 March 2010 and the Group expects this valuation to show that liabilities exceed the value of the assets. Following this valuation, the Group and scheme Trustees will agree the level of contributions to be paid to the scheme. This could result in the amount of contributions payable in 2010 and subsequent years being materially different from the current rates based on the previous valuation.

Cumulative net actuarial losses of £3,856 million (2008 – £180 million losses; 2007 – £1,536 million gains) have been recognised in the statement of comprehensive income.

History of defined benefit schemes	2009 £m	2008 £m	2007 £m	2006 £m	2005 £m
Fair value of plan assets	18,805	16,651	20,264	18,894	17,331
Present value of defined benefit obligations	21,399	18,093	20,032	20,865	21,040
Net (deficit)/surplus	(2,594)	(1,442)	232	(1,971)	(3,709)
Experience gains/(losses) on plan liabilities	139	(91)	(204)	(20)	(68)
Experience gains/(losses) on plan assets	1,157	(5,318)	140	585	1,654
Actual return/(loss) on pension schemes assets	2,310	(3,917)	1,437	1,654	2,667
Actual return/(loss) on pension schemes assets – %	13.9%	(19.2)%	7.6%	9.6%	18.1%

The table below sets out the sensitivities of the pension cost for the year and the present value of defined benefit obligations at the balance sheet dates to a change in the principal actuarial assumptions:

	Increase/(decrease) in pension cost for the year		Increase/(decrease) in obligation at 31 December	
	2009 £m	2008 £m	2009 £m	2008 £m
0.25% increase in the discount rate	(31)	(44)	(899)	(786)
0.25% increase in inflation	60	86	742	696
0.25% additional rate of increase in pensions in payment	39	46	495	423
0.25% additional rate of increase in deferred pensions	17	9	229	103
0.25% additional rate of increase in salaries	13	33	94	199
Longevity increase of 1 year	37	34	480	337

5 Auditors' remuneration

Amounts paid to the Group's auditors for statutory audit and other services are set out below:

	Group	
	2009 £m	2008 £m
Fees payable for the audit of the Group's annual accounts	5.0	4.3
Fees payable to the auditors and their associates for other services to the Group:		
– The audit of the Bank's subsidiaries pursuant to legislation	7.9	7.9
Total audit fees	12.9	12.2

Fees payable to the auditors for non-audit services are disclosed in the consolidated financial statements of The Royal Bank of Scotland Group plc.

6 Tax

	Group		
	2009 £m	2008 £m	2007 £m
Current taxation:			
Charge for the year	198	646	2,373
Over provision in respect of prior periods	(229)	(257)	(25)
Relief for overseas taxation	—	(34)	(198)
	(31)	355	2,150
Deferred taxation:			
(Credit)/charge for the year	(658)	(849)	89
Under/(over) provision in respect of prior periods	166	(11)	(336)
Tax (credit)/charge for the year	(523)	(505)	1,903

The actual tax (credit)/charge differs from the expected tax (credit)/charge computed by applying the standard rate of UK corporation tax of 28% (2008 – 28.5%; 2007 – 30%) as follows:

	2009 £m	2008 £m	2007 £m
Expected tax (credit)/charge	(1)	(2,627)	2,747
Non-deductible goodwill impairment	33	1,949	12
Unrecognised timing differences	(274)	274	29
Other non-deductible items	335	294	218
Non-taxable items:			
– gain on redemption of own debt	(626)	—	—
– other	(134)	(305)	(568)
Taxable foreign exchange movements	(39)	161	4
Foreign profits taxed at other rates	232	4	(13)
Increase/(decrease) in deferred tax liability following change in the rate of UK corporation tax	—	1	(156)
Unutilised losses brought forward and carried forward	14	12	(9)
Adjustments in respect of prior periods (1)	(63)	(268)	(361)
Actual tax (credit)/charge	(523)	(505)	1,903

Notes:

(1) The prior period tax adjustments principally comprise releases of tax provisions in respect of structured transactions and investment disposals, and adjustments to reflect submitted tax computations in the UK and overseas.

7 Profit attributable to preference shareholders

	Group		
	2009 £m	2008 £m	2007 £m
Non-cumulative preference shares of US$0.01	267	350	210
Non-cumulative preference shares of €0.01	179	205	110
Non-cumulative preference shares of £1	77	83	11
Total	523	638	331

Notes:

(1) In accordance with IAS 32, certain preference shares issued by the Bank are included in subordinated liabilities and the related finance cost in interest payable.

(2) Between 1 January 2010 and the date of approval of these accounts, dividends amounting to US$29 million have been declared in respect of equity preference shares for payment on 31 March 2010.

8 Ordinary dividends

	2009 £m	2008 £m	2007 £m
Ordinary dividends paid to holding company	2,000	4,000	2,000

9 (Loss)/profit dealt with in the accounts of the Bank

As permitted by section 408(3) of the Companies Act 2006, no income statement or statement of comprehensive income for the Bank has been presented as a primary financial statement. Of the loss attributable to ordinary shareholders, £1,063 million (2008 – £1,947 million loss; 2007 – £6,924 million profit) has been dealt with in the accounts of the Bank.

10 Financial instruments

Classification

The following tables analyse the Group's financial assets and financial liabilities in accordance with the categories of financial instruments in IAS 39. Assets and liabilities outside the scope of IAS 39 are shown separately as non financial assets/liabilities.

	Group								
2009	Held-for-trading £m	Designated as at fair value through profit or loss £m	Hedging derivatives £m	Available-for-sale £m	Loans and receivables £m	Other financial instruments (amortised cost) £m	Finance leases £m	Non financial assets/ liabilities £m	Total £m
Assets									
Cash and balances at central banks	—	—		—	27,060				27,060
Loans and advances to banks (1)	49,425	178		—	18,838				68,441
Loans and advances to customers (2, 3)	41,908	1,354		—	479,678		13,229		536,169
Debt securities (4)	103,139	249		71,502	10,291				185,181
Equity shares	356	239		1,810	—				2,405
Settlement balances	—	—		—	9,153				9,153
Derivatives	443,518	—	2,835	—					446,353
Intangible assets								11,814	11,814
Property, plant and equipment								17,309	17,309
Deferred taxation								2,228	2,228
Prepayments, accrued income and other assets	—	—		—	33			12,632	12,665
Assets of disposal groups								14,203	14,203
	638,346	2,020	2,835	73,312	545,053		13,229	58,186	1,332,981
Liabilities									
Deposits by banks (5)	59,399	—				56,739			116,138
Customer accounts (6, 7)	54,306	3,450				395,546			453,302
Debt securities in issue (8, 9)	4,084	10,087				158,242			172,413
Settlement balances and short provisions	36,472	—				7,922			44,394
Derivatives	421,765	—	2,779			—			424,544
Accruals, deferred income and other liabilities	—	—				2,887	467	13,120	16,474
Retirement benefit liabilities								2,622	2,622
Deferred taxation								1,187	1,187
Subordinated liabilities (10)	—	646				34,071			34,717
Liabilities of disposal groups								10,993	10,993
	576,026	14,183	2,779			655,407	467	27,922	1,276,784
Equity									56,197
									1,332,981

For notes relating to this table refer to page 124.

2008	Held-for-trading £m	Designated as at fair value through profit or loss £m	Hedging derivatives £m	Available-for-sale £m	Loans and receivables £m	Other financial instruments (amortised cost) £m	Finance leases £m	Non financial assets/ liabilities £m	Total £m
	Group								
Assets									
Cash and balances at central banks	—	—		—	6,806				6,806
Loans and advances to banks (1)	60,957	—		—	18,430				79,387
Loans and advances to customers (2, 3)	52,173	1,767		—	551,110		14,453		619,503
Debt securities (4)	101,773	2,599		61,638	11,756				177,766
Equity shares	577	275		1,839	—				2,691
Settlement balances	—	—		—	10,871				10,871
Derivatives	933,203	—	4,254	—	—				937,457
Intangible assets								12,591	12,591
Property, plant and equipment								16,628	16,628
Deferred taxation								2,833	2,833
Prepayments, accrued income and other assets	—	—		—	32			11,365	11,397
	1,148,683	4,641	4,254	63,477	599,005		14,453	43,417	1,877,930
Liabilities									
Deposits by banks (5)	86,938	—				95,044			181,982
Customer accounts (6, 7)	57,817	2,707				392,605			453,129
Debt securities in issue (8, 9)	3,991	12,164				163,787			179,942
Settlement balances and short positions	37,172	—				8,785			45,957
Derivatives	905,546	—	3,559			—			909,105
Accruals, deferred income and other liabilities	260	—				1,619	22	14,784	16,685
Retirement benefit liabilities								1,446	1,446
Deferred taxation								2,483	2,483
Subordinated liabilities (10)	—	708				39,243			39,951
	1,091,724	15,579	3,559			701,083	22	18,713	1,830,680
Equity									47,250
									1,877,930

For notes relating to this table refer to page 124.

10 Financial instruments continued

2007	Held-for-trading £m	Designated as at fair value through profit or loss £m	Hedging derivatives £m	Available-for-sale £m	Loans and receivables £m	Other financial instruments (amortised cost) £m	Finance leases £m	Non financial assets/liabilities £m	Total £m
	Group								
Assets									
Cash and balances at central banks	—	—		—	5,559				5,559
Loans and advances to banks (1)	72,697	—		—	23,649				96,346
Loans and advances to customers (2, 3)	105,420	2,622		—	430,837		12,570		551,449
Debt securities (4)	136,785	2,854		24,293	500				164,432
Equity shares	3,786	156		1,567	—				5,509
Settlement balances	—	—		—	5,326				5,326
Derivatives	205,056	—	919	—					205,975
Intangible assets								17,761	17,761
Property, plant and equipment								13,025	13,025
Deferred taxation								240	240
Prepayments, accrued income and other assets	—	—		—	19			6,097	6,116
	523,744	5,632	919	25,860	465,890		12,570	37,123	1,071,738
Liabilities									
Deposits by banks (5)	71,714	—				79,794			151,508
Customer accounts (6, 7)	61,990	1,920				379,072			442,982
Debt securities in issue (8, 9)	9,455	9,021				111,656			130,132
Settlement balances and short positions	47,058	—				6,791			53,849
Derivatives	201,802	—	1,270						203,072
Accruals, deferred income and other liabilities	210	—				1,545	19	10,393	12,167
Retirement benefit liabilities								334	334
Deferred taxation								2,063	2,063
Subordinated liabilities (10)	—	358				27,438			27,796
	392,229	11,299	1,270			606,296	19	12,790	1,023,903
Equity									47,835
									1,071,738

Notes:

(1) Includes reverse repurchase agreements of £30,830 million (2008 – £31,436 million; 2007 – £67,619 million), items in the course of collection from other banks of £2,474 million (2008 – £2,779 million; 2007 – £2,729 million) and amounts due from fellow subsidiaries of £5,274 million (2008 – £7,297 million; 2007 – £1,966 million).

(2) Includes reverse repurchase agreements of £33,812 million (2008 – £27,972 million; 2007 – £79,056 million), amounts due from holding company of £4 million (2008 – £1,828 million; 2007 – £5,572 million) and amounts due from fellow subsidiaries of £1,945 million (2008 – £2,656 million; 2007 – £3,516 million).

(3) The change in fair value of loans and advances to customers designated as at fair value through the profit and loss attributable to changes in credit risk was £157 million income for the year and cumulatively a credit of £140 million (2008 – charge £301 million; cumulative £408 million credit; 2007 – not material)

(4) Includes treasury bills and similar securities of £38,617 million (2008 – £23,797 million; 2007 – £14,604 million) and other eligible bills of £253 million (2008 – £54 million; 2007 – £1,914 million).

(5) Includes repurchase agreements of £35,582 million (2008 – £64,317 million; 2007 – £75,154 million), items in the course of transmission to other banks of £770 million (2008 – £542 million; 2007 – £372 million) and amounts due to fellow subsidiaries of £8,888 million (2008 – £6,327 million; 2007 – £9,127 million).

(6) Includes repurchase agreements of £66,025 million (2008 – £54,095 million; 2007 – £75,029 million), amounts due to holding company of £16,494 million (2008 – £15,801 million; 2007 – £1,012 million) and amounts due to fellow subsidiaries of £2,297 million (2008 – £2,488 million; 2007 £2,105 million).

(7) The carrying amount of other customer accounts designated as at fair value through profit or loss is £101 million higher (2008 – £44 million lower; 2007 – £77 million greater) than the principal amount. No amounts have been recognised in profit or loss for changes in credit risk associated with these liabilities as the changes are immaterial measured as the change in fair value from movements in the period in the credit risk premium payable.

(8) Comprises bonds and medium term notes of £92,612 million (2008 – £70,153 million; 2007 – £40,945 million) and certificates of deposit and other commercial paper of £79.801 million (2008 – £109,789 million; 2007 – £89,187 million).

(9) £828 million (2008 – £665 million; 2007 – £152 million) has been recognised in profit or loss for changes in credit risk associated with these liabilities measured as the change in fair value from movements in the period in the credit risk premium payable by the Group. The carrying amount is £810 million (2008 – £1,145 million; 2007 – £317 million) lower than the principal amount.

(10) Includes amounts due to holding company of £14,966 million (2008 – £11,572 million; 2007 – £6,113 million).

(11) During 2009 and 2008 the Group reclassified financial assets from the held-for-trading category into the loans and receivables category and during 2008 from the available-for-sale category into the loans and receivables category and from the held-for-trading category into the available-for-sale category (see pages 128 to 133).

The following tables analyse the Bank's financial assets and financial liabilities in accordance with the categories of financial instruments in IAS 39. Assets and liabilities outside the scope of IAS 39 are shown separately as non financial assets/liabilities.

	Bank							
2009	Held-for-trading £m	Designated as at fair value through profit or loss £m	Hedging derivatives £m	Available-for-sale £m	Loans and receivables £m	Other financial instruments (amortised cost) £m	Non financial assets/ liabilities £m	Total £m
Assets								
Cash and balances at central banks	—	—		—	21,099			21,099
Loans and advances to banks (1)	42,263	178		—	34,924			77,365
Loans and advances to customers (2)	43,757	817		—	293,974			338,548
Debt securities (3)	71,219	1		53,527	89,851			214,598
Equity shares	349	7		669	—			1,025
Investments in Group undertakings							29,385	29,385
Settlement balances	—	—		—	4,159			4,159
Derivatives	448,395	—	2,518	—				450,913
Intangible assets							210	210
Property, plant and equipment							2,447	2,447
Deferred taxation							1,728	1,728
Prepayments, accrued income and other assets	—	—		—	—		9,988	9,988
Assets of disposal groups							7,150	7,150
	605,983	1,003	2,518	54,196	444,007		50,908	1,158,615
Liabilities								
Deposits by banks (4)	57,975	—				130,573		188,548
Customer accounts (5, 6)	52,485	659				236,648		289,792
Debt securities in issue (7, 8)	4,483	10,059				115,272		129,814
Settlement balances and short positions	23,811	—				4,541		28,352
Derivatives	428,787	—	1,218			—		430,005
Accruals, deferred income and other liabilities	—	—				2,170	7,779	9,949
Retirement benefit liabilities							16	16
Subordinated liabilities	—	646				29,867		30,513
Liabilities of disposal groups							6,108	6,108
	567,541	11,364	1,218			519,071	13,903	1,113,097
Equity								45,518
								1,158,615

For notes relating to this table refer to page 127.

10 Financial instruments continued

2008	Held-for-trading £m	Designated as at fair value through profit or loss £m	Hedging derivatives £m	Available-for-sale £m	Loans and receivables £m	Other financial instruments (amortised cost) £m	Non financial assets/liabilities £m	Total £m
	Bank							
Assets								
Cash and balances at central banks	—	—		—	3,714			3,714
Loans and advances to banks (1)	56,089	—		—	35,628			91,717
Loans and advances to customers (2)	59,146	1,160		—	266,734			327,040
Debt securities (3)	67,911	906		41,898	48,983			159,698
Equity shares	463	28		529	—			1,020
Investments in Group undertakings							26,814	26,814
Settlement balances	—	—		—	5,335			5,335
Derivatives	934,709	—	3,796	—				938,505
Intangible assets							136	136
Property, plant and equipment							2,368	2,368
Deferred taxation							1,323	1,323
Prepayments, accrued income and other assets	—	—		—	—		5,930	5,930
	1,118,318	2,094	3,796	42,427	360,394		36,571	1,563,600
Liabilities								
Deposits by banks (4)	85,126	—				116,140		201,266
Customer accounts (5, 6)	46,178	170				182,918		229,266
Debt securities in issue (7, 8)	3,993	12,099				99,057		115,149
Settlement balances and short positions	23,827	—				5,534		29,361
Derivatives	910,188	—	986					911,174
Accruals, deferred income and other liabilities	260	—				1,087	8,271	9,618
Retirement benefit liabilities							23	23
Subordinated liabilities	—	708				32,990		33,698
	1,069,572	12,977	986			437,726	8,294	1,529,555
Equity								34,045
								1,563,600

For notes relating to this table refer to page 127.

2007	Held-for-trading £m	Designated as at fair value through profit or loss £m	Hedging derivatives £m	Available-for-sale £m	Loans and receivables £m	Other financial instruments (amortised cost) £m	Non financial assets/liabilities £m	Total £m
	Bank							
Assets								
Cash and balances at central banks	—	—		—	3,333			3,333
Loans and advances to banks (1)	60,640	—		—	31,342			91,982
Loans and advances to customers (2)	109,992	791		—	218,364			329,147
Debt securities (3)	97,455	996		8,799	—			107,250
Equity shares	3,634	10		375	—			4,019
Investments in Group undertakings	—	—		—	—		22,210	22,210
Settlement balances	—	—		—	2,046			2,046
Derivatives	207,266	—	647	—				207,913
Intangible assets							295	295
Property, plant and equipment							2,116	2,116
Deferred taxation							319	319
Prepayments, accrued income and other assets	—	—		—	—		1,680	1,680
	478,987	1,797	647	9,174	255,085		26,620	772,310
Liabilities								
Deposits by banks (4)	71,261	—				125,707		196,968
Customer accounts (5, 6)	57,823	54				140,049		197,926
Debt securities in issue (7, 8)	9,455	8,895				61,527		79,877
Settlement balances and short positions	30,567	—				3,110		33,677
Derivatives	203,733	—	501					204,234
Accruals, deferred income and other liabilities	210	—				1,080	4,493	5,783
Retirement benefit liabilities							11	11
Subordinated liabilities (9)	—	358				22,387		22,745
	373,049	9,307	501			353,860	4,504	741,221
Equity								31,089
								772,310

Notes:

(1) Includes reverse repurchase agreements of £19,844 million (2008 – £19.263 million; 2007 – £52,128 million), items in the course of collection from other banks of £426 million (2008 – £484 million; 2007 – £530 million), amounts due from subsidiaries of £28,418 million (2008 – £29,619 million; 2007 – £22,367 million) and amounts due from fellow subsidiaries of £5,192 million (2008 – £6,862 million; 2007 – £1,748 million).

(2) Includes reverse repurchase agreements of £23,189 million (2008 – £22,564 million; 2007 – £58,785 million), amounts due from subsidiaries of £101,223 million (2008 – £39,908 million; 2007 – £66,102 million), amounts due from fellow subsidiaries of £1,626 million (2008 – £2,632 million; 2007 – £2,666 million) and amounts due from holding company of £4 million (2008 – £1,828 million; 2007 – £5,572 million).

(3) Includes treasury bills and similar securities of £24,886 million (2008 – £23,415 million; 2007 – £14,200 million).

(4) Includes repurchase agreements of £24,991 million (2008 – £52,290 million; 2007 – £59,955 million), items in the course of transmission to other banks of £319 million (2008 – £312 million; 2007 – £68 million), amounts due to subsidiaries of £113,240 million (2008 – £63,198 million; 2007 – £74,006 million) and amounts due to fellow subsidiaries of nil (2008 – £5,715 million; 2007 – £8,473 million).

(5) Includes repurchase agreements of £26,854 million (2008 – £24,041 million; 2007 – £30,177 million), amounts due to fellow subsidiaries of £1,363 million (2008 – £1,940 million; 2007 – £123 million), amounts due to holding company of £16,494 million (2008 – £15,800 million; 2007 – £1,013 million) and amounts due to subsidiaries of £142,266 million (2008 – £68,282 million; 2007 – £53,565 million).

(6) The carrying amount of other customer accounts designated as at fair value through profit or loss is £28 million greater (2008 – £2 million lower; 2007 – £15 million lower) than the principal amount. No amounts have been recognised in profit or loss for changes in credit risk associated with these liabilities as the changes are immaterial measured as the change in fair value from movements in the period in the credit risk premium payable.

(7) Comprises bonds and medium term notes of £70,482 million (2008 – £40,595 million; 2007 – £17,274 million) and certificates of deposit and other commercial paper of £59,332 million (2008 – £74,553 million; 2007 – £62,603 million).

(8) £828 million (2008 – £665 million; 2007 – £152 million) has been recognised in profit or loss for changes in credit risk associated with these liabilities measured as the change in fair value from movements in the period in the credit risk premium payable by the Group. The carrying amount is £714 million (2008 – £1,055 million; 2007 – £252 million) lower than the principal amount.

(9) Includes amounts due to holding company of £14,966 million (2008 – £11,572 million; 2007 – £6,113 million).

(10) During 2009 and 2008 the Bank reclassified financial assets from the held-for-trading category into the loans and receivables category and during 2008 from the available-for-sale category into the loans and receivables category and from the held-for-trading category into the available-for-sale category (see pages 128 to 133).

Amounts included in the consolidated income statement:

	Group 2009 £m	2008 £m	2007 £m
Gains on financial assets/liabilities designated as at fair value through profit or loss	1,027	198	721
(Losses)/gains on disposal or settlement of loans and receivables	(16)	4	10

10 Financial instruments continued

Reclassification of financial instruments

The Group reclassified financial assets from the held-for-trading (HFT) and available-for-sale (AFS) categories into the loans and receivables (LAR) category (as permitted by paragraph 50D of IAS 39 as amended) and from the held-for-trading category into the available-for-sale category (as permitted by paragraph 50B of IAS 39 as amended).

The turbulence in the financial markets during the second half of 2008 was regarded by management as rare circumstances in the context of paragraph 50B of IAS 39 as amended.

The tables below show the carrying value and fair value and the effect on profit and loss of reclassification undertaken by the Group in 2008 and 2009.

	Group					
	2009					
	31 December 2009		After reclassification			
	Carrying value £m	Fair value £m	Income £m	Impairment losses £m	Amount that would have been recognised £m	Reduction in profit or loss as result of reclassi-fication £m
Reclassified from HFT to LAR:						
Loans						
Leveraged finance	2,574	2,257	109	(902)	482	1,275
Corporate and other loans	5,142	3,954	124	(361)	(297)	(60)
	7,716	6,211	233	(1,263)	185	1,215
Debt securities						
CDO	21	21	2	—	2	—
RMBS	1,284	964	(90)	—	(22)	68
CMBS	492	345	(16)	—	23	39
CLOs	607	500	(39)	(16)	42	97
Other ABS	1,030	965	3	—	(2)	(5)
Other	876	871	35	—	254	219
	4,310	3,666	(105)	(16)	297	418
Total	12,026	9,877	128	(1,279)	482	1,633
Reclassified from HFT to AFS: (1)						
Debt securities						
CDO	238	238	(18)	(110)	(22)	106
RMBS	3,042	3,042	335	(84)	460	209
CMBS	63	63	(3)	—	10	13
CLOs	1,923	1,923	(63)	—	398	461
Other ABS	508	508	20	—	44	24
Other	1	1	14	(118)	(51)	53
	5,775	5,775	285	(312)	839	866
Reclassified from AFS to LAR: (2)						
Debt securities	869	745	21	—	21	—
Total	18,670	16,397	434	(1,591)	1,342	2,499

Notes:

(1) The amount taken to AFS reserves was £763 million.

(2) The amount that would have been taken to AFS reserves if reclassification had not occurred is £(73) million.

The table below shows the carrying value and fair value of reclassification undertaken by the Bank in 2008 and 2009.

	Bank	
	31 December 2009	
	Carrying value £m	Fair value £m
Reclassified from HFT to LAR:		
Loans		
Leveraged finance	2,508	2,224
Corporate and other loans	6,045	5,013
	8,553	7,237
Debt securities		
CDO	21	21
RMBS	1,284	964
CMBS	492	345
CLOs	607	500
Other ABS	1,030	965
Other	876	871
	4,310	3,666
Total	12,863	10,903
Reclassified from HFT to AFS: (1)		
Debt securities		
CDO	238	238
RMBS	3,042	3,042
CMBS	63	63
CLOs	1,923	1,923
Other ABS	508	508
Other	1	1
	5,775	5,775
Reclassified from AFS to LAR: (2)		
Debt securities	869	745
Total	19,507	17,423

Notes:

(1) The amount taken to AFS reserves was £763 million.

(2) The amount that would have been taken to AFS reserves if reclassification had not occurred is £(73) million.

10 Financial instruments continued

The following tables are for reclassifications in 2009. The balance sheet values of these assets, the effect of the reclassification on the income statement for the period from the date of reclassification to 31 December 2009 and the gains and losses relating to these assets recorded in the income statement for the years ended 31 December 2009, 2008 and 2007 were as follows:

	Group											
	2009										2008	2007
	2009 – on reclassification			31 December 2009			After reclassification				Gains/(losses) recognised in the income statement in prior periods	
	Carrying value £m	Effective interest rate %	Expected cash flows £m	Carrying value £m	Fair value £m	Gains/(losses) up to the date of reclassification £m	Income £m	Impairment losses £m	Amount that would have been recognised £m	Reduction in profit or loss as result of reclassification £m	£m	£m
Reclassified from HFT to LAR:												
Loans												
Leveraged finance	510	13.37	1,075	—	—	—	(70)	(71)	(141)	—	(76)	—
Corporate and other loans	1,230	2.85	1,565	887	924	(103)	26	(180)	(115)	39	14	25
	1,740		2,640	887	924	(103)	(44)	(251)	(256)	39	(62)	25
Debt securities												
RMBS	86	3.30	94	78	74	(2)	2	—	(3)	(5)	(3)	—
CMBS	64	2.17	67	41	36	(3)	(6)	—	(10)	(4)	(14)	—
Other ABS	39	2.51	41	7	7	1	1	—	—	(1)	(10)	—
Other	66	13.19	147	64	71	(29)	3	—	11	8	(12)	—
	255		349	190	188	(33)	—	—	(2)	(2)	(39)	—
Total	1,995		2,989	1,077	1,112	(136)	(44)	(251)	(258)	37	(101)	25

	Bank				
	2009 – on reclassification			31 December 2009	
	Carrying value £m	Effective interest rate %	Expected cash flows £m	Carrying value £m	Fair value £m
Reclassified from HFT to LAR:					
Loans					
Leveraged finance	510	13.37	1,075	—	—
Corporate and other loans	1,230	2.85	1,565	887	924
	1,740		2,640	887	924
Debt securities					
RMBS	86	3.30	94	78	74
CMBS	64	2.17	67	41	36
Other ABS	39	2.51	41	7	7
Other	66	13.19	147	64	71
	255		349	190	188
Total	1,995		2,989	1,077	1,112

10 Financial instruments continued

The following tables are for reclassifications in 2008. The balance sheet values of these assets, the effect of the reclassification on the income statement for the period from the date of reclassification to 31 December 2008 and the gains and losses relating to these assets recorded in the income statement for the years ended 31 December 2008, 2007 and 2006 were as follows:

	Group											
	2008										2007	2006
	2008 – on reclassification			31 December 2008			After reclassification					
	Carrying value £m	Effective interest rate %	Expected cash flows £m	Carrying value £m	Fair value £m	Gains/ (losses) up to the date of reclassi- fication £m	Income £m	Impairment losses £m	Amount that would have been recognised £m	Increase in profit or loss as a result of reclassi- fication £m	Gains/(losses) recognised in the income statement in prior periods £m	£m
Reclassified from HFT to LAR:												
Loans:												
Leverage loans	3,602	10.14	6,091	4,305	2,714	(457)	455	—	(1,015)	1,470	(155)	—
Corporate and other loans	5,025	6.23	7,570	5,808	4,897	(76)	201	—	(705)	906	(50)	3
	8,627		13,661	10,113	7,611	(533)	656	—	(1,720)	2,376	(205)	3
Debt securities:												
CDO	215	4.92	259	236	221	4	5	—	(11)	16	5	6
RMBS	1,534	6.05	1,815	1,743	1,354	(108)	171	—	(227)	398	(12)	—
CMBS	1,877	4.77	2,402	2,145	1,775	(42)	50	—	(293)	343	(19)	—
CLOs	744	6.65	1,040	995	733	(21)	104	—	(158)	262	(14)	(2)
Other ABS	1,649	5.24	2,547	1,485	1,296	(61)	116	—	(73)	189	3	(1)
Other	2,538	2.62	2,764	2,602	2,388	72	3	—	(166)	169	94	476
	8,557		10,827	9,206	7,767	(156)	449	—	(928)	1,377	57	479
Total	17,184		24,488	19,319	15,378	(689)	1,105	—	(2,648)	3,753	(148)	482
Reclassified from HFT to AFS:												
Debt securities: (1)												
CDO	924	4.65	1,253	294	294	(158)	(387)	(51)	(598)	160	(119)	—
RMBS	5,205	8.03	8,890	5,170	5,170	(530)	21	—	(131)	152	(4)	73
CMBS	98	5.53	166	91	91	(10)	(22)	—	(40)	18	4	—
CLOs	3,247	4.83	3,930	2,517	2,517	(313)	(784)	—	(1,336)	552	(34)	1
Other ABS	620	4.36	1,056	618	618	(41)	1	—	—	1	(8)	72
Other	210	20.23	610	175	175	7	4	—	(41)	45	—	—
	10,304		15,905	8,865	8,865	(1,045)	(1,167)	(51)	(2,146)	928	(161)	146
Reclassified from AFS to LAR:												
Debt securities (2)	694	1.38	760	1,017	957	(12)	6	—	6	—	—	—
Total	28,182		41,153	29,201	25,200	(1,746)	(56)	(51)	(4,788)	4,681	(309)	628

Notes:

(1) The amount taken to AFS reserve was £(958) million.

(2) The amount that would have been in AFS reserve if reclassification had not occurred is £(37) million.

(3) The above table has been restated.

	Bank				
	2008 – on reclassification			31 December 2008	
2008	Carrying value £m	Effective interest rate %	Expected cash flows £m	Carrying value £m	Fair value £m
Reclassified from HFT to LAR:					
Loans					
Leverage loans	3,464	8.71	5,562	4,136	2,635
Corporate and other loans	4,803	6.20	6,890	5,549	4,644
	8,267		12,452	9,685	7,279
Debt securities					
CDO	215	4.92	259	236	221
RMBS	1,533	6.05	1,815	1,743	1,354
CMBS	1,673	4.84	2,131	1,937	1,635
CLOs	744	6.65	1,040	995	733
Other ABS	1,649	5.24	2,547	1,485	1,296
Other	2,538	2.62	2,765	2,602	2,387
	8,352		10,557	8,998	7,626
Total	16,619		23,009	18,683	14,905
Reclassified from HFT to AFS:					
Debt securities (1)					
CDO	924	4.65	1,253	294	294
RMBS	5,205	8.03	8,890	5,170	5,170
CMBS	98	5.53	166	91	91
CLOs	3,247	4.83	3,930	2,517	2,517
Other ABS	620	4.36	1,056	618	618
Other	210	20.23	610	175	175
	10,304		15,905	8,865	8,865
Reclassified from AFS to LAR:					
Debt securities (2)	694	1.38	760	1,017	957
Total	27,617		39,674	28,565	24,727

Notes:

(1) The amount taken to AFS reserves was £(958) million.

(2) The amount that would have been in AFS reserve if reclassification had not occurred is £(37) million.

(3) The above table has been restated.

10 Financial instruments continued

Valuation of financial instruments carried at fair value

Control environment

The RBS Group's control environment for the determination of the fair value of financial instruments includes formalised protocols for the review and validation of fair values independent from the businesses entering into the transactions. There are specific controls to ensure consistent pricing policies and procedures, incorporating disciplined price verification. The RBS Group ensures that appropriate attention is given to bespoke transactions, structured products, illiquid products and other instruments which are difficult to price.

A key element of the control environment is the independent price verification ('IPV') process. Valuations are first performed by the business which entered into the transaction. Such valuations may be directly from available prices, or may be derived using a model and variable model inputs. These valuations are reviewed, and if necessary amended, by a team, independent of those trading the financial instruments, in the light of available pricing evidence. IPV is performed at a frequency to match the availability of independent data. For liquid instruments IPV is performed daily. The minimum frequency of review in the RBS Group is monthly for exposures in the regulatory trading book, and six monthly for exposures in the regulatory banking. The IPV control includes formalised reporting and escalation of any valuation differences in breach of established thresholds. The Global Pricing Unit determines IPV policy, monitors adherence to that policy, and performs additional independent reviews on highly subjective valuation issues for GBM and Non-Core.

Certain assets in the non-core business are comparably more difficult and subjective to value. The valuations of these portfolios are subject to a further level of review through an additional Non-Core valuation committee comprising senior representatives of the trading function, risk management and the Global Pricing Unit which meets regularly and are responsible for monitoring, assessing and enhancing the adequacy of the valuation techniques being adopted for these instruments.

Valuation models are subject to a review process which requires different levels of model documentation, testing and review, depending on the complexity of the model and the size of the Group's exposure. A key element of the control environment over model use in the RBS Group is a modelled product review committee, made up of valuations experts from several functions within the RBS Group. This committee sets the policy for model documentation, testing and review, and prioritises models with significant exposure for review by the RBS Group's Quantitative Research Centre. Potential valuation uncertainty is a key input in determining model review priorities at these meetings. The Quantitative Research Centre, which is independent of the trading businesses, assesses the appropriateness of the application of the model to the product, the mathematical robustness of the model, and (where appropriate), considers alternative modelling approaches.

GBM's senior management valuations control committee meets formally monthly to discuss independent pricing, reserving and valuation issues relating to both GBM and Non-Core exposures. All material methodology changes require review and ratification by this committee. The committee includes valuation specialists representing several independent review functions including Market Risk, the quantitative research centre and finance.

The Group Executive Valuation Committee discusses the issues escalated by the modelled product review committee, GBM senior management valuations control committee and other relevant issues. The committee covers key material and subjective valuation issues within the trading business. The committee will provide ratification to the appropriateness of areas with very high residual valuation uncertainty. Committee membership includes the Group Finance Director, the Group Chief Accountant, Head of Group Market Risk, GBM CFO and Non-Core CFO, and representation from front office trading and Finance.

Valuation techniques

The RBS Group uses a number of methodologies to determine the fair values of financial instruments for which observable prices in active markets for identical instruments are not available. These techniques include: relative value methodologies based on observable prices for similar instruments; present value approaches where future cash flows from the asset or liability are estimated and then discounted using a risk-adjusted interest rate; option pricing models (such as Black-Scholes or binomial option pricing models) and simulation models such as Monte-Carlo.

The principal inputs to these valuation techniques are listed below. Values between and beyond available data points are obtained by interpolation and extrapolation. When utilising valuation techniques, the fair value can be significantly affected by the choice of valuation model and by underlying assumptions concerning factors such as the amounts and timing of cash flows, discount rates and credit risk.

- Bond prices – quoted prices are generally available for government bonds, certain corporate securities and some mortgage-related products.

- Credit spreads – where available, these are derived from prices of CDS or other credit based instruments, such as debt securities. For others, credit spreads are obtained from pricing services.

- Interest rates – these are principally benchmark interest rates such as the London Inter-Bank Offered Rate (LIBOR) and quoted interest rates in the swap, bond and futures markets.

- Foreign currency exchange rates – there are observable markets both for spot and forward contracts and futures in the world's major currencies.

- Equity and equity index prices – quoted prices are generally readily available for equity shares listed on the world's major stock exchanges and for major indices on such shares.

- Commodity prices – many commodities are actively traded in spot and forward contracts and futures on exchanges in London, New York and other commercial centres.

- Price volatilities and correlations – volatility is a measure of the tendency of a price to change with time. Correlation measures the degree to which two or more prices or other variables are observed to move together. If they move in the same direction there is positive correlation; if they move in opposite directions there is negative correlation. Volatility is a key input in valuing options and the valuation of certain products such as derivatives with more than one underlying variable that are correlation-dependent. Volatility and correlation values are obtained from broker quotations, pricing services or derived from option prices.

- Prepayment rates – the fair value of a financial instrument that can be prepaid by the issuer or borrower differs from that of an instrument that cannot be prepaid. In valuing prepayable instruments that are not quoted in active markets, the Group considers the value of the prepayment option.

- Counterparty credit spreads – adjustments are made to market prices (or parameters) when the creditworthiness of the counterparty differs from that of the assumed counterparty in the market price (or parameters).

- Recovery rates/loss given default – these are used as an input to valuation models and reserves for ABS and other credit products as an indicator of severity of losses on default. Recovery rates are primarily sourced from market data providers or inferred from observable credit spreads.

In order to determine a reliable fair value, where appropriate, management applies valuation adjustments to the pricing information gathered from the above sources. These adjustments reflect the Group's assessment of factors that market participants would consider in setting a price, to the extent that these factors are not reflected in that pricing information. Furthermore, on an ongoing basis, the Group assesses the appropriateness of any model used. To the extent that the price provided by internal models does not represent the fair value of the instrument, for instance in highly stressed market conditions, the Group makes adjustments to the model valuation to calibrate to other available pricing sources. Where unobservable inputs are used, the Group may determine a range of possible valuations derived from differing stress scenarios to determine the sensitivity associated with the valuation. When establishing the fair value of a financial instrument using a valuation technique, the Group considers certain adjustments to the modelled price which market participants would make when pricing that instrument. Such adjustments include the credit quality of the counterparty and adjustments to compensate for any known model limitations.

On initial recognition of financial assets and liabilities valued using valuation techniques incorporating information other than observable market data, any difference between the transaction price and that derived from the valuation technique is deferred. Such amounts are recognised in profit or loss over the life of the transaction; when market data become observable; or when the transaction matures or is closed out as appropriate. At 31 December 2009, net gains of £159 million (2008 – £42 million; 2007 – £62 million) were carried forward in the balance sheet. During the year net gains of £138 million (2008 – £25 million; 2007 – £57 million) were deferred and £21 million (2008 – £47 million; 2007 – £10 million) recognised in the income statement.

10 Financial instruments continued

Valuation reserves

When valuing financial instruments in the trading book, adjustments are made to mid-market valuations to cover bid-offer spread, liquidity and credit risk.

Valuation reserves and adjustments comprise:

	2009 £m	2008 £m
Credit valuation adjustments:		
Monoline insurers	1,925	3,289
CDPCs	495	746
Other counterparties	1,401	1,089
	3,821	5,124
Bid-offer and liquidity reserves	2,532	2,547
	6,353	7,671
Debit valuation adjustments:		
Debt securities in issue	(1,297)	(1,622)
Derivatives	(417)	(360)
Total debit valuation adjustments	(1,714)	(1,982)
Total reserves	4,639	5,689

Credit valuation adjustments (CVA) represent an estimate of the adjustment to fair value that a market participant would make to incorporate the credit risk inherent in counterparty derivative exposures. The Group makes such credit adjustments to derivative exposures it has to counterparties, as well as debit valuation adjustments to liabilities issued by the Group. CVA is discussed in Risk, capital and liquidity management – Market turmoil exposures – Credit valuation adjustments (pages 80 to 85). Bid-offer and liquidity reserves and own credit are discussed below.

Bid-offer and liquidity reserves

Trading positions are adjusted to bid (for assets) or offer (for liabilities) levels, by marking individual cash based positions directly to bid or offer or by taking bid-offer reserves calculated on a portfolio basis for derivatives.

The bid-offer approach is based on current market spreads and standard market bucketing of risk. Risk data is used as the primary source of information within bid-offer calculations and is aggregated when it is more granular than market standard buckets.

Bid-offer adjustments for each risk factor are determined by aggregating similar risk exposures arising on different products. Additional basis bid/offer reserves are taken where these are charged in the market. Risk associated with non identical underlying exposures is not netted down unless there is evidence that the cost of closing the combined risk exposure is less than the cost of closing on an individual basis. For example: interest rate delta bid-offer methodology (when viewed in isolation) allows aggregation of risk across different tenor bases. Tenor basis bid-offer reserves are then applied to compensate for the netting within the (original) delta bid-offer calculation.

Bid-offer spreads vary by maturity and risk type to reflect different spreads in the market. For positions where there is no observable quote, the bid-offer spreads are widened in comparison to proxies to reflect reduced liquidity or observability. Bid-offer methodologies also incorporate liquidity triggers whereby wider spreads are applied to risks above pre-defined thresholds.

Netting is applied across risk buckets where there is market evidence to support this. For example calendar netting and cross strike netting effects are taken into account where such trades occur regularly within the market. Netting will also apply where long and short risk in two different risk buckets can be closed out in a single market transaction at less cost than via two separate transactions (closing out the individual bucketed risk in isolation).

Vanilla risk on exotic products is typically reserved as part of the overall portfolio based calculation e.g. delta and vega risk is included within the delta and vega bid-offer calculations. Aggregation of risk arising from different models is in line with the RBS Group's risk management practices; the model review control process considers the appropriateness of model selection in this respect.

Product related risks such as correlation risk attract specific bid to offer reserves. Additional reserves are provided for exotic products to ensure overall reserves match market close-out costs. These market close-out costs inherently incorporate risk decay and cross-effects which are unlikely to be adequately reflected in the static hedge based on vanilla instruments.

Where there is limited bid-offer information for a product a conservative approach is taken, taking into account pricing approach and risk management strategy.

Market risk close-out costs excluding CVA were £2,532 million as at 31 December 2009 (2008 – £2,547 million).

Own credit

When valuing financial liabilities recorded at fair value, the Group takes into account the effect of its own credit standing. The categories of financial liabilities on which own credit spread adjustments are made are issued debt held at fair value, including issued structured notes, and derivatives. An own credit adjustment is applied to positions where it is believed that counterparties would consider the Group's creditworthiness when pricing trades.

For issued debt and structured notes, this adjustment is based on independent quotes from market participants for the debt issuance spreads above average inter-bank rates, (at a range of tenors) which the market would demand when purchasing new senior or sub-debt issuances from the Group. Where necessary, these quotes are interpolated using a curve shape derived from CDS prices.

The own credit adjustment:

- does not alter cash flows;
- is not used for performance management; and
- is disregarded for regulatory capital reporting processes.

The fair value of the Group's derivative financial liabilities has also been adjusted to reflect the Group's own credit risk. The adjustment takes into account collateral posted by the Group and the effects of master netting agreements.

The reserve movement between periods will not equate to the reported profit or loss for own credit. The balance sheet reserves are stated by conversion of underlying currency balances at spot rates for each period whereas the income statement includes intra-period foreign exchange sell-offs.

The effect of change in credit spreads could be reversed in future periods.

The table below shows own credit adjustments on own liabilities.

	Debt securities in issue				
Cumulative own credit adjustment	Held-for-trading (1) £m	Designated as at fair value through profit and loss £m	Total £m	Derivatives (2) £m	Total £m
At 31 December 2009	547	750	1,297	417	1,714
At 31 December 2008	805	817	1,622	360	1,982
At 31 December 2007	123	152	275	—	275

Book values of underlying liabilities	£bn	£bn	£bn	£bn	£bn
At 31 December 2009	7.4	11.3	18.7	15.8	34.5
At 31 December 2008	8.4	14.0	22.4	25.8	48.2

Notes:

(1) The held-for-trading portfolio consists of wholesale and retail note issuaries.

(2) The effect of foreign exchange rates, new issues and redemptions are not captured separately.

10 Financial instruments continued

Valuation hierarchy

The table below shows financial instruments carried at fair value by valuation method.

	2009				2008				2007			
	Level 1 (1) £bn	Level 2 (2) £bn	Level 3 (3) £bn	Total £bn	Level 1 (1) £bn	Level 2 (2) £bn	Level 3 (3) £bn	Total £bn	Level 1 (1) £bn	Level 2 (2) £bn	Level 3 (3) £bn	Total £bn
Assets												
Fair value through profit or loss:												
Loans and advances to banks	—	49.6	—	49.6	—	61.0	—	61.0	—	72.6	0.1	72.7
Loans and advances to customers	—	42.8	0.5	43.3	—	50.8	3.1	53.9	—	94.9	13.1	108.0
Debt securities	59.7	41.0	2.7	103.4	50.1	50.5	3.8	104.4	59.0	70.2	10.4	139.6
Equity shares	0.4	—	0.2	0.6	0.5	—	0.4	0.9	3.7	—	0.2	3.9
Derivatives	0.3	440.5	5.5	446.3	1.4	929.7	6.3	937.4	1.0	201.9	3.1	206.0
	60.4	573.9	8.9	643.2	52.0	1,092.0	13.6	1,157.6	63.7	439.6	26.9	530.2
Available-for-sale:												
Debt securities	35.2	35.0	1.3	71.5	16.2	43.1	2.3	61.6	2.2	21.8	0.3	24.3
Equity shares (5)	0.3	0.9	0.6	1.8	0.1	1.0	0.7	1.8	0.1	1.0	0.5	1.6
	35.5	35.9	1.9	73.3	16.3	44.1	3.0	63.4	2.3	22.8	0.8	25.9
	95.9	609.8	10.8	716.5	68.3	1,136.1	16.6	1,221.0	66.0	462.4	27.7	556.1
Liabilities												
Deposits by banks and customers	—	117.1	0.1	117.2	—	147.1	0.3	147.4	—	134.1	1.5	135.6
Debt securities in issue	—	13.6	0.6	14.2	—	15.4	0.8	16.2	—	13.3	5.2	18.5
Short positions	24.4	11.9	0.2	36.5	32.0	5.2	—	37.2	43.3	3.7	—	47.0
Derivatives	0.2	422.7	1.6	424.5	0.7	905.6	2.8	909.1	1.3	199.5	2.3	203.1
Other financial liabilities (4)	—	0.6	—	0.6	—	0.7	0.3	1.0	—	0.4	0.2	0.6
	24.6	565.9	2.5	593.0	32.7	1,074.0	4.2	1,110.9	44.6	351.0	9.2	404.8

Notes:

(1) Level 1: valued using unadjusted quoted prices in active markets, examples include G10 government securities, listed equity shares, certain exchange-traded derivatives and certain US agency securities.

(2) Level 2: includes most government agency securities, investment-grade corporate bonds, certain mortgage products, certain bank and bridge loans, repos and reverse repos, less liquid listed equities, state and municipal obligations, most physical commodities and certain money market securities and loan commitments and most OTC derivatives.

(3) Level 3: includes cash instruments which trade infrequently, certain commercial mortgage loans, unlisted equity shares, certain residual interests in securitisations, super senior tranches of high grade and mezzanine CDOs, other mortgage-based products and less liquid debt securities, certain structured debt securities in issue, and OTC derivatives where valuation depends upon unobservable inputs such as certain credit and exotic derivatives. No gain or loss is recognised on the initial recognition of a financial instrument valued using a technique incorporating significant unobservable data.

(4) Comprise subordinated liabilities and write downs relating to undrawn syndicated loan facilities.

(5) 2008 has been revised to reflect reclassification between level 2 and level 3.

Level 3 portfolios

The tables below presents the Level 3 financial instruments carried at fair value as at the balance sheet date, valuation basis, main assumptions used in the valuation of these instruments and reasonably possible increases or decreases in fair value based on reasonably possible alternative assumptions:

		2009			2008		
			Reasonably possible alternative assumptions			Reasonably possible alternative assumptions	
	Valuation basis/technique and main assumptions	Carrying value £m	Increase in fair value £m	Decrease in fair value £m	Carrying value £m	Increase in fair value £m	Decrease in fair value £m
Assets							
Loans and advances	Proprietary model; Credit spreads, indices	549	40	10	3,148	70	50
Debt securities:							
– RMBS (1)	Industry standard model; Prepayment rates, probability of default, loss severity and yield	358	30	10	448	40	90
– CMBS (2)	Industry standard model; Prepayment rates, probability of default, loss severity and yield	141	30	10	487	20	20
– CDOs (3)	Proprietary model; Implied collateral valuation, defaults rates, housing prices, correlation	1,025	120	80	1,105	230	230
– CLOs (4)	Industry standard simulation model; Credit spreads, recovery rates, correlation	818	80	50	963	40	40
– other	Proprietary model; Credit spreads	1,620	180	80	3,054	50	50
Equity shares	Private equity – valuation statements; Fund valuations	813	120	110	1,081	70	140
Derivatives:							
– credit: other	Proprietary CVA model, industry option models, correlation model; Counterparty credit risk, correlation, volatility	2,589	360	350	4,410	580	560
– credit: APS	Proprietary model; Correlation, expected losses, recovery rates, credit spreads	1,400	1,370	1,540	n/a	n/a	n/a
– other	Proprietary model; Volatility, correlation, dividends	1,520	80	90	1,935	130	130
		10,833	2,410	2,330	16,631	1,230	1,310
2007					27,700	510	600
Liabilities							
Debt securities in issue	Proprietary model; correlation, volatility	592	—	—	804	20	20
Derivatives:							
– credit: other	Proprietary CVA model; industry option models, correlation model; Correlation, volatility	728	20	80	1,591	100	100
– credit: APS (5)	Proprietary model; Expected losses, credit spreads	202	20	10	n/a	n/a	n/a
– other	Proprietary model; Volatility, correlation	672	30	30	1,207	90	90
Other portfolios	Proprietary model; Credit spreads, correlation	265	30	10	588	40	60
		2,459	100	130	4,190	250	270
2007					9,200	25	25

Notes:

(1) Residential mortgage-backed securities.

(2) Commercial mortgage-backed securities.

(3) Collateralised debt obligations.

(4) Collateralised loan obligations.

(5) Reflects arrangements with fellow subsidiary.

10 Financial instruments continued

For each of the portfolio categories shown in the above table, set out below is a description of the types of products that comprise the portfolio and the valuation techniques that are applied in determining fair value, including a description of valuation techniques used for levels 2 and 3 and inputs to those models and techniques. Where reasonably possible alternative assumptions of unobservable inputs used in models would change the fair value of the portfolio significantly, the alternative inputs are indicated. Where there have been significant changes to valuation techniques during the year a discussion of the reasons for this are also included.

Loans and advances to customers

Loans in level 3 primarily comprise commercial mortgages.

Commercial mortgages

These senior and mezzanine commercial mortgages are loans secured on commercial land and buildings that were originated or acquired by the Group for securitisation. Senior commercial mortgages carry a variable interest rate and mezzanine or more junior commercial mortgages may carry a fixed or variable interest rate. Factors affecting the value of these loans may include, but are not limited to, loan type, underlying property type and geographic location, loan interest rate, loan to value ratios, debt service coverage ratios, prepayment rates, cumulative loan loss information, yields, investor demand, market volatility since the last securitisation, and credit enhancement. Where observable market prices for a particular loan are not available, the fair value will typically be determined with reference to observable market transactions in other loans or credit related products including debt securities and credit derivatives. Assumptions are made about the relationship between the loan and the available benchmark data.

Debt securities

RMBS

RMBS where the underlying assets are US agency-backed mortgages and there is regular trading are generally classified as level 2 in the fair value hierarchy. RMBS are also classified as level 2 when regular trading is not prevalent in the market, but similar executed trades or third-party data including indices, broker quotes and pricing services can be used to substantiate the fair value. RMBS are classified as level 3 when trading activity is not available and a model with significant unobservable data is utilised.

In determining whether an instrument is similar to that being valued, the Group considers a range of factors, principally: the lending standards of the brokers and underwriters that originated the mortgages, the lead manager of the security, the issue date of the respective securities, the underlying asset composition (including origination date, loan to value ratios, historic loss information and geographic location of the mortgages), the credit rating of the instrument, and any credit protection that the instrument may benefit from, such as insurance wraps or subordinated tranches. Where there are instances of market observable data for several similar RMBS tranches, the Group considers the extent of similar characteristics shared with the instrument being valued, together with the frequency, tenor and nature of the trades that have been observed. This method is most frequently used for US and UK RMBS. RMBS of Dutch and Spanish originated mortgages guaranteed by those governments are valued using the credit spreads of the respective government debt and certain assumptions made by the Group, or based on observable prices from Bloomberg or consensus pricing services.

The Group primarily uses an industry standard model to project the expected future cash flows to be received from the underlying mortgages and to forecast how these cash flows will be distributed to the various holders of the RMBS. This model utilises data provided by the servicer of the underlying mortgage portfolio, layering on assumptions for mortgage prepayments, probability of default, expected losses, and yield. The Group uses data from third-party sources to calibrate its assumptions, including pricing information from third party pricing services, independent research, broker quotes, and other independent sources. An assessment is made of third-party data source to determine its applicability and reliability. The Group adjusts the model price with a liquidity premium to reflect the price that the instrument could be traded in the market and may also make adjustments for model deficiencies.

The fair value of securities within each class of asset changes on a broadly consistent basis in response to changes in given market factors. However, the extent of the change, and therefore the range of reasonably possible alternative assumptions, may be either more or less pronounced, depending on the particular terms and circumstances of the individual security. The Group believes that probability of default was the least transparent input into Alt-A and prime RMBS modelled valuations (and most sensitive to variations).

Commercial mortgage backed securities

CMBS is valued using an industry standard model and the inputs, where possible, are corroborated using observable market data.

Collateralised debt obligations

CDOs purchased from third parties are valued using independent, third-party quotes or independent lead manager indicative prices. For super senior CDOs which have been originated by the Group no specific third-party information is available. The valuation of these super senior CDOs therefore takes into consideration outputs from a proprietary model, market data and appropriate valuation adjustments.

A collateral net asset value methodology using dealer buy side marks to determine an upper bound for super senior CDO valuations. An ABS index implied collateral valuation, is also used which provides a market calibrated valuation data point. Both the ABS index implied valuation and the collateral net asset value methodology apply an assumed immediate liquidation approach.

Collateralised loan obligations

To determine the fair value of CLOs purchased from third parties, the Group use third-party broker or lead manager quotes as the primary pricing source. These quotes are benchmarked to consensus pricing sources where they are available.

For CLOs originated and still held by the Group, the fair value is determined using a correlation model based on a Monte Carlo simulation framework. The main model inputs are credit spreads and recovery rates of the underlying assets and their correlation. A credit curve is assigned to each underlying asset based on prices, from third-party dealer quotes, and cash flow profiles, sourced from an industry standard model. Losses are calculated taking into account the attachment and detachment point of the exposure. Where the correlation inputs to this model are not observable CLOs are deemed to be level 3.

Other asset-backed and corporate debt securities

Where observable market prices for a particular debt security are not available, the fair value will typically be determined with reference to observable market transactions in other related products, such as similar debt securities or credit derivatives. Assumptions are made about the relationship between the individual debt security and the available benchmark data. Where significant management judgement has been applied in identifying the most relevant related product, or in determining the relationship between the related product and the instrument itself, the valuation is shown in level 3.

Equity shares

Private equity investments include unit holdings and limited partnership interests primarily in corporate private equity funds, debt funds and fund of hedges funds. Externally managed funds are valued using recent prices where available. Where not available, the fair value of investments in externally managed funds is generally determined using statements or other information provided by the fund managers.

The Group considers that valuations may rely significantly on the judgements and estimates made by the fund managers, particularly in assessing private equity components. Given the decline in liquidity in world markets, and the level of subjectivity, these are included in level 3.

Derivatives

Derivatives are priced using quoted prices for the same or similar instruments where these are available. However, the majority of derivatives are valued using pricing models. Inputs for these models are usually observed directly in the market, or derived from observed prices. However, it is not always possible to observe or corroborate all model inputs. Unobservable inputs used are based on estimates taking into account a range of available information including historic analysis, historic traded levels, market practice, comparison to other relevant benchmark observable data and consensus pricing data.

Credit derivatives – APS

The Group has purchased credit protection over a portfolio of specified assets and exposures (covered assets) from HMT with a par value of £282 billion including £48.8 billion of assets held by ABN AMRO which are not included on the Group's balance sheet. The protection is subject to a first loss of £60 billion and covers 90% of subsequent losses. Once a covered asset has experienced a trigger event, losses and recoveries in respect of that asset are included in the balance receivable under the APS. Receipts from HMT will, over time, amount to 90% of cumulative losses (net of cumulative recoveries) on the portfolio of covered assets less the first loss amount.

The Group has a right to terminate the APS at any time provided that the Financial Services Authority has confirmed in writing to HMT that it has no objection to the proposed termination. On termination the Group must pay HMT the higher of the regulatory capital relief received and £2.5 billion less premiums paid plus the aggregate of amounts received from the UK Government under the APS. In consideration for the protection provided by the APS, the Group paid an initial premium of £1.4 billion on 31 December 2009. A further premium of £700 million is payable on 3 December 2010 and subsequently annual premiums of £500 million until the earlier of 2099 and the termination of the agreement.

The APS is a single contract providing credit protection in respect of the covered assets. Under IFRS, credit protection is treated either as a financial guarantee contract or as a derivative financial instrument depending on the terms of the agreement and the nature of the protected assets and exposures. The Group has concluded, principally because the covered portfolio includes significant exposure in the form of derivatives, that the APS does not meet the criteria to be treated as a financial guarantee contract. The contract has therefore been accounted for as a derivative financial instrument. It was recognised initially and measured subsequently at fair value with changes in fair value recognised in profit or loss. There is no change in the recognition and measurement of the covered assets recognised on the Group's balance sheet as a result of the APS.

The Bank has also entered into two agreements with ABN AMRO Bank N.V. (ABN AMRO), a fellow subsidiary, under which it has sold credit protection over the exposures held by ABN AMRO and its subsidiaries that are subject to the APS. These agreements cover 100% of losses on these assets. One agreement provides protection over a portfolio that includes significant exposure in the form of derivatives; the other covers assets that are measured at amortised cost. The former agreement is accounted for as a credit derivative. The second agreement meets the definition of a financial guarantee contract and is accounted for as such.

Where protection is provided on a particular seniority of exposure, as is the case with the APS, which requires initial losses to be taken by the Group, it is termed "tranched" protection. The model being used to value the APS – Gaussian Copula model with stochastic recoveries is used by the Group to value tranches traded by the exotic credit desk and is a model that is currently used within the wider market.

The option to exit the APS is not usually present in such tranched trades and consequently, there is no standard market practice for reflecting this part of the trade within the standard model framework. The approach that has been adopted assumes that the Group will not exit the trade before the minimum level of fees has been paid and at this point it will be clear whether it should exit the trade or not. The APS derivative is valued as the payment of the minimum level of fees in return for protection receipts which are in excess of both the first loss and the total future premiums.

The model primarily uses the following information, obtained in relation to each individual asset: notional, maturity, probability of default and expected recovery rate given default. Other required information is the correlation between the underlying assets; and the size of the first loss.

The APS protects a wide range of asset types, and hence, the correlation between the underlying assets cannot be observed from market data. In the absence of this, the Group determines a reasonable level for this input. The expected recovery rate given default is based on internally assessed levels. The probability of default is calculated with reference to data observable in the market. Where possible, data is obtained for each asset within the APS, but for most of the assets, such observable data does not exist. Therefore, this important input is determined from information available for portfolios of similarly rated entities. As the inputs into the valuation model are not all observable the APS derivative is a level 3 asset. The value of the credit protection at 31 December 2009 was £1.4 billion, representing the initial premium paid at 31 December 2009.

10 Financial instruments continued

The Group has used the following reasonably possible alternative assumptions in relation to those inputs that could have significant effect on the valuation of the APS CDS:

- correlation: +/- 10%
- expected losses on covered assets that have triggered: +/- £1 billion
- range of possible recovery rates on non-triggered assets: +/- 10%
- credit spreads: +/- 10 basis points

Using the above reasonably possible alternative assumptions, the fair value of the APS derivative could be higher by approximately £1,370 million or lower by approximately £1,540 million.

Additionally the credit derivative (liability) with ABN AMRO had a value of £0.2 billion at 31 December 2009.

Credit derivatives – other

The Group's other credit derivatives include vanilla and bespoke portfolio tranches, gap risk products and certain other unique trades. The bespoke portfolio tranches are synthetic tranches referenced to a bespoke portfolio of corporate names on which the Group purchases credit protection. Bespoke portfolio tranches are valued using Gaussian Copula, a standard method which uses observable market inputs (credit spreads, index tranche prices and recovery rates) to generate an output price for the tranche via a mapping methodology. In essence this method takes the expected loss of the tranche expressed as a fraction of the expected loss of the whole underlying portfolio and calculates which detachment point on the liquid index, and hence which correlation level, coincides with this expected loss fraction. Where the inputs into this valuation technique are observable in the market, bespoke tranches are considered to be level 2 assets. Where inputs are not observable, bespoke tranches are considered to be level 3 assets. However, all transactions executed with a CDPC counterparty are considered level 3 as the counterparty credit risk assessment is a significant component of these valuations.

Gap risk products are leveraged trades, with the counterparty's potential loss capped at the amount of the initial principal invested. Gap risk is the probability that the market will move discontinuously too quickly to exit a portfolio and return the principal to the counterparty without incurring losses, should an unwind event be triggered. This optionality is embedded within these portfolio structures and is very rarely traded outright in the market. Gap risk is not observable in the markets and, as such, these structures are deemed to be level 3 instruments.

Other unique trades are valued using a specialised model for each instrument and the same market data inputs as all other trades where applicable. By their nature, the valuation is also driven by a variety of other model inputs, many of which are unobservable in the market. Where these instruments have embedded optionality it is valued using a variation of the Black-Scholes option pricing formula, and where they have correlation exposure it is valued using a variant of the Gaussian Copula model. The volatility or unique correlation inputs required to value these products are generally unobservable and the instruments are therefore deemed to be level 3 instruments.

Equity derivatives

Equity derivative products are split into equity exotic derivatives and equity hybrids. Equity exotic derivatives have payouts based on the performance of one or more stocks, equity funds or indices. Most payouts are based on the performance of a single asset and are valued using observable market option data. Unobservable equity derivative trades are typically complex basket options on stocks. Such basket option payouts depend on the performance of more than one equity asset and require correlations for their valuation. Valuation is then performed using industry standard valuation models, with unobservable correlation inputs calculated by reference to correlations observed between similar underlyings.

Equity hybrids have payouts based on the performance of a basket of underlyings where the underlyings are from different asset classes. Correlations between these different underlyings are typically unobservable with no market information for closely related assets available. Where no market for the correlation input exists, these inputs are based on historical time series.

Interest rate

Interest rate options provide a payout (or series of payouts) linked to the performance of one or more underlying, including interest rates and foreign exchange rates.

Exotic options do not trade in active markets except in a small number of cases. Consequently, the Group uses models to determine fair value using valuation techniques typical for the industry. These techniques can be divided, firstly, into modelling approaches and, secondly, into methods of assessing appropriate levels for model inputs. The Group uses a variety of proprietary models for valuing exotic trades.

Exotic valuation inputs include correlation between interest rates and foreign exchange rates. Correlations for more liquid rate pairs are valued using independently sourced consensus pricing levels. Where a consensus pricing benchmark is unavailable, these instruments are categorised as level 3.

Debt securities in issue

The carrying value of debt securities in issue is represented partly by underlying cash and partly through a derivative component. The classification of the amount in level 3 is driven by the derivative component and not by the cash element.

Other financial instruments

Other than the portfolios discussed above, there are other financial instruments which are held at fair value determined from data which are not market observable, or incorporating material adjustments to market observed data. These include subordinated liabilities and write downs relating to undrawn syndicated loan facilities.

Level 3 portfolio movement table

	At 1 January 2009 £m	Gains or (losses) recognised in the income statement or SOCI (1) £m	Transfers in/(out) of Level 3 £m	Reclass-ification £m	Purchases and issues £m	Sales and settlements £m	Foreign exchange £m	At 31 December 2009 £m	Gains or (losses) relating to instruments held at year end £m
Assets									
Fair value through profit or loss:									
Loans and advances to customers	3,148	108	(156)	(1,537)	19	(898)	(135)	549	7
Debt securities	3,780	(124)	(835)	(157)	1,291	(1,147)	(124)	2,684	(89)
Equity shares	352	(49)	(7)	—	14	(106)	(6)	198	(20)
Derivatives	6,345	(3,057)	366	—	3,327	(1,276)	(196)	5,509	(381)
FVTPL assets (2)	13,625	(3,122)	(632)	(1,694)	4,651	(3,427)	(461)	8,940	(483)
Available-for-sale:									
Debt securities	2,277	(372)	(255)	—	128	(470)	(30)	1,278	(8)
Equity shares	729	(140)	62	—	53	(51)	(38)	615	(127)
AFS assets (3)	3,006	(512)	(193)	—	181	(521)	(68)	1,893	(135)
	16,631	(3,634)	(825)	(1,694)	4,832	(3,948)	(529)	10,833	(618)
Liabilities									
Deposits by banks and customers	290	43	(217)	—	15	(24)	(5)	102	—
Debt securities in issue	804	(13)	3	—	72	(274)	—	592	(75)
Short positions	41	(45)	166	—	4	(4)	—	162	12
Derivatives	2,798	(51)	(713)	—	305	(638)	(99)	1,602	(32)
Other financial liabilities	257	—	—	—	—	(242)	(14)	1	—
Total liabilities	4,190	(66)	(761)	—	396	(1,182)	(118)	2,459	(95)

Notes:

(1) Net losses recognised in the income statement and statement of comprehensive income were £3,640 million and £60 million respectively. Net losses on FVTPL assets and liabilities of £3,188 million were included in income from trading activities. £452 million net losses relating to AFS assets were recorded within interest income, dividend income and impairment losses as appropriate.

(2) FVTPL: Fair value through profit or loss.

(3) AFS: Available-for-sale.

Assets reduced in the year due to disposals, write downs, transfers and reclassifications. Decrease in loans and advances to customers of £2,599 million primarily reflected the reclassification of certain leveraged and real estate finance loans from held-for-trading to loans and receivables in first half of the year. The decrease in debt securities of £2,095 million reflects wind-down of the US fund derivative portfolio, £1,090 million of debt securities transferred to level 2 due to increased observability as well as liquidations and write-downs. Derivative assets included hedges with CDPCs, illiquid credit and interest rate derivatives.

Purchases and issues include novations from a fellow subsidiary of £944 million of fair value through profit and loss debt securities, £1,737 million of derivative assets and £62 million of available-for-sale debt securities.

Sales and settlements include £577 million of derivative assets and £437 million of derivative liabilities relating to Sempra included in disposal groups in 2009.

10 Financial instruments continued

Fair value of financial instruments not carried at fair value.

The following table shows the carrying values and the fair values of financial instruments carried on the balance sheet at amortised cost.

	Group						Bank					
	2009 Carrying value £bn	2009 Fair value £bn	2008 Carrying value £bn	2008 Fair value £bn	2007 Carrying value £bn	2007 Fair value £bn	2009 Carrying value £bn	2009 Fair value £bn	2008 Carrying value £bn	2008 Fair value £bn	2007 Carrying value £bn	2007 Fair value £bn
Financial assets												
Cash and balances at central banks	27.1	27.1	6.8	6.8	5.6	5.6	21.1	21.1	3.7	3.7	3.3	3.3
Loans and advances to banks	18.8	18.8	18.4	18.4	23.6	23.6	34.9	34.9	35.6	35.7	31.3	31.3
Loans and advances to customers	492.9	465.1	565.6	521.7	443.4	446.0	294.0	277.5	266.7	238.3	218.4	218.5
Debt securities	10.3	9.5	11.8	10.5	0.5	0.5	89.9	90.0	49.0	47.7	—	—
Settlement balances	9.2	9.2	10.9	10.9	5.3	5.3	4.2	4.2	5.3	5.3	2.0	2.0
Financial liabilities												
Deposits by banks	56.7	56.7	95.0	94.4	79.8	79.6	130.6	130.5	116.1	116.0	125.7	125.7
Customer accounts	395.5	395.0	392.6	392.1	379.0	378.8	236.6	238.5	182.9	182.4	140.0	140.0
Debt securities in issue	158.2	155.4	163.8	158.7	111.7	111.7	115.3	115.6	99.1	98.7	61.5	61.5
Subordinated liabilities	34.1	31.7	39.2	36.1	27.4	26.2	29.9	27.8	33.0	30.5	22.4	21.1
Settlement balances and short positions	7.9	7.9	8.8	8.8	6.8	6.8	4.5	4.5	5.5	5.5	3.1	3.1

The fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. Quoted market values are used where available; otherwise, fair values have been estimated based on discounted expected future cash flows and other valuation techniques. These techniques involve uncertainties and require assumptions and judgments covering prepayments, credit risk and discount rates. Changes in these assumptions would significantly affect estimated fair values. The fair values reported would not necessarily be realised in an immediate sale or settlement. As a wide range of valuation techniques is available, it may be inappropriate to compare the Group's fair value information to independent markets or other financial institutions' fair values.

The fair values of intangible assets, such as core deposits, credit card and other customer relationships are not included in the calculation of these fair values since these are not financial instruments.

The assumptions and methodologies underlying the calculation of fair values of financial instruments at the balance sheet date are set out below:

The fair value of financial instruments which are of short maturity (3 months or less) approximates their carrying value. This applies mainly to cash and balances at central banks, items in the course of collection from other banks, settlement balances, items in the course of transmission to other banks and demand deposits.

Loans and advances to banks and customers
Fair value is estimated by grouping loans into homogeneous portfolios and applying a discount rate to the cash flows. The discount rate is based on the market rate applicable at the balance sheet date for a similar portfolio with similar maturity and credit risk characteristics.

Debt securities
Fair values are determined using quoted prices where available or by reference to quoted prices of similar instruments.

Deposits by banks and customer accounts
The fair values of deposits are estimated using discounted cash flow valuation techniques.

Debt securities in issue and subordinated liabilities
Fair values are determined using quoted prices where available or by reference to valuation techniques and adjusting for own credit spreads where appropriate.

Remaining maturity

The following tables show the residual maturity of financial instruments, based on contract date of maturity.

	Group								
	2009			2008			2007		
	Less than 12 months £m	More than 12 months £m	Total £m	Less than 12 months £m	More than 12 months £m	Total £m	Less than 12 months £m	More than 12 months £m	Total £m
Assets									
Cash and balances at central banks	27,051	9	27,060	6,804	2	6,806	5,559	—	5,559
Loans and advances to banks	65,422	3,019	68,441	77,874	1,513	79,387	91,951	4,395	96,346
Loans and advances to customers	171,907	364,262	536,169	245,607	373,896	619,503	251,553	299,896	551,449
Debt securities	54,042	131,139	185,181	54,909	122,857	177,766	34,593	129,839	164,432
Equity shares	—	2,405	2,405	—	2,691	2,691	—	5,509	5,509
Settlement balances	9,150	3	9,153	10,869	2	10,871	5,298	28	5,326
Derivatives	70,023	376,330	446,353	175,147	762,310	937,457	41,432	164,543	205,975
Liabilities									
Deposits by banks	111,025	5,113	116,138	176,319	5,663	181,982	143,919	7,589	151,508
Customer accounts	436,337	16,965	453,302	438,114	15,015	453,129	430,297	12,685	442,982
Debt securities in issue	96,732	75,681	172,413	122,495	57,447	179,942	79,552	50,580	130,132
Settlement balances and short positions	12,468	31,926	44,394	18,090	27,867	45,957	30,597	23,252	53,849
Derivatives	70,968	353,576	424,544	166,208	742,897	909,105	45,362	157,710	203,072
Subordinated liabilities	1,366	33,351	34,717	1,859	38,092	39,951	811	26,985	27,796

	Bank								
	2009			2008			2007		
	Less than 12 months £m	More than 12 months £m	Total £m	Less than 12 months £m	More than 12 months £m	Total £m	Less than 12 months £m	More than 12 months £m	Total £m
Assets									
Cash and balances at central banks	21,099	—	21,099	3,714	—	3,714	3,333	—	3,333
Loans and advances to banks	66,292	11,073	77,365	84,230	7,487	91,717	85,920	6,062	91,982
Loans and advances to customers	146,843	191,705	338,548	179,790	147,250	327,040	185,992	143,155	329,147
Debt securities	56,574	158,024	214,598	48,458	111,240	159,698	27,045	80,205	107,250
Equity shares	—	1,025	1,025	—	1,020	1,020	—	4,019	4,019
Settlement balances	4,156	3	4,159	5,334	1	5,335	2,018	28	2,046
Derivatives	70,322	380,591	450,913	172,539	765,966	938,505	41,750	166,163	207,913
Liabilities									
Deposits by banks	176,708	11,840	188,548	194,512	6,754	201,266	190,825	6,143	196,968
Customer accounts	202,735	87,057	289,792	200,767	28,499	229,266	183,887	14,039	197,926
Debt securities in issue	72,799	57,015	129,814	83,500	31,649	115,149	58,420	21,457	79,877
Settlement balances and short positions	8,695	19,657	28,352	13,277	16,084	29,361	26,100	7,577	33,677
Derivatives	71,667	358,338	430,005	163,500	747,674	911,174	45,367	158,867	204,234
Subordinated liabilities	429	30,084	30,513	850	32,848	33,698	603	22,142	22,745

10 Financial instruments continued

On balance sheet liabilities

The following tables show, by contractual maturity, the undiscounted cash flows payable up to a period of 20 years from the balance sheet date, including future payments of interest.

	Group					
2009	0-3 months £m	3-12 months £m	1-3 years £m	3-5 years £m	5-10 years £m	10-20 years £m
Deposits by banks	44,112	7,622	2,959	1,371	135	11
Customers accounts	379,452	9,988	3,784	2,387	3,277	2,011
Debt securities in issue	75,943	28,689	43,068	8,806	7,095	1,599
Derivatives held for hedging	391	1,008	1,174	173	14	19
Subordinated liabilities	2,231	2,291	4,607	5,107	13,678	2,523
Settlement balances and other liabilities	9,817	39	93	91	233	83
	511,946	49,637	55,685	17,935	24,432	6,246
Guarantee and commitments – notional amount						
Guarantees (1, 2)	11,202	—	—	—	—	—
Commitments (3)	248,529	—	—	—	—	—
	259,731	—	—	—	—	—
2008						
Deposits by banks	83,879	5,938	3,114	1,758	662	34
Customer accounts	368,115	18,634	2,313	2,811	4,105	2,718
Debt securities in issue	110,728	30,213	22,461	3,581	5,600	4,038
Derivatives held for hedging	67	755	1,926	674	597	317
Subordinated liabilities	972	2,659	5,113	5,583	17,213	13,287
Settlement balances and other liabilities	10,407	5	7	4	7	6
	574,168	58,204	34,934	14,411	28,184	20,400
2007						
Deposits by banks	71,944	4,739	1,539	2,344	39	48
Customer accounts	367,881	6,043	1,833	1,697	4,732	2,488
Debt securities in issue	73,927	20,638	15,256	7,789	4,884	2,200
Derivatives held for hedging	38	357	531	227	210	97
Subordinated liabilities	402	1,909	4,686	3,305	15,770	9,540
Settlement balances and other liabilities	7,242	5	14	6	12	7
	521,434	33,691	23,859	15,368	25,647	14,380

Notes:

(1) The Group is only called upon to satisfy a guarantee when the guaranteed party fails to meet its obligations. The Group expects most guarantees it provides to expire unused.

(2) Guarantees exclude the Asset Protection Scheme related financial guarantee contract of £20,680 million between the Bank and a fellow subsidiary.

(3) The Group has given commitments to provide funds to customers under undrawn formal facilities, credit lines and other commitments to lend subject to certain conditions being met by the counterparty. The Group does not expect all facilities to be drawn, and some may lapse before drawdown.

2009	0-3 months £m	3-12 months £m	1-3 years £m	3-5 years £m	5-10 years £m	10-20 years £m
	Bank					
Deposits by banks	100,007	13,531	15,069	2,160	556	28
Customers accounts	196,316	7,049	1,124	3,265	28,606	2,733
Debt securities in issue	42,687	26,770	41,699	8,187	6,726	553
Derivatives held for hedging	135	427	508	96	28	58
Subordinated liabilities	592	1,874	3,667	4,864	12,953	1,770
Settlement balances and other liabilities	5,709	4	—	—	—	—
	345,446	49,655	62,067	18,572	48,869	5,142
Guarantee and commitments – notional amount						
Guarantees (1, 2)	5,592	—	—	—	—	—
Commitments (3)	158,752	—	—	—	—	—
	164,344	—	—	—	—	—

2008	0-3 months £m	3-12 months £m	1-3 years £m	3-5 years £m	5-10 years £m	10-20 years £m
Deposits by banks	102,525	9,033	2,990	1,840	778	47
Customer accounts	156,050	16,035	1,216	4,353	4,241	2,801
Debt securities in issue	59,229	25,623	18,247	2,299	4,752	2,178
Derivatives held for hedging	24	195	349	154	206	152
Subordinated liabilities	718	1,541	3,210	4,832	16,647	10,819
Settlement balances and other liabilities	6,621	—	—	—	—	—
	325,167	52,427	26,012	13,478	26,624	15,997

2007	0-3 months £m	3-12 months £m	1-3 years £m	3-5 years £m	5-10 years £m	10-20 years £m
Deposits by banks	115,262	6,782	2,170	1,859	901	58
Customer accounts	125,043	4,170	3,978	3,197	4,840	2,673
Debt securities in issue	39,694	17,282	8,155	1,801	2,478	2,123
Derivatives held for hedging	36	143	157	101	110	31
Subordinated liabilities	328	1,172	2,994	2,681	14,536	7,889
Settlement balances and other liabilities	3,093	1	8	4	8	—
	283,456	29,550	17,462	9,643	22,873	12,774

Notes:

(1) The Bank is only called upon to satisfy a guarantee when the guaranteed party fails to meet its obligations. The Bank expects most guarantees it provides to expire unused.

(2) Guarantees exclude the Asset Protection Scheme related financial guarantee contract of £20,680 million between the Bank and a fellow subsidiary.

(3) The Bank has given commitments to provide funds to customers under undrawn formal facilities, credit lines and other commitments to lend subject to certain conditions being met by the counterparty. The Bank does not expect all facilities to be drawn, and some may lapse before drawdown.

The tables above show the timing of cash outflows to settle financial liabilities. They have been prepared on the following basis:

Financial liabilities are included at the earliest date on which the counterparty can require repayment regardless of whether or not such early repayment results in a penalty. If repayment is triggered by, or is subject to, specific criteria such as market price hurdles being reached, the liability is included at the earliest possible date that the conditions could be fulfilled without considering the probability of the conditions being met. For example, if a structured note is automatically prepaid when an equity index exceeds a certain level, the cash outflow will be included in the less than three months period whatever the level of the index at the year end. The settlement date of debt securities in issue issued by certain securitisation vehicles consolidated by the Group depends on when cash flows are received from the securitised assets.

Where these assets are prepayable, the timing of the cash outflow relating to securities assumes that each asset will be prepaid at the earliest possible date.

Liabilities with a contractual maturity of greater than 20 years – the principal amounts of financial liabilities that are repayable after 20 years or where the counterparty has no right to repayment of the principal are excluded from the table as are interest payments after 20 years.

Held-for-trading assets and liabilities – held-for-trading assets and liabilities amounting to £638.3 billion (assets), £576.0 billion (liabilities) (2008 – £1,148.7 billion assets and £1,091.7 billion liabilities) for the Group and £606.0 billion (assets) and £567.5 billion (liabilities) (2008 – £1,118.3 billion assets and £1,069.6 billion liabilities) for the Bank have been excluded from the tables in view of their short term nature.

11 Financial assets – impairments

The following tables show the movement in the provision for impairment losses for loans and advances.

	Group					
	Individually assessed £m	Collectively assessed £m	Latent £m	Total 2009 £m	2008 £m	2007 £m
At 1 January	1,947	3,380	1,328	6,655	4,235	3,929
Currency translation and other adjustments	(187)	21	(77)	(243)	453	30
(Disposals)/acquisitions	—	—	—	—	(178)	6
Amounts written-off	(2,932)	(2,784)	—	(5,716)	(2,447)	(1,652)
Recoveries of amounts previously written-off	29	278	—	307	211	245
Charged to the income statement	6,342	3,921	1,110	11,373	4,555	1,843
Unwind of discount	(194)	(162)	—	(356)	(174)	(166)
At 31 December (1)	5,005	4,654	2,361	12,020	6,655	4,235

Note:

(1) The provision for impairment losses at 31 December 2009 includes £90 million relating to loans and advances to banks (2008 – £83 million; 2007 – £2 million).

	Bank					
	Individually assessed £m	Collectively assessed £m	Latent £m	Total 2009 £m	2008 £m	2007 £m
At 1 January	1,219	897	359	2,475	1,273	1,353
Currency translation and other adjustments	(184)	(80)	1	(263)	92	(9)
Amounts written-off	(2,196)	(505)	—	(2,701)	(794)	(553)
Recoveries of amounts previously written-off	5	61	—	66	57	76
Charged to the income statement	3,845	911	413	5,169	1,908	471
Unwind of discount	(40)	(56)	—	(96)	(61)	(65)
At 31 December (1)	2,649	1,228	773	4,650	2,475	1,273

Note:

(1) The provision for impairment losses at 31 December 2009 includes £80 million relating to loans and advances to banks (2008 – £81 million; 2007 – nil).

	Group		
Impairment losses charged to the income statement	2009 £m	2008 £m	2007 £m
Loans and advances to customers	11,365	4,474	1,843
Loans and advances to banks	8	81	—
	11,373	4,555	1,843
Debt securities	603	71	20
Equity shares	198	80	2
	801	151	22
	12,174	4,706	1,865

	Group		
	2009 £m	2008 £m	2007 £m
Gross income not recognised but which would have been recognised under the original terms of non-accrual and restructured loans			
Domestic	613	384	390
Foreign	657	229	64
	1,270	613	454
Interest on non-accrual and restructured loans included in net interest income			
Domestic	213	150	165
Foreign	143	24	16
	356	174	181

The following tables show an analysis of impaired financial assets.

	Group								
	2009			2008			2007		
	Cost £m	Provision £m	Carrying value £m	Cost £m	Provision £m	Carrying value £m	Cost £m	Provision £m	Carrying value £m
Loans and receivables									
Loans and advances to banks (1)	100	90	10	83	83	—	2	2	—
Loans and advances to customers (2)	27,415	9,569	17,846	13,643	5,244	8,399	6,665	3,633	3,032
	27,515	9,659	17,856	13,726	5,327	8,399	6,667	3,635	3,032

	Group		
	Carrying value 2009 £m	Carrying value 2008 £m	Carrying value 2007 £m
Available-for-sale			
Debt securities (1)	758	15	1
Equity shares (1)	178	40	9
	936	55	10

	Bank								
	2009			2008			2007		
	Cost £m	Provision £m	Carrying value £m	Cost £m	Provision £m	Carrying value £m	Cost £m	Provision £m	Carrying value £m
Loans and receivables									
Loans and advances to banks (1)	90	80	10	81	81	—	—	—	—
Loans and advances to customers (3)	11,696	3,797	7,899	5,622	2,035	3,587	2,088	1,091	997
	11,786	3,877	7,909	5,703	2,116	3,587	2,088	1,091	997

	Bank		
	Carrying value 2009 £m	Carrying value 2008 £m	Carrying value 2007 £m
Available-for-sale			
Debt securities (1)	754	15	—
Equity shares (1)	153	31	—
	907	46	—

Notes:

(1) Impairment provisions individually assessed.

(2) Impairment provisions individually assessed on balances of £18,383 million (2008 – £6,864 million; 2007 – £1,226 million).

(3) Impairment provisions individually assessed on balances of £9,295 million (2008 – £3,761 million; 2007 – £518 million).

11 Financial assets – impairments continued

The Group and Bank hold collateral in respect of certain loans and advances to banks and to customers that are past due or impaired. Such 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 following tables show financial and non-financial assets, recognised on the Group's and Bank's balance sheets, obtained during the year by taking possession of collateral or calling on other credit enhancements.

	Group		
	2009 £m	2008 £m	2007 £m
Residential property	52	41	31
Other property	110	—	—
Cash	283	59	18
Other assets	42	30	4
	487	130	53

	Bank		
	2009 £m	2008 £m	2007 £m
Cash	242	30	15

In general, the Group seeks to dispose of property and other assets not readily convertible into cash obtained by taking possession of collateral as rapidly as the market for the individual asset permits.

The following loans and advances to customers were past due at the balance sheet date but not considered impaired:

	Group					Bank				
	Past due 1-29 days £m	Past due 30-59 days £m	Past due 60-89 days £m	Past due 90 days or more £m	Total £m	Past due 1-29 days £m	Past due 30-59 days £m	Past due 60-89 days £m	Past due 90 days or more £m	Total £m
2009	6,272	2,252	2,386	3,069	13,979	1,212	477	585	1,157	3,431
2008	7,851	2,138	1,139	1,669	12,797	1,201	415	221	645	2,482
2007	6,233	1,613	981	256	9,083	1,703	440	190	168	2,501

These balances include loans and advances to customers that are past due through administrative and other delays in recording payments or in finalising documentation and other events unrelated to credit quality.

Loans that have been renegotiated in the past 12 months that would otherwise have been past due or impaired amounted to £2,698 million (Bank – £1,843 million) as at 31 December 2009 (2008: Group – £2,637 million; Bank – £2,141 million; 2007: Group – £577 million; Bank – £259 million).

12 Derivatives

Companies in the Group transact derivatives as principal either as a trading activity or to manage balance sheet foreign exchange, interest rate and credit risk.

The Group enters into fair value hedges, cash flow hedges and hedges of net investments in foreign operations. The majority of the Group's interest rate hedges relate to the management of the Group's non-trading interest rate risk. The Group manages this risk to Value-at-Risk limits. The risk is assessed using gap reports that show maturity mismatches. To the extent that such mismatches exceed predetermined limits they are closed by executing derivatives principally interest rate swaps. Suitable larger ticket financial instruments are fair value hedged; the remaining exposure, where possible, is hedged by derivatives documented as cash flow hedges and qualifying for hedge accounting. The majority of the Group's fair value hedges involve interest rate swaps hedging the interest rate risk in recognised financial assets and financial liabilities. Cash flow hedges relate to exposure to variability in future interest payments and receipts on forecast transactions and on recognised financial assets and financial liabilities. The Group hedges its net investments in foreign operations with currency borrowings and forward exchange contracts.

For cash flow hedge relationships of interest rate risk, the hedged items are actual and forecast variable interest rate cash flows arising from financial assets and financial liabilities with interest rates linked to LIBOR, EURIBOR or the Bank of England Official Bank Rate. The financial assets are customer loans and the financial liabilities are customer deposits and LIBOR linked medium-term notes and other issued securities. As at 31 December 2009, variable rate financial assets of £17.0 billion for the Group and £15.1 billion for the Bank, and variable rate financial liabilities of £25.2 billion for the Group and £8.1 billion for the Bank were hedged in such cash flow hedge relationships.

For cash flow hedging relationships, the initial and ongoing prospective effectiveness is assessed by comparing movements in the fair value of the expected highly probable forecast interest cash flows with movements in the fair value of the expected changes in cash flows from the hedging interest rate swap or by comparing the respective changes in the price value of a basis point. Prospective effectiveness is measured on a cumulative basis i.e. over the entire life of the hedge relationship. The method of calculating hedge ineffectiveness is the hypothetical derivative method. Retrospective effectiveness is assessed by comparing the actual movements in the fair value of the cash flows and actual movements in the fair value of the hedged cash flows from the interest rate swap over the life to date of the hedging relationship.

Exchange rate contracts in cash flow hedge relationships hedge future foreign currency cash inflow and outflows; mainly principal and interest on foreign currency loans.

For fair value hedge relationships of interest rate risk, the hedged items are typically large corporate fixed rate loans, fixed rate finance leases, fixed rate medium-term notes or preference shares classified as debt. As at 31 December 2009, fixed rate financial assets of £18.7 billion for the Group and £10.4 billion for the Bank, and fixed rate financial liabilities of £29.1 billion for the Group and £28.2 billion for the Bank were hedged by interest rate swaps in fair value hedge relationships.

The initial and ongoing prospective effectiveness of fair value hedge relationships is assessed on a cumulative basis by comparing movements in the fair value of the hedged item attributable to the hedged risk with changes in the fair value of the hedging interest rate swap. Retrospective effectiveness is assessed by comparing the actual movements in the fair value of the hedged items attributable to the hedged risk with actual movements in the fair value of the hedging derivative over the life to date of the hedging relationship.

12 Derivatives continued

The following table shows the notional amounts and fair values of the Group's derivatives:

	Group								
	2009			2008			2007		
	Notional amounts £bn	Assets £m	Liabilities £m	Notional amounts £bn	Assets £m	Liabilities £m	Notional amounts £bn	Assets £m	Liabilities £m
Exchange rate contracts									
Spot, forwards and futures	1,974	26,766	26,329	2,230	84,165	82,395	1,669	16,486	18,091
Currency swaps	960	29,310	30,815	848	41,004	44,241	359	8,231	7,628
Options purchased	436	16,768	—	656	39,025	—	450	11,943	—
Options written	472	—	15,603	702	—	37,024	469	—	11,317
Interest rate contracts									
Interest rate swaps	30,786	270,305	255,141	36,701	517,731	502,408	20,479	115,928	114,799
Options purchased	3,225	54,993	—	5,774	99,924	—	3,886	27,609	—
Options written	2,592	—	52,270	3,887	—	97,842	3,424	—	27,553
Futures and forwards	6,551	2,090	2,035	9,049	8,530	7,273	2,805	708	876
Credit derivatives	1,611	42,580	37,816	2,111	131,680	122,198	1,112	21,234	18,537
Equity and commodity contracts	95	3,541	4,535	534	15,398	15,724	110	3,836	4,271
		446,353	424,544		937,457	909,105		205,975	203,072

Certain derivative asset and liability balances with the London Clearing House, which meet the offset criteria in IAS 32 'Financial Instruments: Presentation', are now shown net.

Included above are derivatives held for hedging purposes as follows:

	Group					
	2009		2008		2007	
	Assets £m	Liabilities £m	Assets £m	Liabilities £m	Assets £m	Liabilities £m
Fair value hedging:						
Interest rate swaps	1,598	1,122	2,047	1,290	546	379
Exchange rate contacts	8	—	—	—	—	—
Cash flow hedging:						
Exchange rate contracts	2	—	—	77	4	24
Interest rate swaps	1,227	1,646	2,168	2,178	369	777
Commodity contracts	—	—	39	14	—	—
Net investment hedging:						
Exchange rate contracts	—	11	—	—	—	90
Amounts above include:						
Due from/to holding company	446	1,169	361	1,168	179	173
Due from/to fellow subsidiaries	31,574	28,175	56,063	53,222	2,771	2,740

Hedge effectiveness recognised in other operating income comprised:

	Group		
	2009 £m	2008 £m	2007 £m
Fair value hedging:			
Gains/(losses) on the hedged items attributable to the hedged risk	628	(949)	66
(Losses)/gains on the hedging instruments	(571)	905	(72)
Fair value effectiveness	57	(44)	(6)
Cash flow hedging effectiveness	14	(16)	9
	71	(60)	3

The following tables show for the Group, when the hedged cash flows are expected to occur and when they will affect income for designated cash flow hedges.

	2009								
Hedged forecast cash flows expected to occur	0-1 years £m	1-2 years £m	2-3 years £m	3-4 years £m	4-5 years £m	5-10 years £m	10-20 years £m	Over 20 years £m	Total £m
Forecast receivable cash flows	389	384	357	212	117	202	40	—	1,701
Forecast payable cash flows	(356)	(345)	(269)	(217)	(170)	(480)	(444)	(84)	(2,365)
Hedged forecast cash flows affect profit or loss									
Forecast receivable cash flows	389	385	356	200	117	194	40	—	1,681
Forecast payable cash flows	(356)	(341)	(262)	(213)	(168)	(469)	(444)	(83)	(2,336)

	2008								
Hedged forecast cash flows expected to occur	0-1 years £m	1-2 years £m	2-3 years £m	3-4 years £m	4-5 years £m	5-10 years £m	10-20 years £m	Over 20 years £m	Total £m
Forecast receivable cash flows	648	641	568	459	329	869	240	41	3,795
Forecast payable cash flows	(417)	(357)	(273)	(232)	(197)	(527)	(307)	(47)	(2,357)
Hedged forecast cash flows affect profit or loss									
Forecast receivable cash flows	649	639	561	453	327	835	237	36	3,737
Forecast payable cash flows	(413)	(355)	(268)	(229)	(192)	(513)	(305)	(47)	(2,322)

The following table shows the notional amounts and fair values of the Bank's derivatives.

	Bank								
	2009			2008			2007		
	Notional amounts £bn	Assets £m	Liabilities £m	Notional amounts £bn	Assets £m	Liabilities £m	Notional amounts £bn	Assets £m	Liabilities £m
Exchange rate contracts									
Spot, forwards and futures	1,991	26,972	26,687	2,260	85,353	83,417	1,683	16,877	18,061
Currency swaps	974	29,698	32,996	863	41,783	48,100	363	8,896	7,927
Options purchased	438	16,806	—	659	39,133	—	452	12,022	—
Options written	474	—	15,629	706	—	37,134	471	—	11,400
Interest rate contracts									
Interest rate swaps	31,095	273,894	257,731	36,786	522,729	504,692	20,544	116,633	115,141
Options purchased	3,183	54,859	—	5,750	99,648	—	3,816	27,549	—
Options written	2,555	—	52,342	3,873	—	97,812	3,364	—	27,545
Futures and forwards	6,519	2,085	2,038	8,991	8,524	7,270	2,781	707	876
Credit derivatives	1,618	42,809	37,893	2,358	132,531	123,555	1,124	21,539	18,998
Equity and commodity contracts	94	3,790	4,689	374	8,804	9,194	109	3,690	4,286
		450,913	430,005		938,505	911,174		207,913	204,234

12 Derivatives continued

Included in the above are derivatives held for hedging purposes as follows:

	Bank					
	2009		2008		2007	
	Assets £m	Liabilities £m	Assets £m	Liabilities £m	Assets £m	Liabilities £m
Fair value hedging:						
Interest rate contracts	1,458	550	1,850	411	372	241
Cash flow hedging:						
Exchange rate contracts	2	—	—	77	4	24
Interest rate contracts	1058	668	1,907	498	271	236
Commodity contracts	—	—	39	—	—	—
Amounts above include:						
Due from/to holding company	446	1,169	361	1,168	179	173
Due from/to fellow subsidiaries	31,554	28,170	56,054	52,954	2,771	2,740
Due from/to subsidiaries	7,233	5,912	12,445	11,141	4,059	2,443

The following tables show for the Bank, when the hedged cash flows are expected to occur and when they will affect income for designated cash flow hedges.

	2009								
Hedged forecast cash flows expected to occur	0-1 years £m	1-2 years £m	2-3 years £m	3-4 years £m	4-5 years £m	5-10 years £m	10-20 years £m	Over 20 years £m	Total £m
Forecast receivable cash flows	320	315	287	166	73	106	—	—	1,267
Forecast payable cash flows	(105)	(100)	(87)	(79)	(73)	(308)	(404)	(84)	(1,240)
Hedged forecast cash flows affect profit or loss									
Forecast receivable cash flows	320	316	286	153	73	99	—	—	1,247
Forecast payable cash flows	(105)	(98)	(86)	(79)	(73)	(308)	(404)	(84)	(1,237)

	2008								
Hedged forecast cash flows expected to occur	0-1 years £m	1-2 years £m	2-3 years £m	3-4 years £m	4-5 years £m	5-10 years £m	10-20 years £m	Over 20 years £m	Total £m
Forecast receivable cash flows	594	587	521	418	300	771	177	41	3,409
Forecast payable cash flows	(137)	(107)	(66)	(54)	(49)	(182)	(175)	(47)	(817)
Hedged forecast cash flows affect profit or loss									
Forecast receivable cash flows	595	585	514	412	298	737	174	36	3,351
Forecast payable cash flows	(135)	(107)	(64)	(54)	(49)	(180)	(175)	(47)	(811)

13 Debt securities

2009	UK central and local government £m	US central and local government £m	Other central and local government £m	Bank and building society £m	Mortgage and other asset backed securities(1) £m	Corporate £m	Other(2) £m	Total £m
	Group							
Held-for-trading	8,120	10,398	47,276	5,599	26,246	4,722	778	103,139
Designated as at fair value through profit or loss	1	—	—	3	207	36	2	249
Available-for-sale	17,086	8,885	9,553	3,649	31,640	667	22	71,502
Loans and receivables	1	—	—	—	7,562	2,728	—	10,291
	25,208	19,283	56,829	9,251	65,655	8,153	802	185,181
Available-for-sale								
Gross unrealised gains	72	31	32	7	674	15	—	831
Gross unrealised losses	(50)	(88)	(24)	(7)	(1,162)	(15)	(2)	(1,348)

2008								
Held-for-trading	5,363	9,842	33,223	8,204	35,771	8,661	709	101,773
Designated as at fair value through profit or loss	1,994	510	—	—	1	88	6	2,599
Available-for-sale	10,915	1,008	2,796	9,726	36,052	1,117	24	61,638
Loans and receivables	—	—	—	102	7,915	3,738	1	11,756
	18,272	11,360	36,019	18,032	79,739	13,604	740	177,766
Available-for-sale								
Gross unrealised gains	16	30	25	13	308	1	1	394
Gross unrealised losses	—	(5)	(95)	(108)	(2,763)	(114)	(1)	(3,086)

2007								
Held-for-trading	8,952	14,405	36,410	9,420	50,606	16,622	370	136,785
Designated as at fair value through profit or loss	1,881	397	6	123	203	140	104	2,854
Available-for-sale	605	562	1,545	5,816	13,609	1,415	741	24,293
Loans and receivables	—	—	—	—	500	—	—	500
	11,438	15,364	37,961	15,359	64,918	18,177	1,215	164,432
Available-for-sale								
Gross unrealised gains	23	13	7	4	14	8	1	70
Gross unrealised losses	—	(35)	(2)	(29)	(125)	(5)	—	(196)

Notes:

(1) Includes securities issued by US federal agencies and government sponsored entities.

(2) Includes non asset-backed securities issued by US federal agencies and government sponsored entities.

(3) During 2009 the Group reclassified financial assets from the held-for-trading and available-for-sale categories into the loans and receivables category and from the held-for-trading category into the available-for-sale category (see page 128).

Gross gains of £557 million (2008 – £64 million; 2007 – £56 million) and gross losses of £229 million (2008 – £72 million; 2007 – £5 million) were realised by the Group on the sale of available-for-sale securities.

13 Debt securities continued

2009	UK central and local government £m	US central and local government £m	Other central and local government £m	Bank and building society £m	Mortgage and other asset backed securities(1) £m	Corporate £m	Other(2) £m	Total £m
	Bank							
Held-for-trading	8,120	636	42,748	5,254	10,829	2,896	736	71,219
Designated as at fair value through profit or loss	—	—	—	—	1	—	—	1
Available-for-sale	17,086	8,746	7,994	3,084	15,274	1,343	—	53,527
Loans and receivables	—	—	—	—	86,580	3,271	—	89,851
	25,206	9,382	50,742	8,338	112,684	7,510	736	214,598
Available-for-sale								
Gross unrealised gains	72	30	16	3	211	14	—	346
Gross unrealised losses	(50)	(87)	(24)	(3)	(846)	(10)	—	(1,020)
2008								
Held-for-trading	5,363	1,960	29,693	8,164	15,433	6,631	667	67,911
Designated as at fair value through profit or loss	—	296	—	—	—	610	—	906
Available-for-sale	10,915	—	1,452	9,013	18,506	2,012	—	41,898
Loans and receivables	—	—	—	290	44,954	3,738	1	48,983
	16,278	2,256	31,145	17,467	78,893	12,991	668	159,698
Available-for-sale								
Gross unrealised gains	16	—	1	12	16	1	—	46
Gross unrealised losses	—	—	(95)	(84)	(2,173)	(182)	—	(2,534)
2007								
Held-for-trading	8,952	3,306	28,598	9,281	30,329	16,055	934	97,455
Designated as at fair value through profit or loss	—	241	—	—	202	553	—	996
Available-for-sale	605	3	606	4,740	682	2,016	147	8,799
	9,557	3,550	29,204	14,021	31,213	18,624	1,081	107,250
Available-for-sale								
Gross unrealised gains	23	—	7	4	7	22	—	63
Gross unrealised losses	—	—	—	(3)	(1)	(3)	—	(7)

Notes:

(1) Includes securities issued by US federal agencies and government sponsored entities.

(2) Includes non asset-backed securities issued by US federal agencies and government sponsored entities.

(3) During 2009 the Bank reclassified financial assets from the held-for-trading and available-for-sale categories into the loans and receivables category and from the held-for-trading category into the available-for-sale category (see page 128).

Impairment losses on available-for-sale debt securities are recognised when there is objective evidence of impairment. The Group reviews its portfolios of available-for-sale financial assets for such evidence 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. The existence of stand alone credit protection of an available-for-sale debt security has no effect on the Group's assessment of whether or not the security is impaired. If an available-for-sale debt security benefits from credit protection that is integral to the security, the creditworthiness of the provider of that protection is taken into account when determining whether there is objective evidence that the security is impaired. Determining whether objective evidence of impairment exists requires the exercise of management judgment. 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 macro-economic outlook in US and Europe. The underlying securities remain unimpaired.

14 Equity shares

	Group								
	2009			2008			2007		
	Listed £m	Unlisted £m	Total £m	Listed £m	Unlisted £m	Total £m	Listed £m	Unlisted £m	Total £m
Held-for-trading	349	7	356	438	139	577	3,617	169	3,786
Designated as at fair value through profit or loss	38	201	239	24	251	275	32	124	156
Available-for-sale	250	1,560	1,810	57	1,782	1,839	76	1,491	1,567
	637	1,768	2,405	519	2,172	2,691	3,725	1,784	5,509
Available-for-sale									
Gross unrealised gains	73	176	249	4	142	146	27	108	135
Gross unrealised losses	(10)	(57)	(67)	(95)	(59)	(154)	(3)	(7)	(10)

Gross gains of £17 million (2008 – £188 million, 2007 – £445 million) and gross losses of £33 million (2008 – £6 million, 2007 – £0.2 million) were realised by the Group on the sale of available-for-sale equity shares.

Dividend income from available-for-sale equity shares was £50 million (2008 – £50 million; 2007 – £70 million).

Unquoted equity investments whose fair value cannot be reliably measured are carried at cost and classified as available-for-sale financial assets. They include the Group's investments in the Federal Home Loan Bank and Federal Reserve Bank that are redeemable at cost of £0.8 billion (2008 – £0.9 billion; 2007 – £0.5 billion), together with a number of individually small shareholdings. Disposals in the year generated losses of £0.6 million (2008 – nil; 2007 – £0.5 million gain).

	Bank								
	2009			2008			2007		
	Listed £m	Unlisted £m	Total £m	Listed £m	Unlisted £m	Total £m	Listed £m	Unlisted £m	Total £m
Held-for-trading	343	6	349	431	32	463	3,605	29	3,634
Designated as at fair value through profit or loss	—	7	7	—	28	28	—	10	10
Available-for-sale	218	451	669	17	512	529	5	370	375
	561	464	1,025	448	572	1,020	3,610	409	4,019
Available-for-sale									
Gross unrealised gains	53	72	125	1	45	46	4	53	57
Gross unrealised losses	(10)	(13)	(23)	(46)	(19)	(65)	—	—	—

Disposals in the year of unquoted equity instruments classified as available-for-sale financial assets generated no gains or losses (2008 – nil; 2007 – £0.1 million loss).

15 Investments in Group undertakings

Investments in Group undertakings are carried at cost less impairment. Movements during the year were as follows:

	Bank		
	2009 £m	2008 £m	2007 £m
At 1 January	26,814	22,210	21,918
Currency translation and other adjustments	(224)	898	23
Additions	42	3,943	137
Additional investments in Group undertakings	3,724	212	424
Redemption of investments in Group undertakings	(914)	(349)	(281)
Impairments	(57)	(100)	(11)
At 31 December	29,385	26,814	22,210

15 Investments in Group undertakings continued

The principal subsidiary undertakings of the Bank are shown below. Their capital consists of ordinary and preference shares, which are unlisted with the exception of certain preference shares issued by National Westminster Bank Plc. All of the subsidiary undertakings are owned directly or indirectly through intermediate holding companies and are all wholly-owned. All of these subsidiaries are included in the Group's consolidated financial statements and have an accounting reference date of 31 December.

	Nature of business	Country of incorporation and principal area of operation
National Westminster Bank Plc (1)	Banking	Great Britain
Citizens Financial Group, Inc.	Banking	US
Coutts & Company (2)	Private Banking	Great Britain
RBS Securities Inc. (3)	Broker dealer	US
Ulster Bank Limited (3, 4)	Banking	Northern Ireland

Notes:

(1) The Bank does not hold any of the NatWest preference shares in issue.

(2) Coutts & Company is incorporated with unlimited liability. Its registered office is 440 Strand, London WC2R 0QS.

(3) Shares are not directly held by the Bank.

(4) Ulster Bank Limited and its subsidiaries also operate in the Republic of Ireland.

The above information is provided in relation to the principal related undertakings as permitted by section 410(2) of the Companies Act 2006. Full information on all related undertakings will be included in the Annual Return delivered to the Registrar of Companies for Scotland.

16 Intangible assets

	Group				
2009	Goodwill £m	Core deposit intangibles £m	Other purchased intangibles £m	Internally generated software £m	Total £m
Cost:					
At 1 January 2009	19,636	401	380	3,216	23,633
Transfers to disposal groups	(238)	—	—	—	(238)
Currency translation and other adjustments	(969)	(55)	(39)	(11)	(1,074)
Acquisition of subsidiaries	26	—	—	—	26
Additions	—	—	53	350	403
Disposals and write-off of fully amortised assets	—	(2)	—	(53)	(55)
At 31 December 2009	18,455	344	394	3,502	22,695
Accumulated amortisation and impairment:					
At 1 January 2009	7,804	309	250	2,679	11,042
Currency translation and other adjustments	(474)	(33)	(27)	(6)	(540)
Disposals and write-off of fully amortised assets	—	(1)	—	(37)	(38)
Charge for the year	—	53	28	218	299
Write down of goodwill and other intangible assets	118	—	—	—	118
At 31 December 2009	7,448	328	251	2,854	10,881
Net book value at 31 December 2009	11,007	16	143	648	11,814

2008	Group Goodwill £m	Core deposit intangibles £m	Other purchased intangibles £m	Internally generated software £m	Total £m
Cost:					
At 1 January 2008	16,783	275	278	2,883	20,219
Currency translation and other adjustments	2,689	130	80	9	2,908
Acquisition of subsidiaries	211	—	—	—	211
Additions	—	—	23	340	363
Disposal of subsidiaries	(47)	—	—	—	(47)
Disposals and write-off of fully amortised assets	—	(4)	(1)	(16)	(21)
At 31 December 2008	19,636	401	380	3,216	23,633
Accumulated amortisation and impairment:					
At 1 January 2008	—	176	131	2,151	2,458
Currency translation and other adjustments	—	81	54	1	136
Disposals and write-off of fully amortised assets	—	(3)	(1)	(14)	(18)
Charge for the year	—	55	45	241	341
Write-down of goodwill and other intangible assets	7,804	—	21	300	8,125
At 31 December 2008	7,804	309	250	2,679	11,042
Net book value at 31 December 2008	11,832	92	130	537	12,591

2007	Goodwill £m	Core deposit intangibles £m	Other purchased intangibles £m	Internally generated software £m	Total £m
Cost:					
At 1 January 2007	16,834	265	275	2,518	19,892
Currency translation and other adjustments	(77)	(2)	—	4	(75)
Acquisitions of subsidiaries	66	12	—	—	78
Additions	—	—	6	445	451
Goodwill written off	(40)	—	—	—	(40)
Disposals and write-off of fully amortised assets	—	—	(3)	(84)	(87)
At 31 December 2007	16,783	275	278	2,883	20,219
Accumulated amortisation:					
At 1 January 2007	—	127	97	1,897	2,121
Currency translation and other adjustments	—	—	—	1	1
Disposals and write-off of fully amortised assets	—	—	(1)	(80)	(81)
Charge for the year	—	49	35	333	417
At 31 December 2007	—	176	131	2,151	2,458
Net book value at 31 December 2007	16,783	99	147	732	17,761

16 Intangible assets continued

2009	Bank Goodwill £m	Bank Internally generated software £m	Bank Total £m
Cost:			
At 1 January 2009	23	1,011	1,034
Transfers to disposal groups	(9)	—	(9)
Currency translation and other adjustments	(1)	—	(1)
Acquisition of subsidiaries	26	—	26
Additions	—	190	190
Disposals and write-off of fully amortised assets	—	(53)	(53)
At 31 December 2009	39	1,148	1,187
Accumulated amortisation and impairment:			
At 1 January 2009	12	886	898
Currency translation and other adjustments	—	(2)	(2)
Disposals and write-off of fully amortised assets	—	(37)	(37)
Charge for the year	—	118	118
At 31 December 2009	12	965	977
Net book value at 31 December 2009	27	183	210
2008			
Cost:			
At 1 January 2008	11	844	855
Currency translation and other adjustments	3	2	5
Acquisition of subsidiaries	9	—	9
Additions	—	179	179
Disposals and write-off of fully amortised assets	—	(14)	(14)
At 31 December 2008	23	1,011	1,034
Accumulated amortisation and impairment:			
At 1 January 2008	—	560	560
Disposals and write-off of fully amortised assets	—	(12)	(12)
Charge for the year	—	142	142
Write-down of goodwill and other intangible assets	12	196	208
At 31 December 2008	12	886	898
Net book value at 31 December 2008	11	125	136
2007			
Cost:			
At 1 January 2007	10	617	627
Currency translation and other adjustments	1	—	1
Additions	—	307	307
Disposals and write-off of fully amortised assets	—	(80)	(80)
At 31 December 2007	11	844	855
Accumulated amortisation:			
At 1 January 2007	—	455	455
Disposals and write-off of fully amortised assets	—	(79)	(79)
Charge for the year	—	184	184
At 31 December 2007	—	560	560
Net book value at 31 December 2007	11	284	295

Impairment review

The Group's goodwill acquired in business combinations is reviewed annually at 30 September for impairment by comparing the recoverable amount of each cash generating unit (CGU) to which goodwill has been allocated with its carrying value.

Changes were made to the Group's reporting structure in the first half of 2009, which is detailed on pages 186 and 187. Following the reorganisation of the Group structure, NatWest goodwill was reallocated to the appropriate CGUs.

The CGUs of the Group where the goodwill arising is significant, principally on the acquisitions of NatWest and Charter One are as follows:

2009	Recoverable amount based on	Goodwill at 30 September £m
UK Retail	Value in use	2,697
UK Corporate	Value in use	2,693
Wealth	Value in use	611
Global Transaction Services	Value in use	1,777
US Retail & Commercial	Value in use	2,761

2008	Recoverable amount based on	Goodwill prior to write down £m	Write down £m	Goodwill at 31 December £m
Global Banking & Markets	Value in use	2,225	(2,225)	—
Global Transaction Services	Value in use	1,919	—	1,919
UK Retail & Commercial Banking	Value in use	6,009	—	6,009
US Retail & Commercial Banking	Value in use	7,405	(4,382)	3,023
Europe & Middle East Retail & Commercial Banking	Value in use	1,036	(1,036)	—
Asia Retail & Commercial Banking	Value in use	180	(70)	110

The analysis of goodwill by operating segment is shown in Note 35.

The recoverable amounts for all CGUs in September 2009 were based on the value in use test, using management's latest five-year forecasts. The long-term growth rates have been based on respective country GDP rates adjusted for inflation. The risk discount rates are based on observable market long-term government bond yields and average industry betas adjusted for an appropriate risk premium based on independent analysis.

The recoverable amount of UK Retail, based on a 4% terminal growth rate and 14.6% pre tax discount rate, exceeded the carrying amount by £0.7 billion. A 1% change in the discount rate or the terminal growth rate would change the recoverable amount by approximately £0.9 billion and £0.5 billion respectively. In addition, a 5% change in the forecast pre tax earnings would change the recoverable amount by approximately £0.4 billion.

The recoverable amount UK Corporate, based on a 4% terminal growth rate and a 15.1% pre tax discount rate, exceeded its carrying value by £6.1 billion. A 1% change in the discount rate or similar change in the terminal growth rate would change the recoverable amount by approximately £1.4 billion and £0.9 billion respectively. In addition, a 5% change in the forecast pre tax earnings would change the recoverable amount by approximately £0.8 billion.

The recoverable amount of Wealth, based on a 4% terminal growth rate and a 15.3% pre tax discount rate, exceeded its carrying value by £5.6 billion. A 1% change in the discount rate or similar change in the terminal growth rate would change the recoverable amount by approximately £0.6 billion and £0.5 billion respectively. In addition, a 5% change in the forecast pre tax earnings would change the recoverable amount by approximately £0.4 billion.

The recoverable amount of Global Transaction Services, based on a 3% (2008 – 3%) terminal growth rate and a 16.7% (2008 – 15.7%) pre tax discount rate, exceeded its carrying value by more than 100% (2008 – 100%) and was insensitive to a reasonably possible change in key assumptions.

The recoverable amount of US Retail & Commercial, based on a 5% (2008 – 5%) terminal growth rate and a 14.8% (2008 – 18%) pre tax discount rate, exceeded its carrying value by £2.1 billion (2008 – impairment of £4.4 billion). A 1% change in the discount rate or similar change in the terminal growth rate would change the recoverable amount by approximately £1.0 billion (2008 – £1 billion) and £0.8 billion (2008 – £0.7 billion) respectively. In addition, a 5% change in the forecast pre tax earnings would change the recoverable amount by approximately £0.7 billion (2008 – £0.5 billion).

During the year an impairment charge of £118 million was recorded in relation to NatWest goodwill allocated to Non-Core businesses following the restructure of the Group.

In 2008, the recoverable amounts for all CGUs were based on value in use tests. Goodwill write downs were recorded in Global Banking & Markets, US Retail & Commercial, Europe & Middle East Retail & Commercial Banking and Asia Retail & Commercial Banking divisions.

17 Property, plant and equipment

2009	Investment properties £m	Freehold premises £m	Long leasehold premises £m	Short leasehold premises £m	Computers and other equipment £m	Operating lease assets £m	Total £m
	Group						
Cost or valuation:							
At 1 January 2009	3,868	2,613	223	1,771	3,843	8,982	21,300
Transfers to disposal groups	—	—	—	(57)	(73)	—	(130)
Currency translation and other adjustments	(85)	(67)	—	(62)	(128)	(535)	(877)
Reclassifications	1	18	1	(34)	14	—	—
Additions	1,634	156	8	114	422	2,113	4,447
Expenditure on investment properties	8	—	—	—	—	—	8
Change in fair value of investment properties	(117)	—	—	—	—	—	(117)
Disposals and write-off of fully depreciated assets	(426)	(42)	(19)	(98)	(371)	(1,389)	(2,345)
At 31 December 2009	4,883	2,678	213	1,634	3,707	9,171	22,286
Accumulated impairment, depreciation and amortisation:							
At 1 January 2009	—	466	79	583	1,982	1,562	4,672
Transfers to disposal groups	—	—	—	(7)	(31)	—	(38)
Currency translation and other adjustments	—	(4)	—	(18)	(74)	(64)	(160)
Write down of property, plant and equipment	—	5	—	5	—	—	10
Disposals and write-off of fully depreciated assets	—	(19)	—	(78)	(267)	(431)	(795)
Charge for the year	—	82	8	121	514	563	1,288
At 31 December 2009	—	530	87	606	2,124	1,630	4,977
Net book value at 31 December 2009	4,883	2,148	126	1,028	1,583	7,541	17,309

2008	Investment properties £m	Freehold premises £m	Long leasehold premises £m	Short leasehold premises £m	Computers and other equipment £m	Operating lease assets £m	Total £m
Cost or valuation:							
At 1 January 2008	3,431	2,225	214	1,445	3,387	6,385	17,087
Transfers to disposal groups	—	(15)	(18)	—	—	(27)	(60)
Currency translation and other adjustments	320	162	5	131	414	1,183	2,215
Acquisition of subsidiaries	—	—	—	30	31	—	61
Disposal of subsidiaries	—	—	—	(2)	(52)	—	(54)
Reclassifications	—	(196)	—	197	(1)	—	—
Additions	417	458	22	26	663	3,448	5,034
Expenditure on investment properties	8	—	—	—	—	—	8
Change in fair value of investment properties	(86)	—	—	—	—	—	(86)
Disposals and write-off of fully depreciated assets	(222)	(21)	—	(56)	(599)	(2,007)	(2,905)
At 31 December 2008	3,868	2,613	223	1,771	3,843	8,982	21,300
Accumulated impairment, depreciation and amortisation:							
At 1 January 2008	—	376	74	438	1,888	1,286	4,062
Transfers to disposal groups	—	—	—	—	—	(1)	(1)
Currency translation and other adjustments	—	10	1	49	203	176	439
Disposal of subsidiaries	—	—	—	(1)	(35)	—	(36)
Reclassifications	—	(1)	(2)	1	2	—	—
Write down of property, plant and equipment	—	19	—	—	—	—	19
Disposals and write-off of fully depreciated assets	—	(1)	—	(12)	(531)	(488)	(1,032)
Charge for the year	—	63	6	108	455	589	1,221
At 31 December 2008	—	466	79	583	1,982	1,562	4,672
Net book value at 31 December 2008	3,868	2,147	144	1,188	1,861	7,420	16,628

2007	Investment properties £m	Freehold premises £m	Long leasehold premises £m	Short leasehold premises £m	Computers and other equipment £m	Operating lease assets £m	Total £m
	Group						
Cost or valuation:							
At 1 January 2007	4,884	2,420	276	1,254	2,959	7,151	18,944
Transfers to disposal groups	—	(4)	(13)	—	—	(422)	(439)
Currency translation and other adjustments	96	5	1	3	5	(63)	47
Acquisition of subsidiaries	—	14	6	—	1	—	21
Reclassifications	3	(4)	(2)	1	2	—	—
Additions	449	276	35	231	569	2,328	3,888
Expenditure on investment properties	41	—	—	—	—	—	41
Change in fair value of investment properties	288	—	—	—	—	—	288
Disposals and write-off of fully depreciated assets	(2,330)	(482)	(89)	(44)	(149)	(2,609)	(5,703)
At 31 December 2007	3,431	2,225	214	1,445	3,387	6,385	17,087
Accumulated depreciation and amortisation:							
At 1 January 2007	—	435	95	374	1,630	1,360	3,894
Transfers to disposal groups	—	—	—	—	—	(52)	(52)
Currency translation and other adjustments	—	1	—	1	5	(4)	3
Acquisition of subsidiaries	—	—	2	—	—	—	2
Disposals and write-off of fully depreciated assets	—	(124)	(30)	(25)	(109)	(518)	(806)
Charge for the year	—	64	7	88	362	500	1,021
At 31 December 2007	—	376	74	438	1,888	1,286	4,062
Net book value at 31 December 2007	3,431	1,849	140	1,007	1,499	5,099	13,025

Investment properties are valued to reflect fair value, that is, the market value of the Group's interest at the reporting date excluding any special terms or circumstances relating to the use or financing of the property and transaction costs that would be incurred in making a sale. Observed market data such as rental yield, replacement cost and useful life, reflect relatively few transactions involving property that, necessarily, is not identical to property owned by the Group.

Valuations are carried out by qualified surveyors who are members of the Royal Institution of Chartered Surveyors, or an equivalent overseas body. The valuation as at 31 December 2009 for a significant majority of the Group's investment properties was undertaken with the support of external valuers.

Investment property acquired during 2009 includes £1,336 million arising on assumption by the Group of control of properties for which it provided finance to a customer.

The fair value of investment properties includes £84 million (2008 – £172 million; 2007 – £234 million) of appreciation since purchase.

Rental income from investment properties was £228 million (2008 – £237 million; 2007 – £291 million). Direct operating expenses of investment properties were £16 million (2008 – £2 million; 2007 – £49 million).

Property, plant and equipment, excluding investment properties, include £213 million (2008 – £1,132 million; 2007 – £382 million) assets in the course of construction.

Freehold and long leasehold properties with a net book value of £5 million (2008 – nil; 2007 – £374 million) were sold subject to operating leases.

17 Property, plant and equipment continued

2009	Bank: Freehold premises £m	Long leasehold premises £m	Short leasehold premises £m	Computers and other equipment £m	Operating lease assets £m	Total £m
Cost or valuation:						
At 1 January 2009	1,065	53	633	1,991	110	3,852
Currency translation and other adjustments	(1)	—	(6)	(5)	—	(12)
Additions	24	—	169	310	20	523
Transfer from fellow subsidiary	—	—	—	18	—	18
Disposals and write-off of fully depreciated assets	(11)	(1)	(38)	(244)	(39)	(333)
At 31 December 2009	1,077	52	758	2,070	91	4,048
Accumulated impairment depreciation and amortisation:						
At 1 January 2009	159	24	203	1,008	90	1,484
Currency translation and other adjustments	—	—	(2)	—	—	(2)
Disposals and write-off of fully depreciated assets	(8)	(1)	(28)	(183)	(38)	(258)
Charge for the year	36	2	45	284	10	377
At 31 December 2009	187	25	218	1,109	62	1,601
Net book value at 31 December 2009	890	27	540	961	29	2,447

2008	Freehold premises £m	Long leasehold premises £m	Short leasehold premises £m	Computers and other equipment £m	Operating lease assets £m	Total £m
Cost or valuation:						
At 1 January 2008	860	52	628	2,083	126	3,749
Currency translation and other adjustments	2	—	17	19	—	38
Additions	207	1	28	406	7	649
Transfer from fellow subsidiary	—	—	8	6	—	14
Disposals and write-off of fully depreciated assets	(4)	—	(48)	(523)	(23)	(598)
At 31 December 2008	1,065	53	633	1,991	110	3,852
Accumulated impairment depreciation and amortisation:						
At 1 January 2008	122	22	167	1,221	101	1,633
Currency translation and other adjustments	—	—	5	7	—	12
Transfer from fellow subsidiary	—	—	1	2	—	3
Write down of property, plant and equipment	7	—	—	—	—	7
Disposals and write-off of fully depreciated assets	—	—	(7)	(482)	(23)	(512)
Charge for the year	30	2	37	260	12	341
At 31 December 2008	159	24	203	1,008	90	1,484
Net book value at 31 December 2008	906	29	430	983	20	2,368

2007	Freehold premises £m	Long leasehold premises £m	Short leasehold premises £m	Computers and other equipment £m	Operating lease assets £m	Total £m
Cost or valuation:						
At 1 January 2007	1,017	55	509	1,786	124	3,491
Currency translation and other adjustments	—	—	—	2	—	2
Additions	15	8	140	369	7	539
Disposals and write-off of fully depreciated assets	(172)	(11)	(21)	(74)	(5)	(283)
At 31 December 2007	860	52	628	2,083	126	3,749
Accumulated depreciation and amortisation:						
At 1 January 2007	164	23	144	1,044	94	1,469
Disposals and write-off of fully depreciated assets	(72)	(3)	(10)	(46)	(6)	(137)
Charge for the year	30	2	33	223	13	301
At 31 December 2007	122	22	167	1,221	101	1,633
Net book value at 31 December 2007	738	30	461	862	25	2,116

18 Prepayments, accrued income and other assets

	Group			Bank		
	2009 £m	2008 £m	2007 £m	2009 £m	2008 £m	2007 £m
Prepayments	1,146	768	730	2,111	301	270
Accrued income	885	1,189	962	571	858	685
Deferred expenses	143	289	47	33	252	30
Pension schemes in net surplus	28	4	566	9	4	—
Other assets	10,463	9,147	3,811	7,264	4,515	695
	12,665	11,397	6,116	9,988	5,930	1,680

19 Assets and liabilities of disposal groups

	Group 2009 £m	Bank 2009 £m
Assets of disposal groups		
Loans and advances to banks	314	78
Loans and advances to customers	306	43
Debt securities and equity shares	56	20
Derivatives	6,361	2,824
Intangible assets	238	9
Settlement balances	1,579	502
Property, plant and equipment	92	—
Other assets	5,257	3,674
	14,203	7,150
Liabilities of disposal groups		
Deposits by banks	560	464
Customer accounts	1,961	1,755
Derivatives	6,262	2,966
Settlement balances	950	—
Other liabilities	1,260	923
	10,993	6,108

To comply with EC State Aid requirements the Group has agreed to make a series of divestments over the next four years. Sempra was the only such divestment that met the criteria for classification as a disposal group at 31 December 2009. There were no disposal groups at 31 December 2008 or 2007.

20 Settlement balances and short positions

	Group			Bank		
	2009 £m	2008 £m	2007 £m	2009 £m	2008 £m	2007 £m
Settlement balances (amortised cost)	7,922	8,785	6,791	4,541	5,534	3,110
Short positions (held-for-trading):						
Debt securities – Government	26,646	31,899	41,048	17,759	19,930	26,685
– Other issues	9,825	4,521	5,561	6,051	3,145	3,433
Equity shares	1	752	449	1	752	449
	44,394	45,957	53,849	28,352	29,361	33,677

21 Accruals, deferred income and other liabilities

	Group			Bank		
	2009 £m	2008 £m	2007 £m	2009 £m	2008 £m	2007 £m
Notes in circulation	1,889	1,619	1,545	1,172	1,087	1,080
Current taxation	150	201	1,017	295	47	159
Accruals	5,769	5,870	4,155	3,721	3,826	2,807
Deferred income	1,388	1,564	601	865	1,143	143
Other liabilities (1)	7,278	7,431	4,849	3,896	3,515	1,594
	16,474	16,685	12,167	9,949	9,618	5,783

Note:

(1) Other liabilities include £5 million (2008 – £1 million; 2007 – £9 million) in respect of share-based compensation.

Included in other liabilities are provisions for liabilities and charges as follows:

	Group £m	Bank £m
At 1 January 2009	180	81
Currency translation and other movements	81	101
Charge to income statement	436	343
Releases to income statement	(57)	(42)
Provisions utilised	(148)	(119)
At 31 December 2009	492	364

Note:

(1) Comprises property provisions and other provisions arising in the normal course of business.

22 Deferred taxation

Provision for deferred taxation has been made as follows:

	Group 2009 £m	Group 2008 £m	Group 2007 £m	Bank 2009 £m	Bank 2008 £m	Bank 2007 £m
Deferred tax liability	1,187	2,483	2,063	—	—	—
Deferred tax asset	(2,228)	(2,833)	(240)	(1,728)	(1,323)	(319)
Net deferred tax	(1,041)	(350)	1,823	(1,728)	(1,323)	(319)

Group

	Pension £m	Accelerated capital allowances £m	Provisions £m	Deferred gains £m	IAS transition £m	Fair value of financial instruments £m	Available-for-sale financial assets £m	Intangibles £m	Cash flow hedging £m	Losses carried forward £m	Other £m	Total £m
At 1 January 2008	66	2,798	(305)	105	(615)	(47)	—	222	(259)	—	(142)	1,823
Charge/(credit) to income statement	66	16	(372)	21	203	(125)	(24)	(291)	260	(805)	191	(860)
(Credit)/charge to equity directly	(464)	—	—	(6)	—	3	7	—	(78)	(709)	6	(1,241)
Acquisitions/(disposals) of subsidiaries	—	—	—	—	5	2	(2)	—	—	—	(11)	(6)
Other	(20)	267	(203)	7	(2)	(2)	(27)	90	(102)	(39)	(35)	(66)
At 1 January 2009	(352)	3,081	(880)	127	(409)	(169)	(46)	21	(179)	(1,553)	9	(350)
Charge/(credit) to income statement	678	(159)	(637)	6	39	(90)	(43)	25	169	(482)	2	(492)
(Credit)/charge to equity directly	(1,019)	—	—	(18)	—	—	(19)	—	251	554	—	(251)
Other	7	(104)	81	—	—	5	11	(2)	34	15	5	52
At 31 December 2009	(686)	2,818	(1,436)	115	(370)	(254)	(97)	44	275	(1,466)	16	(1,041)

Bank

	Pension £m	Accelerated capital allowances £m	Provisions £m	Deferred gains £m	IAS transition £m	Fair value of financial instruments £m	Available-for-sale financial assets £m	Cash flow Ihedging £m	Losses carried forward £m	Other £m	Total £m
At 1 January 2008	(10)	68	(81)	30	(215)	(1)	—	(100)	—	(10)	(319)
Charge/(credit) to income statement	4	(17)	33	1	34	—	—	1	(699)	1	(642)
Charge/(credit) to equity directly	(3)	—	—	—	—	—	(3)	344	(709)	6	(365)
Other	—	—	—	—	—	1	(1)	2	—	1	3
At 1 January 2009	(9)	51	(48)	31	(181)	—	(4)	247	(1,408)	(2)	(1,323)
(Credit)/charge to income statement	(2)	(281)	(424)	18	26	—	—	2	(281)	(6)	(948)
(Credit)/charge to equity directly	(2)	—	—	—	—	—	4	(17)	554	—	539
Other	6	—	—	—	—	—	—	(1)	—	(1)	4
At 31 December 2009	(7)	(230)	(472)	49	(155)	—	—	231	(1,135)	(9)	(1,728)

Notes:

(1) Deferred tax assets are recognised, as set out above, that depend on the availability of future taxable profits in excess of profits arising from the reversal of other temporary differences. Business projections prepared for impairment reviews (see Note 16) indicate it is probable that sufficient future taxable income will be available against which to offset these recognised deferred tax assets within five years. In jurisdictions where doubt exists over the availability of future taxable profits, deferred tax assets of £26 million (2008 – £29 million; 2007 – £34 million) have not been recognised in respect of tax losses carried forward of £100 million (2008 – £108 million; 2007 – £110 million). Of these losses, £24 million will expire after five years. The balance of tax losses carried forward has no time limit.

(2) Deferred tax liabilities of £279 million (2008 – £844 million; 2007 – £972 million) have not been recognised in respect of retained earnings of overseas subsidiaries and held-over gains on the incorporation of overseas branches. Retained earnings of overseas subsidiaries are expected to be reinvested indefinitely or remitted to the UK free from further taxation. No taxation is expected to arise in the foreseeable future in respect of held-over gains. The temporary differences at the balance sheet date are significantly reduced from the previous year as a result of change to UK tax legislation which largely exempts from UK tax, overseas dividends received on or after 1 July 2009.

23 Subordinated liabilities

	Group			Bank		
	2009 £m	2008 £m	2007 £m	2009 £m	2008 £m	2007 £m
Dated loan capital	22,067	20,594	14,605	19,688	17,135	11,892
Undated loan capital	9,427	15,208	10,240	7,940	12,774	8,206
Preference shares	3,223	4,149	2,951	2,885	3,789	2,647
	34,717	39,951	27,796	30,513	33,698	22,745

In April 2009, the Group concluded a series of exchange offers and tender offers with the holders of a number of Tier 1 and Upper Tier 2 securities. The exchanges involving instruments classified as liabilities all met the criteria in IFRS for treatment as the extinguishment of the original liability and the recognition of a new financial liability of £1,807 million. Gains on these exchanges, and on the redemption of securities classified as liabilities for cash, totalling £2,694 million were credited to income.

The RBS Group has undertaken that, unless otherwise agreed with the European Commission, neither the holding company nor any of its direct or indirect subsidiaries (excluding companies in the ABN AMRO Group) will pay external investors any dividends or coupons on existing hybrid capital instruments (including preference shares, B shares and upper and lower tier 2 instruments) from a date starting not later than 30 April 2010 and for a period of two years thereafter ("the deferral period"), or exercise any call rights in relation to these capital instruments between 24 November 2009 and the end of the deferral period, unless there is a legal obligation to do so. Hybrid capital instruments issued after 24 November 2009 will generally not be subject to the restriction on dividend or coupon payments or call options.

Certain preference shares are classified as liabilities; these securities remain subject to the capital maintenance rules of the Companies Act 2006.

The following tables analyse the remaining maturity of subordinated liabilities by (1) the final redemption date; and (2) the next call date.

	Group						
2009 – final redemption	2010 £m	2011 £m	2012-2014 £m	2015-2019 £m	Thereafter £m	Perpetual £m	Total £m
Sterling	113	—	164	5,712	345	3,903	10,237
US dollars	380	196	1,457	3,306	77	5,946	11,362
Euro	851	443	1,414	4,336	1,379	2,036	10,459
Other	22	—	554	1,462	—	621	2,659
Total	1,366	639	3,589	14,816	1,801	12,506	34,717

	Group							
2009 – call date	Currently £m	2010 £m	2011 £m	2012–2014 £m	2015–2019 £m	Thereafter £m	Perpetual £m	Total £m
Sterling	174	200	194	496	7,499	1,504	170	10,237
US dollars	1,926	825	1,429	4,260	686	2,236	—	11,362
Euro	564	731	900	3,399	4,386	428	51	10,459
Other	419	572	—	618	878	172	—	2,659
Total	3,083	2,328	2,523	8,773	13,449	4,340	221	34,717

	Group						
2008 – final redemption	2009 £m	2010 £m	2011-2013 £m	2014-2018 £m	Thereafter £m	Perpetual £m	Total £m
Sterling	186	—	167	736	370	7,911	9,370
US dollars	1,268	342	1,125	5,362	86	7,237	15,420
Euro	379	590	1,991	4,891	1,454	3,271	12,576
Other	26	—	—	1,882	—	677	2,585
Total	1,859	932	3,283	12,871	1,910	19,096	39,951

	Group							
2008 – call date	Currently £m	2009 £m	2010 £m	2011–2013 £m	2014–2018 £m	Thereafter £m	Perpetual £m	Total £m
Sterling	—	186	737	1,030	3,507	3,740	170	9,370
US dollars	1,833	3,207	1,537	5,668	1,597	1,578	—	15,420
Euro	—	857	877	4,246	6,098	447	51	12,576
Other	—	497	405	553	914	216	—	2,585
Total	1,833	4,747	3,556	11,497	12,116	5,981	221	39,951

	Group						
2007 – final redemption	2008 £m	2009 £m	2010-2012 £m	2013-2017 £m	Thereafter £m	Perpetual £m	Total £m
Sterling	186	—	—	771	389	5,942	7,288
US dollar	183	747	620	4,003	233	3,987	9,773
Euro	417	220	815	3,731	937	2,567	8,687
Other	25	—	—	1,560	—	463	2,048
Total	811	967	1,435	10,065	1,559	12,959	27,796

	Group							
2007 – call date	Currently £m	2008 £m	2009 £m	2010–2012 £m	2013–2017 £m	Thereafter £m	Perpetual £m	Total £m
Sterling	—	186	—	1,463	1,822	3,652	165	7,288
US dollar	1,348	543	1,795	3,235	1,681	1,171	—	9,773
Euro	—	1,265	591	2,495	4,075	222	39	8,687
Other	—	25	431	837	652	103	—	2,048
Total	1,348	2,019	2,817	8,030	8,230	5,148	204	27,796

23 Subordinated liabilities continued

2009 – final redemption	Bank 2010 £m	2011 £m	2012-2014 £m	2015-2019 £m	Thereafter £m	Perpetual £m	Total £m
Sterling	72	—	164	5,288	—	3,367	8,891
US dollars	65	196	1,202	3,306	1,500	3,754	10,023
Euro	271	—	1,414	4,336	2,517	403	8,941
Other	21	—	554	1,462	—	621	2,658
Total	429	196	3,334	14,392	4,017	8,145	30,513

2009 – call date	Bank Currently £m	2010 £m	2011 £m	2012-2014 £m	2015-2019 £m	Thereafter £m	Total £m
Sterling	—	171	194	430	7,141	955	8,891
US dollars	1,154	513	1,429	4,005	686	2,236	10,023
Euro	—	271	457	3,399	4,386	428	8,941
Other	419	571	—	618	878	172	2,658
Total	1,573	1,526	2,080	8,452	13,091	3,791	30,513

2008 – final redemption	Bank 2009 £m	2010 £m	2011-2013 £m	2014-2018 £m	Thereafter £m	Perpetual £m	Total £m
Sterling	132	—	167	298	—	6,935	7,532
US dollars	371	—	840	5,362	86	5,999	12,658
Euro	326	—	1,515	4,891	1,454	2,742	10,928
Other	21	—	—	1,882	—	677	2,580
Total	850	—	2,522	12,433	1,540	16,353	33,698

2008 – call date	Bank Currently £m	2009 £m	2010 £m	2011-2013 £m	2014-2018 £m	Thereafter £m	Total £m
Sterling	—	132	397	964	3,135	2,904	7,532
US dollars	582	2,323	1,195	5,383	1,597	1,578	12,658
Euro	—	326	287	3,770	6,098	447	10,928
Other	—	492	405	553	914	216	2,580
Total	582	3,273	2,284	10,670	11,744	5,145	33,698

2007 – final redemption	Bank 2008 £m	2009 £m	2010-2012 £m	2013-2017 £m	Thereafter £m	Perpetual £m	Total £m
Sterling	132	—	—	429	—	4,973	5,534
US dollar	75	199	159	4,004	233	3,077	7,747
Euro	376	220	—	3,731	937	2,157	7,421
Other	20	—	—	1,560	—	463	2,043
Total	603	419	159	9,724	1,170	10,670	22,745

2007 – call date	Bank Currently £m	2008 £m	2009 £m	2010-2012 £m	2013-2017 £m	Thereafter £m	Total £m
Sterling	—	132	—	1,129	1,415	2,858	5,534
US dollar	425	449	1,247	2,774	1,681	1,171	7,747
Euro	—	1,224	220	1,680	4,075	222	7,421
Other	—	20	431	837	652	103	2,043
Total	425	1,825	1,898	6,420	7,823	4,354	22,745

Dated loan capital	2009 £m	2008 £m	2007 £m
The Bank			
€255 million 5.25% subordinated notes 2008	—	—	192
€300 million 4.875% subordinated notes 2009 (redeemed March 2009)	—	298	228
€1,000 million floating rate subordinated notes 2013	—	—	744
US$50 million floating rate subordinated notes 2013	36	36	26
€1,000 million 6.0% subordinated notes 2013	1,014	1,083	790
€500 million 6.0% subordinated notes 2013	452	487	374
£150 million 10.5% subordinated bonds 2013 (2)	177	180	169
US$1,250 million floating rate subordinated notes 2014 (redeemed July 2009)	—	862	630
AUD590 million 6.0% subordinated notes 2014 (callable April 2010)	330	281	254
AUD410 million floating rate subordinated notes 2014 (callable April 2010)	229	195	182
CAD700 million 4.25% subordinated notes 2015 (callable March 2010)	419	409	358
£250 million 9.625% subordinated bonds 2015	301	311	286
US$750 million floating rate subordinated notes 2015 (callable September 2010)	462	513	374
€750 million floating rate subordinated notes 2015	741	783	564
CHF400 million 2.375% subordinated notes 2015	244	257	166
CHF100 million 2.375% subordinated notes 2015	69	72	41
CHF200 million 2.375% subordinated notes 2015	117	125	86
US$500 million floating rate subordinated notes 2016 (callable October 2011)	308	346	252
US$1,500 million floating rate subordinated notes 2016 (callable April 2011)	926	1,038	757
€500 million 4.5% subordinated notes 2016 (callable January 2011)	476	511	379
CHF200 million 2.75% subordinated notes 2017 (callable December 2012)	120	129	89
€100 million floating rate subordinated notes 2017	89	97	73
€500 million floating rate subordinated notes 2017 (callable June 2012)	445	482	371
€750 million 4.35% subordinated notes 2017 (callable January 2017)	728	770	548
AUD450 million 6.5% subordinated notes 2017 (callable February 2012)	255	217	202
AUD450 million floating rate subordinated notes 2017 (callable February 2012)	250	214	199
US$1,500 million floating rate subordinated callable step-up notes 2017 (callable August 2012)	925	1,029	752
€2,000 million 6.93% subordinated notes 2018 (callable April 2018)	2,017	2,136	—
US$125.6 million floating rate subordinated notes 2020	78	87	64
€1,000 million 4.625% subordinated notes 2021 (callable September 2016)	962	1,019	724
€300 million CMS linked floating rate subordinated notes 2022	292	303	228
€144.4 million floating rate subordinated notes 2022 (callable June 2022)	143	152	—
Due to the holding company			
US$400 million 6.4% subordinated notes 2009 (redeemed April 2009) (1)	—	278	202
US$300 million 6.375% subordinated notes 2011 (1)	201	231	163
US$750 million 5% subordinated notes 2013 (1)	504	581	384
US$750 million 5% subordinated notes 2014 (1)	522	617	386
US$250 million 5% subordinated notes 2014 (1)	151	168	123
US$675 million 5.05% subordinated notes 2015 (1)	469	551	358
US$350 million 4.7% subordinated notes 2018 (1)	232	287	174
£2,000 million 4.5% subordinated notes 2019 (issued September 2009) (1)	2,004	—	—
£3,000 million 4.5% subordinated notes 2019 (issued December 2009) (1)	3,000	—	—
	19,688	17,135	11,892
National Westminster Bank Plc			
US$1,000 million 7.375% subordinated notes 2009 (redeemed October 2009)	—	697	507
€600 million 6.0% subordinated notes 2010	564	623	474
€500 million 5.125% subordinated notes 2011	455	488	376
£300 million 7.875% subordinated notes 2015	365	379	349
£300 million 6.5% subordinated notes 2021	351	376	330
Charter One Financial, Inc.			
US$400 million 6.375% subordinated notes 2012	255	287	212
RBS Holdings, USA Inc.			
US$100 million 5.575% senior subordinated revolving credit 2009 (redeemed October 2009)	—	69	50
US$170 million subordinated loan capital floating rate notes 2009 (redeemed October 2009)	—	116	85
US$500 million subordinated loan capital floating rate notes 2010 (callable on any interest payment date)	311	342	249
First Active plc			
£60 million 6.375% subordinated bonds 2018 (callable April 2013)	66	66	65
Other minority interest subordinated issues	12	16	16
	22,067	20,594	14,605

Notes:

(1) On-lent to The Royal Bank of Scotland Group plc on a subordinated basis.

(2) Unconditionally guaranteed by The Royal Bank of Scotland Group plc.

(3) In the event of certain changes in tax laws, dated loan capital issues may be redeemed in whole, but not in part, at the option of the issuer, at the principal amount thereof plus accrued interest, subject to prior regulatory approval.

(4) Except as stated above, claims in respect of the Group's dated loan capital are subordinated to the claims of other creditors. None of the Group's dated loan capital is secured.

(5) Interest on all floating rate subordinated notes is calculated by reference to market rates.

23 Subordinated liabilities (continued)

Undated loan capital	2009 £m	2008 £m	2007 £m
The Bank			
£150 million 5.625% undated subordinated notes (callable June 2032)	144	144	144
£96 million (2008 and 2007 – £175 million) 7.375% undated subordinated notes (callable August 2010) (3)	101	190	183
€152 million 5.875% undated subordinated notes	—	—	114
£117 million (2008 and 2007 – £350 million) 6.25% undated subordinated notes (callable December 2012) (3)	126	380	354
£138 million (2008 and 2007 – £500 million) 6% undated subordinated notes (callable September 2014) (3)	143	565	517
€197 million (2008 and 2007 – €500 million) 5.125% undated subordinated notes (callable July 2014) (3)	194	516	371
€243 million (2008 and 2007 – €1,000 million) floating rate undated subordinated notes (callable July 2014) (3)	214	966	742
£178 million (2008 and 2007 – £500 million) 5.125% undated subordinated notes (callable March 2016) (3)	189	556	499
£200 million 5.125% subordinated upper tier 2 notes (callable September 2026)	210	210	210
£260 million (2008 and 2007 – £600 million) 5.5% undated subordinated notes (callable December 2019) (3)	272	677	595
£174 million (2008 and 2007 – £500 million) 6.2% undated subordinated notes (callable March 2022) (3)	206	614	543
£145 million (2008 and 2007 – £200 million) 9.5% undated subordinated bonds (callable August 2018) (3, 4)	176	253	228
£400 million 5.625% subordinated upper tier 2 notes (redeemed April 2009)	—	397	397
£83 million (2008 and 2007 – £300 million) 5.625% undated subordinated notes (callable September 2026) (3)	90	431	318
£51 million (2008 and 2007 – £350 million) 5.625% undated subordinated notes (callable June 2032) (3)	55	364	363
£190 million (2008 and 2007 – £400 million) 5% undated subordinated notes (callable March 2011) (3)	197	424	402
JPY25 billion 2.605% undated subordinates notes (callable November 2034)	173	217	103
CAD700 million 5.37% fixed rate undated subordinated notes (callable May 2016)	452	464	363
Due to the holding company			
US$350 million undated floating rate primary capital notes (callable on any interest payment date) (1)	216	240	175
€1,250 million 6.467% perpetual regulatory tier one securities (callable June 2012) (1)	1,174	1,325	979
US$1,200 million 7.648% perpetual regulatory tier one securities (callable September 2031) (1, 2)	748	831	606
£1,500 million floating rate perpetual subordinated notes (1)	1,500	1,500	—
$600 million floating rate perpetual subordinated notes (1)	370	412	—
$1,600 million floating rate perpetual subordinated notes (1)	990	1,098	—
	7,940	12,774	8,206
National Westminster Bank Plc			
US$293 million (2008 and 2007 – $500 million) primary capital floating rate notes, Series A (callable on any interest payment date) (3)	205	343	251
US$312 million (2008 and 2007 – $500 million) primary capital floating rate notes, Series B (callable on any interest payment date) (3)	182	347	256
US$332 million (2008 and 2007 – $500 million) primary capital floating rate notes, Series C (callable on any interest payment date) (3)	192	346	255
€400 million 6.625% fixed/floating rate undated subordinated notes (callable April 2010)	359	388	303
€100 million floating rate undated step-up notes (callable April 2010)	90	97	74
£162 million (2008 and 2007 – £325 million) 7.625% undated subordinated step-up notes (callable January 2010) (3)	174	363	357
£127 million (2008 and 2007 – £200 million) 7.125% undated subordinated step-up notes (callable October 2022) (3)	127	201	205
£68 million (2008 and 2007 – £200 million) 11.5% undated subordinated notes (callable December 2022) (3, 5)	79	269	269
First Active plc			
£20 million 11.75% perpetual tier two capital	26	26	23
€38 million 11.375% perpetual tier two capital	51	52	39
£1.3 million floating rate perpetual tier two capital	2	2	2
	9,427	15,208	10,240

Notes:

(1) On lent to The Royal Bank of Scotland Group plc on a subordinated basis.

(2) The Bank can satisfy interest payment obligations by issuing ordinary shares to appointed Trustees sufficient to enable them, on selling those shares, to settle the interest payment.

(3) Partially redeemed following the completion of the exchange and tender offers in April 2009.

(4) Guaranteed by the holding company.

(5) Exchangeable at the option of the issuer into 8.392% (gross) non-cumulative preference shares of £1 each of National Westminster Bank Plc at any time.

(6) Except as stated above, claims in respect of the Group's undated loan capital are subordinated to the claims of other creditors. None of the Group's undated loan capital is secured.

(7) In the event of certain changes in tax laws, undated loan capital issues may be redeemed in whole, but not in part, at the option of the Group, at the principal amount thereof plus accrued interest, subject to prior regulatory approval.

(8) Interest on all floating rate subordinated notes is calculated by reference to market rates.

Preference shares	2009 £m	2008 £m	2007 £m
The Bank			
Non-cumulative preference shares of US$0.01 (1)			
Series F US$200 million 7.65% (redeemable at option of issuer)	123	137	100
Series H US$300 million 7.25% (redeemable at option of issuer)	185	205	150
Series L US$750 million 6.8% (callable March 2009)	462	514	374
Series M US$850 million 4.709% (callable July 2013)	522	640	421
Series N US$650 million 6.425% (redeemable January 2034)	439	677	344
Series R US$850 million 5.75% (callable September 2009)	524	582	424
Series 1 US$1,000 million 9.118% (callable March 2010)	630	698	508
Non-cumulative preference shares of £1			
Series 1 £200 million 7.387% (2)	—	211	201
£125 million 7.25% (2)	—	125	125
	2,885	3,789	2,647
National Westminster Bank Plc			
Non-cumulative preference shares of £1			
Series A £140 million 9% (non-redeemable)	145	145	143
Non-cumulative preference shares of US$25			
Series C US$300 million 7.7628% (3)	193	215	161
	3,223	4,149	2,951

Notes:

(1) Issued by the Bank to the holding company on terms which, in general, mirror the original issues by the holding company.

(2) Converted into ordinary shares of £1 each in July 2009 (see Note 25 on page 174).

(3) Series C preference shares each carry a gross dividend of 8.625% inclusive of associated tax credit. Redeemable at the option of the issuer at US$25 per share.

24 Minority interests

	Group		
	2009 £m	2008 £m	2007 £m
At 1 January	1,292	152	396
Currency translation adjustments and other adjustments	(126)	344	(11)
Profit attributable to minority interests	235	208	53
Dividends paid	(261)	(84)	(31)
Equity raised	9	812	—
Equity withdrawn and disposals	(3)	(140)	(255)
At 31 December	1,146	1,292	152

25 Share capital and reserves

	Allotted, called up and fully paid			Authorised		
	2009 £m	2008 £m	2007 £m	2009 m	2008 m	2007 m
Ordinary shares of £1	6,609	6,481	5,481	£7,980	£7,980	£7,980
Non-cumulative preference shares of US$0.01	—	2	2	$5	$5	$3
Non-cumulative preference shares of €0.01	—	—	—	—	—	—
Perpetual zero coupon preference shares of £1	—	—	—	£100	£100	£100
Non-cumulative preference shares of £1	—	126	126	£2,200	£2,200	£2,200

	Allotted, called up and fully paid			Authorised		
Number of shares – millions	2009	2008	2007	2009	2008	2007
Ordinary shares of £1	6,609	6,481	5,481	7,980	7,980	7,980
Non-cumulative preference shares of US$0.01	59	313	313	549	549	349
Non-cumulative preference shares of €0.01	1	3	3	66	66	66
Perpetual zero coupon preference shares of £1	—	—	—	100	100	100
Non-cumulative preference shares of £1	—	126	126	2,200	2,200	2,200

Ordinary shares and preference shares

In July 2009, the Bank converted 126,350,000 non-cumulative preference shares of £1 each, held by the holding company, to ordinary shares of £1 each, increasing the issued ordinary share capital of the Bank by 126,350,000 ordinary shares of £1 each.

In July 2009, the Bank allotted 1,350,449 ordinary shares of £1 each to the holding company.

In July 2009, the Bank redeemed 2,526,000 non-cumulative preference shares of €0.01 each and 254,015,000 non-cumulative preference shares of $0.01 each, both held by the holding company.

Reserves

The merger reserve comprises the premium on shares issued to acquire NatWest less goodwill amortisation charged under previous GAAP. No share premium was recorded in the Bank financial statements through the operation of the merger relief provisions of the Companies Act 1985.

UK law prescribes that only reserves of the Bank are taken into account for the purpose of making distributions and the permissible applications of the share premium account.

The Group optimises capital efficiency by maintaining reserves in subsidiaries, including regulated entities. Certain preference shares and subordinated debt are also included within regulatory capital. The remittance of reserves to the parent or the redemption of shares or subordinated capital by regulated entities may be subject to maintaining the capital resources required by the relevant regulator.

26 Leases

Minimum amounts receivable under non-cancellable leases:

	Group								
	Finance lease contracts				Hire purchase agreements				Operating lease assets: future minimum lease rentals
Year in which receipt will occur	Gross amount £m	Unearned finance income £m	Other movements £m	Present value £m	Gross amount £m	Unearned finance income £m	Other movements £m	Present value £m	£m
2009									
Receivable:									
Within 1 year	1,507	(470)	(23)	1,014	2,356	(311)	(7)	2,038	763
After 1 year but within 5 years	5,496	(1,790)	(131)	3,575	3,272	(286)	(81)	2,905	2,348
After 5 years	10,942	(2,455)	(313)	8,174	316	(14)	(21)	281	947
Total	17,945	(4,715)	(467)	12,763	5,944	(611)	(109)	5,224	4,058
2008									
Receivable:									
Within 1 year	1,485	(613)	(24)	848	2,462	(334)	—	2,128	897
After 1 year but within 5 years	6,112	(2,004)	(128)	3,980	3,813	(365)	(34)	3,414	2,307
After 5 years	12,567	(3,094)	(341)	9,132	396	(31)	(44)	321	1,058
Total	20,164	(5,711)	(493)	13,960	6,671	(730)	(78)	5,863	4,262
2007									
Receivable:									
Within 1 year	1,297	(390)	(23)	884	2,175	(301)	—	1,874	670
After 1 year but within 5 years	4,968	(1,766)	(144)	3,058	3,523	(381)	(25)	3,117	1,612
After 5 years	11,648	(3,187)	(288)	8,173	278	(4)	(29)	245	682
Total	17,913	(5,343)	(455)	12,115	5,976	(686)	(54)	5,236	2,964

	Group		
	2009 £m	2008 £m	2007 £m
Nature of operating lease assets in balance sheet			
Transportation	6,039	5,883	3,502
Cars and light commercial vehicles	1,249	1,199	1,282
Other	253	338	315
	7,541	7,420	5,099
Amounts recognised as income and expense			
Finance leases – contingent rental income	(139)	(37)	(23)
Operating leases – minimum rentals payable	435	380	305
Finance lease contracts and hire purchase agreements			
Accumulated allowance for uncollectable minimum receivables	313	213	122

	Bank		
	2009 £m	2008 £m	2007 £m
Amounts recognised as income and expense			
Operating leases – minimum rentals payable	164	164	116

26 Leases (continued)

Residual value exposures

The tables below give details of the unguaranteed residual values included in the carrying value of finance lease receivables (see page 175) and operating lease assets (see page 162).

	Year in which residual value will be recovered				
2009	Within 1 year £m	After 1 year but within 2 years £m	After 2 years but within 5 years £m	After 5 years £m	Total £m
Operating leases					
Transportation	164	327	1,607	2,255	4,353
Cars and light commercial vehicles	624	134	113	7	878
Other	31	32	40	7	110
Finance lease contracts	23	35	96	313	467
Hire purchase agreements	7	21	60	21	109
	849	549	1,916	2,603	5,917
2008					
Operating leases					
Transportation	794	130	1,701	2,103	4,728
Cars and light commercial vehicles	577	195	182	8	962
Other	112	35	48	7	202
Finance lease contracts	24	29	99	341	493
Hire purchase agreements	—	9	25	44	78
	1,507	398	2,055	2,503	6,463

The Group provides asset finance to its customers through acting as a lessor. It purchases plant, equipment and intellectual property, renting them to customers under lease arrangements that, depending on their terms, qualify as either operating or finance leases.

27 Collateral and securitisations

Securities repurchase agreements and lending transactions

The Group enters into securities repurchase agreements and securities lending transactions under which it receives or transfers collateral 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.

The fair value (and carrying value) of securities transferred under repurchase transactions included within debt securities on the balance sheet were £65.6 billion (2008 – £75.7 billion; 2007 – £75.0 billion) for the Group and £30.1 billion (2008 – £70.2 billion; 2007 – £30.6 billion) for the Bank. All of these securities could be sold or repledged by the holder. Securities received as collateral under reverse repurchase agreements amounted to £64.3 billion (2008 – £54.9 billion), of which £62.8 billion (2008 – £49.1 billion) had been resold or repledged as collateral for the Group's own transactions.

Other collateral given

Group assets pledged against Group liabilities	Group 2009 £m	Group 2008 £m	Bank 2009 £m	Bank 2008 £m
Loans and advances to banks	13	13	—	—
Loans and advances to customers	141,907	107,409	46,553	16,480
Debt securities	8,798	15,108	1,602	4,872
	150,718	122,530	48,155	21,352

Liabilities secured by Group assets	Group 2009 £m	Group 2008 £m	Bank 2009 £m	Bank 2008 £m
Deposits by banks	12,724	11,322	—	—
Customer accounts	4,068	11,050	2,975	4,867
Debt securities in issue	34,952	52,755	163	343
	51,744	75,127	3,138	5,210

Note:

(1) The table above includes assets used as collateral for central bank liquidity schemes.

Of the assets above, £128.7 billion (2008 – £90.8 billion) relate to securitisations. In securitisations, debt securities are issued that are secured on assets of the Group; the rights to the cash flows from those assets are transferred to special purpose vehicles which issue debt securities. The remaining balances primarily relate to assets charged as security against deposits from federal banks and other public sector bodies.

Securitisations and other asset transfers

Continued recognition

The table below sets out the asset categories together with the carrying amounts of the assets and associated liabilities for those securitisations (see pages 87 and 88) and other asset transfers where substantially all the risks and rewards of the asset have been retained by the Group.

	Group			
	2009		2008	
Asset type	Assets £m	Liabilities £m	Assets £m	Liabilities £m
Residential mortgages	68,963	15,749	53,528*	18,613
Credit card receivables	2,975	1,592	3,004	3,197
Other loans	36,448	1,010	1,679	1,071
Commercial paper conduits	19,671	17,888	31,473	30,833
Finance lease receivables	597	597	1,077	857
	128,654	36,836	90,761	54,571

*revised

Continuing involvement

At 31 December 2009, securitised assets were £1.3 billion (2008 – £1.1 billion) retained interest £46 million (2008 – £50 million) subordinated assets £17 million (2008 – £9 million) and related liabilities £17 million (2008 – £9 million).

28 Capital resources

The Group's regulatory capital resources at 31 December in accordance with Financial Services Authority (FSA) definitions were as follows:

Composition of regulatory capital	2009 £m	2008 £m
Tier 1		
Ordinary shareholders' equity	53,630	36,711
Minority interests	1,146	1,292
Adjustment for:		
– Goodwill and other intangible assets	(11,814)	(12,591)
– Goodwill and other intangible assets of discontinued businesses	(238)	—
– Unrealised losses on available-for-sale debt securities	279	1,855
– Reserves arising on revaluation of property and unrealised gains on available-for-sale equities	(184)	(154)
– Other regulatory adjustments	(796)	(56)
Less expected loss over provisions	(2,560)	(771)
Less securitisation positions	(1,270)	(561)
Less APS first loss	(4,654)	—
Core Tier 1 capital	33,539	25,725
Preference shares	2,883	10,896
Innovative Tier 1 securities	3,542	4,177
Tax on the excess of expected losses over provisions	1,020	307
Less deductions from Tier 1 capital	(132)	(85)
Total Tier 1 capital	40,852	41,020
Tier 2		
Reserves arising on revaluation of property and unrealised gains on available-for-sale equities	184	154
Collective impairment allowances	796	666
Perpetual subordinated debt	7,170	12,085
Term subordinated debt	18,860	16,488
Minority and other interests in Tier 2 capital	11	11
Less deductions from Tier 2 capital	(4,982)	(1,725)
Less APS first loss	(4,654)	—
Total Tier 2 capital	17,385	27,679
Supervisory deductions		
Unconsolidated investments	(121)	(119)
Other deductions	(93)	(111)
Deductions from total capital	(214)	(230)
Total regulatory capital	58,023	68,469

Note:

(1) The Group adopted Basel II with effect from 1 January 2008; data for 2007 has not been provided as it is not directly comparable.

In the management of capital resources, the Group is governed by the RBS Group's policy which is 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 FSA. The FSA uses Risk Asset Ratio (RAR) as a measure of capital adequacy for UK banks, 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%. The RBS Group has complied with the FSA's capital requirements throughout the year.

A number of subsidiaries and sub-groups within the Group, principally banking entities, are subject to various individual regulatory capital requirements in the UK and overseas.

29 Memorandum items

Contingent liabilities and commitments

The amounts shown in the table below are intended only to provide an indication of the volume of business outstanding at 31 December. Although the Group is exposed to credit risk in the event of non-performance of the obligations undertaken by customers, the amounts shown do not, and are not intended to, provide any indication of the Group's expectation of future losses.

	Group			Bank		
	2009 £m	2008 £m	2007 £m	2009 £m	2008 £m	2007 £m
Contingent liabilities:						
Guarantees and assets pledged as collateral security	31,926	15,075	11,661	26,272	7,248	6,838
Other contingent liabilities	11,183	17,842	11,215	8,829	15,067	8,168
	43,109	32,917	22,876	35,101	22,315	15,006
Commitments:						
Undrawn formal standby facilities, credit lines and other commitments to lend						
– less than one year	119,449	156,290	153,348	54,097	75,800	61,582
– one year and over	129,080	138,059	105,915	104,655	111,241	82,603
Other commitments	3,408	6,788	2,491	287	366	1,630
	251,937	301,137	261,754	159,039	187,407	145,815

Notes:

(1) In the normal course of business, the Bank guarantees specified third party liabilities of certain subsidiaries; it also gives undertakings that individual subsidiaries will fulfil their obligations to third parties under contractual or other arrangements.

Banking commitments and contingent obligations, which have been entered into on behalf of customers and for which there are corresponding obligations from customers, are not included in assets and liabilities. The Group's maximum exposure to credit loss, in the event of non-performance by the other party and where all counterclaims, collateral or security proves valueless, is represented by the contractual nominal amount of these instruments included in the table above. These commitments and contingent obligations are subject to the Group's normal credit approval processes.

Contingent liabilities

Guarantees – the Group gives guarantees on behalf of customers. A financial guarantee represents an irrevocable undertaking that the Group will meet a customer's obligations to third parties if the customer fails to do so. The maximum amount that the Group could be required to pay under a guarantee is its principal amount as disclosed in the table above. The Group expects most guarantees it provides to expire unused.

Other contingent liabilities – these include standby letters of credit, supporting customer debt issues and contingent liabilities relating to customer trading activities such as those arising from performance and customs bonds, warranties and indemnities.

Commitments

Commitments to lend – under a loan commitment the Group agrees to make funds available to a customer in the future. Loan commitments, which are usually for a specified term may be unconditionally cancellable or may persist, provided all conditions in the loan facility are satisfied or waived. Commitments to lend include commercial standby facilities and credit lines, liquidity facilities to commercial paper conduits and unutilised overdraft facilities.

Other commitments – these include documentary credits, which are commercial letters of credit providing for payment by the Group to a named beneficiary against presentation of specified documents, forward asset purchases, forward deposits placed and undrawn note issuance and revolving underwriting facilities, and other short-term trade related transactions.

Trustee and other fiduciary activities

In its capacity as trustee or other fiduciary role, the Group may hold or place assets on behalf of individuals, trusts, companies, pension schemes and others. The assets and their income are not included in the Group's financial statements. The Group earned fee income of £415 million (2008 – £476 million; 2007 – £507 million) from these activities. The Bank earned fee income of £46 million (2008 – £45 million; 2007 – £49 million).

29 Memorandum items (continued)

Contractual obligations for future expenditure not provided in the accounts

The following table shows contractual obligations for future expenditure not provided for in the accounts at the year end.

	Group			Bank		
	2009 £m	2008 £m	2007 £m	2009 £m	2008 £m	2007 £m
Operating leases						
Minimum rentals payable under non-cancellable leases (1)						
Within 1 year	399	407	350	165	159	141
After 1 year but within 5 years	1,301	1,354	1,193	612	586	525
After 5 years	2,729	3,010	3,010	1,674	1,808	1,758
	4,429	4,771	4,553	2,451	2,553	2,424
Property, plant and equipment						
Contracts to buy, enhance or maintain investment properties	—	7	9	—	—	—
Lessor contracts for capital expenditure (2)	2,724	6,063	883	—	—	18
Other capital expenditure	62	97	108	27	39	22
	2,786	6,167	1,000	27	39	40
Contracts to purchase goods or services (3)	611	1,157	1,107	402	419	584
Total	7,826	12,095	6,660	2,880	3,011	3,048

	Group			Bank		
	2009 £m	2008 £m	2007 £m	2009 £m	2008 £m	2007 £m
Amounts above include:						
Obligations to fellow subsidiaries						
Within 1 year	7	7	7	7	7	7
After 1 year but within 5 years	27	28	28	27	28	28
After 5 years	42	49	56	42	49	56
	76	84	91	76	84	91

Notes:

(1) Predominantly property leases

(2) Of which due within 1 year: Group – £370 million (2008 – £3,769 million; 2007 – £463 million), Bank – nil (2008 – nil; 2007 – £3 million).

(3) Of which due within 1 year: Group – £441 million (2008 – £872 million; 2007 – £632 million), Bank – £239 million (2008 – £235 million; 2007 – £349 million).

The Financial Services Compensation Scheme

The Financial Services Compensation Scheme (FSCS), the UK's statutory fund of last resort for customers of authorised financial services firms, pays compensation if a firm is unable to meet its obligations. The FSCS funds compensation for customers by raising management expenses levies and compensation levies on the industry. In relation to protected deposits, each deposit-taking institution contributes towards these levies in proportion to their share of total protected deposits on 31 December of the year preceding the scheme year (which runs from 1 April to 31 March), subject to annual maxima set by the Financial Services Authority (FSA). In addition, the FSCS has the power to raise levies (‘exit levies’) on firms who have ceased to participate in the scheme and are in the process of ceasing to be authorised for the amount that the firm would otherwise have been asked to pay during the relevant levy year. The FSCS also has the power to raise exit levies on such firms which look at their potential liability to pay levies in future years.

FSCS has borrowed from HM Treasury to fund the compensation costs associated with Bradford & Bingley, Heritable Bank, Kaupthing Singer & Friedlander, Landsbanki ‘Icesave’ and London Scottish Bank plc. These borrowings are on an interest-only basis until September 2011. The annual limit on the FSCS management expenses levy for the three years from September 2008 in relation to these institutions has been capped at £1 billion per annum.

The FSCS will receive funds from asset sales, surplus cash flow, or other recoveries in relation to these institutions which will be used to reduce the principal amount of the FSCS's borrowings. Only after the interest only period, which is expected to end in September 2011, will a schedule for repayment of any remaining principal outstanding (after recoveries) on the borrowings be agreed between the FSCS and HM Treasury. It is expected that, from that point, the FSCS will begin to raise compensation levies (principal repayments). No provision has been made for these levies as the amount is not yet known and is unlikely to be determined before 2011.

The Group has accrued £135 million for its share of FSCS management expenses levies for the 2009/10 and 2010/11 scheme years.

Litigation

As a participant in the financial services industry, the Group operates in a legal and regulatory environment that exposes it to potentially significant litigation risks. As a result, the Bank and other members of the RBS Group are involved in various disputes and legal proceedings in the United Kingdom, the United States and other jurisdictions, including litigation. Such cases are subject to many uncertainties, and their outcome is often difficult to predict, particularly in the earlier stages of a case.

Other than as set out in this section, so far as the Group is aware, neither the Bank nor any member of the RBS Group is or has been engaged in or has pending or threatened any governmental, legal or arbitration proceedings which may have or have had in the recent past (covering the 12 months immediately preceding the date of this document) a significant effect on the Group's financial position or profitability.

Unarranged overdraft charges

In common with other banks in the United Kingdom, the Royal Bank and NatWest have received claims and complaints from a large number of customers in the United Kingdom seeking refunds of unarranged overdraft charges (the "Charges"). The vast majority of these claims and complaints have challenged the Charges on the basis that they contravene the Unfair Terms in Consumer Contracts Regulations 1999 (the "Regulations") or are unenforceable under the common law penalty doctrine (or both).

In July 2007, the Office of Fair Trading ("OFT") issued proceedings in a test case in the English High Court against the banks which was intended to determine certain issues concerning the legal status and enforceability of contractual terms relating to the Charges. The test case concluded in November 2009 with a judgment of the Supreme Court in favour of the banks. As a result of the court rulings made in the test case, the RBS Group expects substantially all of the customer claims and complaints it has received relating to the Charges to fail. The RBS Group cannot at this stage predict with any certainty the final outcome of all customer claims and complaints. It is unable reliably to estimate any liability that may arise as a result of or in connection with these matters or its effect on the Group's consolidated net assets, operating results or cash flows in any particular period.

Shareholder litigation

The holding company and a number of its subsidiaries and certain individual officers and directors have been named as defendants in a class action filed in the United States District Court for the Southern District of New York. The consolidated amended complaint alleges certain false and misleading statements and omissions in public filings and other communications during the period 1 March 2007 to 19 January 2009, and variously asserts claims under Sections 11, 12 and 15 of the Securities Act 1933, Sections 10 and 20 of the Securities Exchange Act 1934 and Rule 10b-5 thereunder.

The putative class is composed of (1) all persons who purchased or otherwise acquired RBS Group securities between 1 March 2007 and 19 January 2009; and/or (2) all persons who purchased or otherwise acquired Series Q, R, S, T and/or U non-cumulative dollar preference shares issued pursuant or traceable to the 8 April 2005 SEC registration statement and were damaged thereby. Plaintiffs seek unquantified damages on behalf of the putative class.

RBS Group has also received notification of similar prospective claims in the United Kingdom and elsewhere but no court proceedings have been commenced in relation to these claims.

RBS Group considers that it has substantial and credible legal and factual defences to these claims and will defend them vigorously. The RBS Group is unable reliably to estimate the liability, if any, that might arise or its effect on the Group's consolidated net assets, operating results or cash flows in any particular period.

Other securitisation and securities related litigation in the United States

RBS Group companies have been named as defendants in a number of purported class action and other lawsuits in the United States that relate to the securitisation and securities underwriting businesses. In general, the cases involve the issuance of mortgage backed securities, collateralised debt obligations, or public debt or equity where the plaintiffs have brought actions against the issuers and underwriters of such securities (including RBS Group companies) claiming that certain disclosures made in connection with the relevant offerings of such securities were false or misleading with respect to alleged "sub-prime" mortgage exposure. RBS Group considers that it has substantial and credible legal and factual defences to these claims and will continue to defend them vigorously. The RBS Group cannot at this stage reliably estimate the liability, if any, that may arise as a result of or in connection with the these lawsuits, individually or in the aggregate, or their effect on the Group's consolidated net assets, operating results or cash flows in any particular period.

Summary of other disputes, legal proceedings and litigation

Members of RBS Group are engaged in other litigation in the United Kingdom and a number of overseas jurisdictions, including the United States, involving claims by and against them arising in the ordinary course of business. RBS Group has reviewed these other actual, threatened and known potential claims and proceedings and, after consulting with its legal advisers, does not expect that the outcome of these other claims and proceedings will have a material adverse effect on the Group's financial position or profitability in any particular period.

29 Memorandum items continued

Investigations

The RBS Group's businesses and financial condition can be affected by the fiscal or other policies and other actions of various governmental and regulatory authorities in the United Kingdom, the European Union, the United States and elsewhere. The RBS Group has engaged, and will continue to engage, in discussions with relevant regulators, including in the United Kingdom and the United States, on an ongoing and regular basis informing them of operational, systems and control evaluations and issues as deemed appropriate or required and it is possible that any matters discussed or identified may result in investigatory actions by the regulators, increased costs being incurred by the RBS Group, remediation of systems and controls, public or private censure or fines. Any of these events or circumstances could have a material adverse impact on the Group, its business, reputation, results of operations or the price of securities issued by it.

In particular there is continuing political and regulatory scrutiny of the operation of the retail banking and consumer credit industries in the United Kingdom and elsewhere. The nature and impact of future changes in policies and regulatory action are not predictable and are beyond the RBS Group's control but could have an adverse impact on the Group's businesses and earnings.

Retail banking

In the European Union, regulatory actions included an inquiry into retail banking initiated on 13 June 2005 in all of the then 25 member states by the European Commission's Directorate General for Competition. The inquiry examined retail banking in Europe generally. On 31 January 2007, the European Commission announced that barriers to competition in certain areas of retail banking, payment cards and payment systems in the European Union had been identified. The European Commission indicated that it will consider using its powers to address these barriers and will encourage national competition authorities to enforce European and national competition laws where appropriate.

Multilateral interchange fees

In 2007, the European Commission issued a decision that while interchange is not illegal per se, MasterCard's current multilateral interchange fee ("MIF") arrangement for cross border payment card transactions with MasterCard and Maestro branded consumer credit and debit cards in the European Union are in breach of competition law. MasterCard was required by the decision to withdraw the relevant cross-border MIFs (i.e. set these fees to zero) by 21 June 2008.

MasterCard appealed against the decision to the European Court of First Instance on 1 March 2008, and the RBS Group has intervened in the appeal proceedings. In addition, in Summer 2008, MasterCard announced various changes to its scheme arrangements. The European Commission was concerned that these changes might be used as a means of circumventing the requirements of the infringement decision. In April 2009 MasterCard agreed an interim settlement on the level of cross-border MIF with the European Commission pending the outcome of the appeal process and, as a result, the European Commission has advised it will no longer investigate the non-compliance issue (although MasterCard is continuing with its appeal).

Visa's cross-border MIFs were exempted in 2002 by the European Commission for a period of five years up to 31 December 2007 subject to certain conditions. On 26 March 2008, the European Commission opened a formal inquiry into Visa's current MIF arrangements for cross border payment card transactions with Visa branded debit and consumer credit cards in the European Union and on 6 April 2009 the European Commission announced that it had issued Visa with a formal Statement of Objections. At the same time Visa announced changes to its interchange levels and introduced some changes to enhance transparency. There is no deadline for the closure of the inquiry.

In the UK, the OFT has carried out investigations into Visa and MasterCard domestic credit card interchange rates. The decision by the OFT in the MasterCard interchange case was set aside by the Competition Appeal Tribunal (the "CAT") in June 2006. The OFT's investigations in the Visa interchange case and a second MasterCard interchange case are ongoing. On 9 February 2007, the OFT announced that it was expanding its investigation into domestic interchange rates to include debit cards. In January 2010 the OFT advised that it did not anticipate issuing a Statement of Objections prior to the European Court's judgment, although it has reserved the right to do so if it considers it appropriate.

The outcome of these investigations is not known, but they may have an impact on the consumer credit industry in general and, therefore, on the RBS Group's business in this sector.

Payment Protection Insurance

Having conducted a market study relating to Payment Protection Insurance ("PPI"), on 7 February 2007 the OFT referred the PPI market to the Competition Commission ("CC") for an in-depth inquiry. The CC published its final report on 29 January 2009 and announced its intention to order a range of remedies, including a prohibition on actively selling PPI at point of sale of the credit product (and for 7 days thereafter), a ban on single premium policies and other measures to increase transparency (in order to improve customers' ability to search and improve price competition). Barclays Bank PLC subsequently appealed certain CC findings to the Competition Appeal Tribunal (the "CAT"). On 16 October 2009, the CAT handed down a judgment quashing the ban on selling PPI at the point of sale of credit products and remitted the matter back to the CC for review. The CC's current Administrative Timetable is to publish a supplementary report by Summer 2010 and give further consideration to its full range of recommended remedies and a draft order to implement them during Autumn 2010.

The FSA has been conducting a broad industry thematic review of PPI sales practices and in September 2008, the FSA announced that it intended to escalate its level of regulatory intervention. Substantial numbers of customer complaints alleging the mis-selling of PPI policies have been made to banks and to the FOS and many of these are being upheld by the FOS against the banks.

In September 2009, the FSA issued a consultation paper on guidance on the fair assessment of PPI mis-selling complaints and, where necessary, the provision of an appropriate level of redress. The consultation also covers proposed rules requiring firms to re-assess (against the new guidance) all PPI mis-selling complaints received and rejected since 14 January 2005. A policy statement containing final guidance and rules is expected in early 2010. Separately, discussions continue between the FSA and the RBS Group in respect of concerns expressed by the FSA over certain categories of historical PPI sales.

Personal current accounts

On 16 July 2008, the OFT published the results of its market study into personal current accounts in the United Kingdom. The OFT found evidence of competition and several positive features in the personal current account market but believes that the market as a whole is not working well for consumers and that the ability of the market to function well has become distorted.

On 7 October 2009, the OFT published a follow-up report summarising the initiatives agreed between the OFT and personal current account providers to address the OFT's concerns about transparency and switching, following its market study. Personal current account providers will take a number of steps to improve transparency, including providing customers with an annual summary of the cost of their account and making charges prominent on monthly statements. To improve the switching process, a number of steps are being introduced following work with BACS, the payment processor, including measures to reduce the impact on consumers of any problems with transferring direct debits.

On 22 December 2009, the OFT published a further report in which it stated that it continued to have significant concerns about the operation of the personal current account market in the United Kingdom, in particular in relation to unarranged overdrafts, and that it believed that fundamental changes are required for the market to work in the best interests of bank customers. The OFT stated that it would discuss these issues intensively with banks, consumer groups and other organisations, with the aim of reporting on progress by the end of March 2010.

Securitisation and collateralised debt obligation business

The New York State Attorney General has issued subpoenas to a wide array of participants in the securitisation and securities industry, focusing on the information underwriters obtained as part of the due diligence process from the independent due diligence firms. RBS Securities Inc. has produced documents requested by the New York State Attorney General principally related to loans that were pooled into one securitisation transaction and will continue to cooperate with the investigation. More recently, the Massachusetts Attorney General has issued a subpoena to RBS Securities Inc. seeking information related to residential mortgage lending practices and sales and securitisation of residential mortgage loans. These respective investigations are in the early stages and therefore it is difficult to predict the potential exposure from any such investigation. The holding company and its subsidiaries are cooperating with these various investigations and requests.

Other investigations

In the UK, the OFT has also been investigating the RBS Group for alleged conduct in breach of Article 101 of the Treaty on the Functioning of the European Union and/or the Chapter 1 prohibition of the Competition Act 1998 relating to the provision of loan products to professional services firms. The holding company and its subsidiaries are co-operating fully with the OFT's investigation.

In April 2009 the FSA notified the RBS Group that it was commencing a supervisory review of the acquisition of ABN AMRO in 2007 and the 2008 capital raisings and an investigation into conduct, systems and controls within the Global Banking & Markets division of the RBS Group. The holding company and its subsidiaries are cooperating fully with this review and investigation.

In November 2009, the FSA informed the RBS Group that it was commencing an investigation into certain aspects of the policies of, and training and controls within, certain of the RBS Group's UK subsidiaries relating to compliance with UK money laundering regulations during the period from December 2007 to December 2008. The holding company and its subsidiaries are cooperating fully with this investigation.

In January 2010, the FSA informed the RBS Group that it intended to commence an investigation into certain aspects of the handling of customer complaints. The scope of the proposed investigation (including which businesses and subsidiaries are affected) is not yet clear. The holding company and its subsidiaries intend to co-operate fully with this investigation.

In the United States, the RBS Group and certain subsidiaries have received requests for information from various governmental agencies, self-regulatory organisations, and state governmental agencies including in connection with sub-prime mortgages and securitisations, collateralised debt obligations and synthetic products related to sub-prime mortgages. In particular, during March 2008, the RBS Group was advised by the US Securities and Exchange Commission that it had commenced a non-public, formal investigation relating to the RBS Group's United States sub-prime securities exposures and United States residential mortgage exposures. The holding company and its subsidiaries are cooperating with these various requests for information and investigations.

30 Net cash inflow/(outflow) from operating activities

	Group			Bank		
	2009 £m	Restated 2008 £m	2007 £m	2009 £m	Restated 2008 £m	2007 £m
Operating (loss)/profit before tax	(3)	(9,216)	9,155	(1,142)	(2,373)	7,759
Decrease/(increase) in prepayments and accrued income	28	(513)	(411)	295	(426)	(221)
Interest on subordinated liabilities	959	1,694	1,452	672	1,487	1,200
(Decrease)/increase in accruals and deferred income	(36)	2,497	(248)	(395)	2,089	220
Provisions for impairment losses	12,174	4,706	1,865	5,924	2,007	473
Loans and advances written-off net of recoveries	(5,409)	(2,236)	(1,407)	(2,635)	(737)	(477)
Unwind of discount on impairment losses	(356)	(174)	(166)	(96)	(61)	(65)
Profit on sale of property, plant and equipment	(40)	(177)	(672)	(2)	(4)	(740)
Profit/(loss) on sale of subsidiaries and associates	16	(417)	(67)	69	(617)	8
Profit on sale of available-for-sale financial assets	(312)	(174)	(496)	(228)	(94)	(231)
Charge for defined benefit pension schemes	389	351	479	(4)	8	5
Pension scheme curtailment gains	(2,148)	—	—	(1,603)	—	—
Cash contribution to defined benefit pension schemes	(744)	(491)	(536)	(1)	(8)	(16)
Other provisions utilised	(148)	(24)	(200)	(119)	(14)	(65)
Depreciation and amortisation	1,587	1,562	1,438	495	483	485
Gain on redemption of own debt	(2,694)	—	—	(2,255)	—	—
Write-down of goodwill and other intangible assets	118	8,144	—	—	215	—
Elimination of foreign exchange differences	5,715	(20,997)	(2,137)	3,623	(16,892)	(2,034)
Other non-cash items	1,335	1,586	969	(113)	2,861	523
Net cash inflow/(outflow) from trading activities	10,431	(13,879)	9,018	2,485	(12,076)	6,824
Decrease/(increase) in loans and advances to banks and customers	81,038	(69,339)	(92,494)	(11,118)	(10,544)	(88,570)
(Increase)/decrease in securities	(3,742)	19,719	(25,033)	(5,430)	14,127	(16,069)
(Increase)/decrease in other assets	(6,029)	(4,494)	(5,122)	(6,291)	(3,920)	(3,003)
Decrease/(increase) in derivative assets	484,743	(724,306)	(103,852)	484,768	(730,592)	(105,426)
Changes in operating assets	556,010	(778,420)	(226,501)	461,929	(730,929)	(213,068)
(Decrease)/increase in deposits by banks and customers	(63,163)	42,367	79,408	50,027	35,638	72,435
(Decrease)/increase in debt securities in issue	(9,213)	49,810	47,526	13,201	35,272	38,056
Increase/(decrease) in other liabilities	637	(3,650)	405	738	2,102	325
(Decrease)/increase in derivative liabilities	(478,299)	706,052	99,559	(478,203)	706,940	100,577
(Decrease)/increase in settlement balances and short positions	(474)	(13,314)	6,472	(335)	(7,605)	10,253
Changes in operating liabilities	(550,512)	781,265	233,370	(414,572)	772,347	221,646
Total income taxes (paid)/received	(785)	(886)	(1,802)	2	83	(526)
Net cash inflow/(outflow) from operating activities	15,144	(11,920)	14,085	49,844	29,425	14,876

31 Analysis of the net investment in business interests and intangible assets

	Group			Bank		
	2009 £m	2008 £m	2007 £m	2009 £m	2008 £m	2007 £m
Fair value given for businesses acquired	(73)	(1,491)	(147)	(31)	(47)	(6)
Additional investments in Group undertakings	—	—	5	(3,766)	(4,155)	(560)
Net outflow of cash in respect of purchases	(73)	(1,491)	(142)	(3,797)	(4,202)	(566)
Cash and cash equivalents in businesses sold	—	—	21	—	—	—
Other assets sold	78	552	16	1	146	—
Repayment of investments	—	—	—	914	349	281
Non-cash consideration	—	(35)	(2)	—	—	—
(Loss)/profit on disposal	(16)	417	67	(69)	617	(8)
Net inflow of cash in respect of disposals	62	934	102	846	1,112	273
Dividends received from joint ventures	—	9	9	—	3	2
Cash expenditure on intangible assets	(386)	(360)	(399)	(174)	(177)	(299)
Net outflow	(397)	(908)	(430)	(3,125)	(3,264)	(590)

32 Interest received and paid

	Group			Bank		
	2009 £m	2008 £m	2007 £m	2009 £m	2008 £m	2007 £m
Interest received	23,120	30,876	27,641	12,375	16,169	12,897
Interest paid	(12,508)	(17,581)	(15,482)	(8,242)	(11,576)	(10,071)
	10,612	13,295	12,159	4,133	4,593	2,826

33 Analysis of changes in financing during the year

	Group						Bank					
	Share capital, share premium and merger reserve			Subordinated liabilities			Share capital and share premium			Subordinated liabilities		
	2009 £m	2008 £m	2007 £m	2009 £m	2008 £m	2007 £m	2009 £m	2008 £m	2007 £m	2009 £m	2008 £m	2007 £m
At 1 January	42,539	32,539	28,889	39,951	27,796	27,786	31,658	21,658	18,008	33,698	22,745	22,403
Issue of ordinary shares	8,151	10,000	—				8,151	10,000	—			
Issue of equity preference shares	—	—	3,650				—	—	3,650			
Redemption of preference shares	(7,825)	—	—				(7,825)	—	—			
Net proceeds from issue of subordinated liabilities				5,000	5,055	1,018				5,000	5,055	968
Repayment of subordinated liabilities				(3,200)	(1,035)	(1,708)				(2,235)	(1,035)	(1,288)
Net cash inflow/(outflow) from financing	326	10,000	3,650	1,800	4,020	(690)	326	10,000	3,650	2,765	4,020	(320)
Currency translation and other adjustments	—	—	—	(7,034)	8,135	700	—	—	—	(5,950)	6,933	662
At 31 December	42,865	42,539	32,539	34,717	39,951	27,796	31,984	31,658	21,658	30,513	33,698	22,745

34 Analysis of cash and cash equivalents

	Group			Bank		
	2009 £m	2008 £m	2007 £m	2009 £m	2008 £m	2007 £m
At 1 January						
– cash	47,223	27,289	28,175	39,093	16,591	16,025
– cash equivalents	33,191	57,472	41,972	34,356	60,658	47,561
	80,414	84,761	70,147	73,449	77,249	63,586
Net cash inflow/(outflow)	12,524	(4,347)	14,614	5,267	(3,800)	13,663
At 31 December	92,938	80,414	84,761	78,716	73,449	77,249
Comprising:						
Cash and balances at central banks	26,627	6,442	5,121	20,744	3,432	3,003
Treasury bills and debt securities	13,626	14,006	6,818	13,626	14,006	6,521
Loans and advances to banks	52,685	59,966	72,822	44,346	56,011	67,725
Cash and cash equivalents	92,938	80,414	84,761	78,716	73,449	77,249

The Bank and certain subsidiaries are required to maintain balances with the Bank of England which, at 31 December 2009, amounted to £354 million (2008 – £282 million; 2007 – £330 million). Certain subsidiary undertakings are required by law to maintain reserve balances with the Federal Reserve Bank in the US. Such reserve balances were nil at 31 December 2009 (2008 – nil; 2007 – US$1 million).

35 Segmental analysis

(a) Divisions

Following a comprehensive strategic review, changes have been made to the Group's operating segments in 2009. A Non-Core division has been created comprising those lines of business, portfolios and individual assets that the Group intends to run off or sell. Furthermore, Business Services (formerly Group Manufacturing) is no longer reported as a separate division and its costs are now allocated to the customer-facing divisions. UK Retail & Commercial Banking has been split into three segments (UK Retail, UK Corporate and Wealth). Ulster Bank has become a specific segment. The remaining elements of Europe & Middle East Retail & Commercial Banking and Asia Retail & Commercial Banking form part of Non-Core. The segment measure is now Operating profit/(loss) before tax which differs from Contribution used previously; it excludes certain infrequent items. Comparative data have been restated accordingly.

The directors manage the Group primarily by class of business and present the segmental analysis on that basis. Segments charge market prices for services rendered to other parts of the Group.

The Group's activities are organised as follows:

UK Retail offers a comprehensive range of banking products and related financial services to the personal market. It serves customers through the Royal Bank and NatWest networks of branches and ATMs in the United Kingdom, and also through telephone and internet channels.

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 RBS Coutts.

Global Banking & Markets (GBM) is a banking partner to major corporations and financial institutions around the world, providing an extensive range of debt and equity financing, risk management and investment services to its customers. The division is organised along six principal business lines: money markets; rates flow trading; currencies and commodities; equities; credit markets and portfolio management & origination.

Global Transaction Services ranks among the top five global transaction services providers, offering global payments, cash and liquidity management, and trade finance and commercial card products and services. It includes the Group's corporate money transmission activities in the United Kingdom and the United States as well as Global Merchant Services, the Group's United Kingdom and international merchant acquiring business.

Ulster Bank is the leading retail and commercial bank in Northern Ireland and the third largest banking group on the island of Ireland. It provides a comprehensive range of financial services through both its Retail Markets division which has a network of branches and operates in the personal and bancassurance sectors, and its Corporate Markets division, which provides services to SME business customers, corporates and institutional markets.

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. It ranks among the top five banks in New England.

Central Functions comprises group and corporate functions, such as treasury, funding and 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. The division contains a range of businesses and asset portfolios primarily from the GBM division, including RBS Sempra Commodities, linked to proprietary trading, 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.

	Group									
	Total revenue			Total income						
2009	External £m	Inter segment £m	Total £m	External £m	Inter segment £m	Total £m	Operating expenses £m	Depreciation and amortisation £m	Impairment losses £m	Operating profit/(loss) before tax £m
UK Retail	6,760	550	7,310	5,025	(92)	4,933	(2,691)	(2)	(1,679)	561
UK Corporate	4,557	116	4,673	4,674	(840)	3,834	(1,301)	(154)	(927)	1,452
Wealth	812	818	1,630	311	699	1,010	(602)	(11)	(33)	364
Global Banking & Markets	10,437	7,971	18,408	7,818	545	8,363	(2,534)	(59)	(317)	5,453
Global Transaction Services	2,282	60	2,342	1,748	(9)	1,739	(880)	(12)	(16)	831
Ulster Bank	1,605	103	1,708	1,049	34	1,083	(711)	(5)	(649)	(282)
US Retail & Commercial	4,080	378	4,458	2,513	343	2,856	(1,988)	(72)	(702)	94
Central items	(70)	9,289	9,219	(3,572)	1,875	(1,697)	(169)	(734)	—	(2,600)
Core	30,463	19,285	49,748	19,566	2,555	22,121	(10,876)	(1,049)	(4,323)	5,873
Non-Core	2,975	1,254	4,229	2,283	(2,555)	(272)	(947)	(439)	(7,851)	(9,509)
	33,438	20,539	53,977	21,849	—	21,849	(11,823)	(1,488)	(12,174)	(3,636)
Eliminations	—	(20,539)	(20,539)	—	—	—	—	—	—	—
	33,438	—	33,438	21,849	—	21,849	(11,823)	(1,488)	(12,174)	(3,636)
Reconciling items										
Amortisation of purchased intangible assets	—	—	—	—	—	—	—	(81)	—	(81)
Integration and restructuring costs	—	—	—	—	—	—	(841)	(18)	—	(859)
Gain on redemption of own debt	2,694	—	2,694	2,694	—	2,694	—	—	—	2,694
Gains on pensions curtailment	—	—	—	—	—	—	2,148	—	—	2,148
Bonus tax	—	—	—	—	—	—	(151)	—	—	(151)
Write-down of goodwill	—	—	—	—	—	—	(118)	—	—	(118)
	36,132	—	36,132	24,543	—	24,543	(10,785)	(1,587)	(12,174)	(3)

35 Segmental analysis continued

	Group									
	Total revenue			Total income						
2008	External £m	Inter segment £m	Total £m	External £m	Inter segment £m	Total £m	Operating expenses £m	Depreciation and amortisation £m	Impairment losses £m	Operating profit/(loss) before tax £m
UK Retail	7,865	1,642	9,507	5,201	(288)	4,913	(2,774)	(2)	(1,019)	1,118
UK Corporate	8,292	225	8,517	6,578	(2,635)	3,943	(1,418)	(150)	(319)	2,056
Wealth	1,123	2,119	3,242	(683)	1,823	1,140	(643)	(9)	(16)	472
Global Banking & Markets	4,147	10,271	14,418	383	1,493	1,876	(1,503)	(97)	(237)	39
Global Transaction Services	2,223	81	2,304	1,712	(27)	1,685	(791)	(1)	(30)	863
Ulster Bank	2,925	585	3,510	1,535	(420)	1,115	(679)	1	(106)	331
US Retail & Commercial	4,200	475	4,675	2,231	447	2,678	(1,408)	(151)	(437)	682
Central items	336	11,310	11,646	(4,255)	3,873	(382)	107	(579)	(2)	(856)
Core	31,111	26,708	57,819	12,702	4,266	16,968	(9,109)	(988)	(2,166)	4,705
Non-Core	3,941	1,561	5,502	2,713	(4,266)	(1,553)	(927)	(452)	(2,540)	(5,472)
	35,052	28,269	63,321	15,415	—	15,415	(10,036)	(1,440)	(4,706)	(767)
Eliminations	—	(28,269)	(28,269)	—	—	—	—	—	—	—
	35,052	—	35,052	15,415	—	15,415	(10,036)	(1,440)	(4,706)	(767)
Reconciling items										
Amortisation of purchased intangible assets	—	—	—	—	—	—	—	(100)	—	(100)
Integration and restructuring costs	—	—	—	—	—	—	(625)	(22)	—	(647)
Strategic disposals	442	—	442	442	—	442	—	—	—	442
Write-down of goodwill and other intangible assets	—	—	—	—	—	—	(8,144)	—	—	(8,144)
	35,494	—	35,494	15,857	—	15,857	(18,805)	(1,562)	(4,706)	(9,216)
2007										
UK Retail	8,698	1,601	10,299	6,155	(362)	5,793	(3,013)	(3)	(1,055)	1,722
UK Corporate	6,640	43	6,683	5,097	(2,227)	2,870	(809)	(325)	(98)	1,638
Wealth	962	2,218	3,180	(1,053)	2,074	1,021	(561)	(11)	(4)	445
Global Banking & Markets	4,876	7,037	11,913	5,094	(1,555)	3,539	(1,939)	(242)	(33)	1,325
Global Transaction Services	2,488	77	2,565	1,961	(356)	1,605	(717)	(2)	(15)	871
Ulster Bank	2,436	197	2,633	1,461	(435)	1,026	(587)	(5)	(39)	395
US Retail & Commercial	4,848	—	4,848	2,501	(56)	2,445	(1,302)	(118)	(246)	779
Central items	1,142	8,907	10,049	(3,184)	3,117	(67)	229	(576)	(2)	(416)
Core	32,090	20,080	52,170	18,032	200	18,232	(8,699)	(1,282)	(1,492)	6,759
Non-Core	8,907	2,574	11,481	4,275	(200)	4,075	(1,078)	(12)	(373)	2,612
	40,997	22,654	63,651	22,307	—	22,307	(9,777)	(1,294)	(1,865)	9,371
Eliminations	—	(22,654)	(22,654)	—	—	—	—	—	—	—
	40,997	—	40,997	22,307	—	22,307	(9,777)	(1,294)	(1,865)	9,371
Reconciling items										
Amortisation of purchased intangible assets	—	—	—	—	—	—	(40)	(84)	—	(124)
Integration costs	—	—	—	—	—	—	(32)	(60)	—	(92)
	40,997	—	40,997	22,307	—	22,307	(9,849)	(1,438)	(1,865)	9,155

Note:

(1) Segmental results for 2008 and 2007 have been restated to reflect transfers of businesses between segments in 2009.

	Group								
	2009			2008			2007		
	Assets £m	Liabilities £m	Cost to acquire fixed assets and intangible assets £m	Assets £m	Liabilities £m	Cost to acquire fixed assets and intangible assets £m	Assets £m	Liabilities £m	Cost to acquire fixed assets and intangible assets £m
UK Retail	107,136	88,006	—	98,636	78,999	6	95,248	75,756	1
UK Corporate	114,205	89,306	598	120,152	83,907	1,418	103,047	68,627	1,467
Wealth	18,104	36,278	11	16,320	35,081	41	14,103	34,555	34
Global Banking & Markets	731,379	749,190	540	1,186,045	1,264,750	791	512,611	562,193	497
Global Transaction Services	10,286	41,192	17	11,870	39,373	5	13,818	36,507	8
Ulster Bank	44,031	40,621	—	49,114	47,972	1	43,407	44,413	33
US Retail & Commercial	75,384	72,408	179	88,673	89,255	204	67,419	55,777	171
Central items	40,795	116,792	603	29,938	97,605	975	8,852	61,301	1,001
Core	1,141,320	1,233,793	1,948	1,600,748	1,736,942	3,441	858,505	939,129	3,212
Non-Core	191,661	42,991	2,910	277,182	93,738	1,964	213,233	84,774	1,168
Group	1,332,981	1,276,784	4,858	1,877,930	1,830,680	5,405	1,071,738	1,023,903	4,380

Note:

(1) Segmental results for 2008 and 2007 have been restated to reflect transfers of businesses between segments in 2009.

Segmental analysis of goodwill is as follows:

	UK Retail £m	UK Corporate £m	Wealth £m	Global Banking & Markets £m	Global Transaction Services £m	Ulster Bank £m	US Retail & Commercial £m	Central items £m	Non-Core £m	Total £m
At 1 January 2007	2,790	2,741	746	1,065	1,657	820	5,429	24	1,562	16,834
Currency translation and other adjustments	—	—	7	(6)	(16)	38	(103)	—	3	(77)
Acquisitions	—	—	—	—	—	—	66	—	—	66
Goodwill written off	—	—	—	—	—	—	—	—	(40)	(40)
At 1 January 2008	2,790	2,741	753	1,059	1,641	858	5,392	24	1,525	16,783
Currency translation and other adjustments	—	—	56	2	424	133	2,013	—	61	2,689
Acquisitions	—	—	—	—	—	—	—	—	211	211
Disposals	—	—	—	—	—	—	—	—	(47)	(47)
Write-down of goodwill	—	(46)	(9)	(1,023)	—	(991)	(4,382)	—	(1,353)	(7,804)
At 1 January 2009	2,790	2,695	800	38	2,065	—	3,023	24	397	11,832
Transfers to disposal groups	—	—	—	—	—	—	—	—	(238)	(238)
Currency translation and other adjustments	—	—	(12)	—	(168)	—	(302)	—	(13)	(495)
Acquisitions	—	—	—	26	—	—	—	—	—	26
Write-down of goodwill	—	—	—	—	—	—	—	—	(118)	(118)
At 31 December 2009	2,790	2,695	788	64	1,897	—	2,721	24	28	11,007

35 Segmental analysis continued

(b) Geographical segments

The geographical analyses in the tables below have been compiled on the basis of location of office where the transactions are recorded.

	Group				
2009	UK £m	USA £m	Europe £m	Rest of the World £m	Total £m
Total revenue	20,806	9,908	3,832	1,586	36,132
Net interest income	7,306	2,798	1,150	289	11,543
Net fees and commissions	3,893	1,501	322	46	5,762
Income/(loss) from trading activities	445	2,376	(37)	223	3,007
Other operating income/(loss)	3,575	186	530	(60)	4,231
Total income	15,219	6,861	1,965	498	24,543
Operating profit/(loss) before tax	752	487	(959)	(283)	(3)
Total assets	866,845	316,900	87,032	62,204	1,332,981
Total liabilities	834,524	301,102	79,175	61,983	1,276,784
Net assets attributable to equity shareholders and minority interests	32,321	15,798	7,857	221	56,197
Contingent liabilities and commitments	176,961	77,635	32,648	7,802	295,046
Cost to acquire property, plant and equipment and intangible assets	1,933	389	2,478	58	4,858

2008					
Total revenue	20,755	6,744	5,542	2,453	35,494
Net interest income	9,917	2,576	802	214	13,509
Net fees and commissions	3,982	1,341	333	94	5,750
(Loss)/income from trading activities	(3,835)	(1,657)	(302)	211	(5,583)
Other operating income/(loss)	1,556	158	489	(22)	2,181
Total income	11,620	2,418	1,322	497	15,857
Operating (loss)/profit before tax	(2,941)	(5,514)	(764)	3	(9,216)
Total assets	1,131,765	583,149	102,318	60,698	1,877,930
Total liabilities	1,104,026	568,344	98,126	60,184	1,830,680
Net assets attributable to equity shareholders and minority interests	27,739	14,805	4,192	514	47,250
Contingent liabilities and commitments	178,411	106,921	36,886	11,836	334,054
Cost to acquire property, plant and equipment and intangible assets	3,167	444	1,687	107	5,405

2007	UK £m	USA £m	Group Europe £m	Rest of the World £m	Total £m
Total revenue	27,057	7,488	4,658	1,794	40,997
Net interest income	8,150	2,098	756	112	11,116
Net fees and commissions	4,299	1,140	435	149	6,023
Income/(loss) from trading activities	1,582	(567)	73	54	1,142
Other operating income	3,167	241	562	56	4,026
Total income	17,198	2,912	1,826	371	22,307
Operating profit before tax	7,533	721	797	104	9,155
Total assets	705,372	251,514	78,419	36,433	1,071,738
Total liabilities	674,989	238,345	74,363	36,206	1,023,903
Net assets attributable to equity shareholders and minority interests	30,383	13,169	4,056	227	47,835
Contingent liabilities and commitments	170,361	66,283	40,135	7,851	284,630
Cost to acquire property, plant and equipment and intangible assets	2,864	238	1,255	23	4,380

36 Directors' and key management remuneration

The directors of the Bank are also directors of the holding company and are remunerated for their services to the RBS Group as a whole. The remuneration of the directors is disclosed in the Report and Accounts of the RBS Group.

Compensation of key management

The aggregate remuneration of directors and other members of key management during the year, borne by the RBS Group, was as follows:

	2009 £000	2008 £000
Short-term benefits	29,292	16,813
Post-employment benefits	9,781	13,174
Other long-term benefits	—	496
Termination benefits	—	345
Share-based payments	8,953	2,078
	48,026	32,906

37 Transactions with directors and key management

(a) At 31 December 2009, the amounts outstanding in relation to transactions, arrangements and agreements entered into by authorised institutions in the Group, as defined in UK legislation, were £3,596,978 in respect of loans to 15 persons who were directors of the Bank at any time during the financial period.

(b) For the purposes of IAS 24 'Related Party Disclosures', key management comprise directors of the Bank and members of the Group Management Committee. The captions in the Group's primary financial statements include the following amounts attributable, in aggregate, to key management:

	2009 £000	2008 £000
Loans and advances to customers	11,196	4,217
Customer accounts	11,713	9,572

Key management have banking relationships with Group entities which are entered into in the normal course of business and on substantially the same terms, including interest rates and security, as for comparable transactions with other persons of a similar standing or, where applicable, with other employees. These transactions did not involve more than the normal risk of repayment or present other unfavourable features.

Key management had no reportable transactions or balances with the holding company.

38 Related parties

UK Government

On 1 December 2008, the UK Government through HM Treasury became the ultimate controlling party of The Royal Bank of Scotland Group plc. The UK Government's shareholding is managed by UK Financial Investments Limited, a company wholly owned by the UK Government. As a result the UK Government and UK Government controlled bodies became related parties of the Group.

The Group enters into transactions with many of these bodies on an arm's length basis. The principal transactions during 2009 were: the Asset Protection Scheme, Bank of England facilities and the issue of debt guaranteed by the UK Government described below. Other transactions include the payment of: taxes including UK corporation tax and value added tax; national insurance contributions; local authority rates; and regulatory fees and levies; together with banking transactions such as loans and deposits undertaken in the normal course of banker-customer relationships. The volume and diversity of these transactions are such that disclosure of their amounts is impractical.

As at 31 December 2009 and 2008, balances with the UK Government and UK Government controlled bodies were:

	2009				2008			
Group	Central government (including the Bank of England) £m	Local government £m	Banks, financial corporations and public corporations £m	2009 Total £m	Central government (including the Bank of England) £m	Local government £m	Banks, financial corporations and public corporations £m	2008 Total £m
Assets								
Balances at central banks	16,521	—	—	16,521	282	—	—	282
Loans and advances to banks	—	—	664	664	—	—	1,053	1,053
Loans and advances to customers	47	985	308	1,340	1	575	431	1,007
Debt securities	18,338	—	—	18,338	19,732	—	—	19,732
Derivatives	204	59	6	269	1,286	60	10	1,356
Other	4,514	—	—	4,514	249	—	—	249
Liabilities								
Deposits by banks	—	—	436	436	26,541	—	605	27,146
Customer accounts	218	1,814	310	2,342	222	1,436	149	1,807
Derivatives	155	33	7	195	276	69	18	365
Other	118	—	—	118	176	—	—	176
Bank								
Assets								
Balances at central banks	16,521	—	—	16,521	282	—	—	282
Loans and advances to banks	—	—	664	664	—	—	1,053	1,053
Loans and advances to customers	1	654	18	673	—	399	14	413
Debt securities	18,338	—	—	18,338	19,111	—	—	19,111
Derivatives	204	59	6	269	1,286	60	10	1,356
Other	4,514	—	—	4,514	249	—	—	249
Liabilities								
Deposits by banks	—	—	436	436	26,541	—	605	27,146
Customer accounts	218	1,814	310	2,342	222	1,436	149	1,807
Derivatives	155	33	7	195	276	69	18	363
Other	118	—	—	118	176	—	—	176

No impairment losses were recognised by the Group in 2009 or 2008 in respect of balances with UK Government and UK Government controlled bodies.

Notes:

(1) In addition to the UK Government's shareholding in the Group, the UK Government and UK Government controlled bodies may hold debt securities, subordinated liabilities and other liabilities or shares issued by the Group in the normal course of their business. It is not practicable to ascertain and disclose these amounts.

(2) Certain of the liability balances are secured.

Asset protection scheme

On 22 December 2009, the Group entered into an agreement (the Asset Protection Scheme (APS)) with HM Treasury (HMT), acting on behalf of the UK Government, under which the Group purchased credit protection over a portfolio of specified assets and exposures (covered assets) from HMT with a par value of £282 billion; including £49 billion of covered assets held by fellow subsidiaries of The Royal Bank of Scotland Group plc. The protection is subject to a first loss of £60 billion and covers 90% of subsequent losses. Once the first loss has been exhausted, losses and recoveries in respect of assets for which a trigger event – failure to pay, bankruptcy or restructuring – has occurred are included in the balance receivable under the APS. Receipts from HMT will, over time, amount to 90% of cumulative losses (net of 90% of cumulative recoveries) on the portfolio of covered assets less the first loss amount. The Group has a right to terminate the APS at any time provided that the Financial Services Authority has confirmed in writing to HMT that it has no objection to the proposed termination. On termination the Group must pay HMT the higher of the regulatory capital relief received and £2.5 billion less premiums paid plus the aggregate of amounts received from the UK Government under the APS. In consideration for the protection provided by the APS, the Group paid an initial premium of £1,400 million on 31 December 2009. A further premium of £700 million is payable on 31 December 2010 and subsequently annual premiums of £500 million until the earlier of 2099 and the termination of the agreement.

The APS is a single contract providing credit protection in respect of a portfolio of financial assets. Under IFRS, credit protection is treated either as a financial guarantee contract or as a derivative financial instrument depending on the terms of the agreement and the nature of the protected assets and exposures. The Group has concluded, because not all the protected assets are held by the Group and the covered portfolio includes significant exposure in the form of derivatives, that the APS does not meet the criteria to be treated as a financial guarantee contract. The contract has therefore been accounted for as a derivative financial instrument: it was recognised initially and measured subsequently at fair value with changes in fair value recognised in profit or loss. There is no change in the recognition and measurement of those covered assets recognised on the Group's balance sheet as a result of the APS. Impairment provisions on covered assets measured at amortised cost are assessed and charged in accordance with the Group's accounting policy; held-for-trading assets, assets designated at fair value and available-for-sale assets within the APS portfolio continue to be measured at fair value with no adjustments to reflect the protection provided by the APS. There is no change in how gains and losses on the covered assets are recognised in the income statement or in other comprehensive income.

The Bank has also entered into two agreements with ABN AMRO Bank N.V. (AA), a fellow subsidiary, under which it has sold credit protection over the exposures held by AA and its subsidiaries that are subject to the APS. These agreements cover 100% of losses on these assets. One agreement provides protection over a portfolio that includes significant exposure in the form of derivatives; the other covers assets that are measured at amortised cost. The former agreement is accounted for as a credit derivative. The second agreement meets the definition of a financial guarantee contract and is accounted for as such.

The Group also participates in a number of schemes operated by the Bank of England and the UK Government and made available to eligible banks and building societies.

Bank of England facilities include:

- Open market operations – these provide market participants with funding at market rates on a tender basis in the form of short and long-term repos on a wide range of collateral and outright purchases of high-quality bonds to enable them to meet the reserves that they must hold at the Bank of England.

- US dollar repo operations – these commenced in September 2008 taking the form of an auction. Eligible collateral consists of securities routinely eligible in the Bank of England's short-term repo open market operations together with conventional US Treasuries.

- The special liquidity scheme – this was launched in April 2008 to allow financial institutions to swap temporarily illiquid assets for treasury bills, with fees charged based on the spread between 3-month LIBOR and the 3-month gilt repo rate. The scheme will operate for up to three years after the end of the drawdown period (30 January 2009) at the Bank of England's discretion.

As at 31 December 2009, the Group's utilisation of these facilities amounted to £21.4 billion (2008 – £41.8 billion).

Government credit guarantee scheme – announced in October 2008,the Scheme provides a guarantee on eligible new debt issued by qualifying institutions for a fee. The fee, payable to HM Treasury on guaranteed issues is based on a per annum rate of 50 basis points plus 100% of the institution's median five-year Credit Default Swap (CDS) spread during the twelve months to 7 July 2008.

As at 31 December 2009, the Group had obtained funding from the Bank of England and issued debt guaranteed by the Government totalling £51.5 billion (2008 – £32.2 billion).

38 Related parties continued

Other related parties

(a) In their roles as providers of finance, Group companies provide development and other types of capital support to businesses. These investments are made in the normal course of business and on arm's length terms. In some instances, the investment may extend to ownership or control over 20% or more of the voting rights of the investee company. However, these investments are not considered to give rise to transactions of a materiality requiring disclosure under IAS 24.

(b) The Group recharges The Royal Bank of Scotland Group Pension Fund with the cost of administration services incurred by it. The amounts involved are not material to the Group.

(c) In accordance with IAS 24, transactions or balances between Group entities that have been eliminated on consolidation are not reported.

(d) The captions in the primary financial statements of the Bank include amounts attributable to subsidiaries. These amounts have been disclosed in aggregate in the relevant notes to the financial statements. The table below discloses items included in income and operating expenses on transactions between the Group and fellow subsidiaries of the RBS Group.

	2009 £m	2008 £m
Income		
Interest receivable	1	569
Interest payable	751	885
Fees and commissions receivable	88	237
Fees and commissions payable	99	14
Expenses		
Premises and equipment	7	7

39 Ultimate holding company

The Group's ultimate holding company is The Royal Bank of Scotland Group plc which is incorporated in Great Britain and registered in Scotland. As at 31 December 2009, The Royal Bank of Scotland Group plc heads the largest group in which the Group is consolidated. Copies of the consolidated accounts may be obtained from The Secretary, The Royal Bank of Scotland Group plc, Gogarburn, PO Box 1000, Edinburgh EH12 1HQ.

Following placing and open offers by The Royal Bank of Scotland Group plc in December 2008 and April 2009, the UK Government, through HM Treasury, currently holds 70.3% of the issued ordinary share capital of the holding company and is therefore the Group's ultimate controlling party.

40 Post balance sheet events

There have been no significant events between the year end and the date of approval of these accounts which would require a change to or disclosure in the accounts.

On 25 March 2010, the RBS Group announced its intention to launch (i) an offer to exchange certain subordinated debt securities issued by Group members for new senior debt and (ii) tender offers in respect of certain preference shares, preferred securities and perpetual securities issued by Group members. The RBS Group expects to announce the offers in early April and will seek shareholder approvals as required in coordination with the annual general meeting of The Royal Bank of Scotland Group plc scheduled to take place on 28 April 2010.

On 30 March 2010, the Office of Fair Trading announced that it had arrived at an early resolution agreement with the RBS Group by which the RBS Group will pay a fine of £29 million and admit a breach in competition law relating to the provision of loan products to professional services firms.

Glossary of terms

Adjustable rate mortgage (ARM) – in the US a variable-rate mortgage. ARMs include: hybrid ARMs which typically have a fixed-rate period followed by an adjustable-rate period; interest-only ARMs where interest only is payable for a specified number of years, typically for three to ten years; and payment-option ARMs that allow the borrower to choose periodically between various payment options.

Alt-A (Alternative A-paper) are mortgage loans with a higher credit quality than sub-prime loans but with features that disqualify the borrower from a traditional prime loan. Alt-A lending characteristics include limited documentation; high loan-to-value ratio; secured on non-owner occupied properties; and debt-to-income ratio above normal limits.

Arrears are the aggregate of contractual payments due on a debt that have not been met by the borrower. A loan or other financial asset is said to be 'in arrears' when payments have not been made.

Asset-backed commercial paper (ABCP) – a form of asset-backed security generally issued by a commercial paper conduit.

Asset-backed securities (ABS) are securities that represent interests in specific portfolios of assets. They are issued by a special purpose entity following a securitisation. The underlying portfolios commonly comprise residential or commercial mortgages but can include any class of asset that yields predictable cash flows. Payments on the securities depend primarily on the cash flows generated by the assets in the underlying pool and other rights designed to assure timely payment, such as guarantees or other credit enhancements. Collateralised bond obligations, collateralised debt obligations, collateralised loan obligations, commercial mortgage backed securities and residential mortgage backed securities are all types of ABS.

Assets under management are assets managed by the Group on behalf of clients.

Collateralised bond obligations (CBOs) are asset-backed securities for which the underlying asset portfolios are bonds, some of which may be sub-investment grade.

Collateralised debt obligations (CDOs) are asset-backed securities for which the underlying asset portfolios are debt obligations: either bonds (collateralised bond obligations) or loans (collateralised loan obligations) or both. The credit exposure underlying synthetic CDOs derives from credit default swaps. The CDOs issued by an individual vehicle are usually divided in different tranches: senior tranches (rated AAA), mezzanine tranches (AA to BB), and equity tranches (unrated). Losses are borne first by the equity securities, next by the junior securities, and finally by the senior securities; junior tranches offer higher coupons (interest payments) to compensate for their increased risk.

Collateralised debt obligation squared (CDO-squared) is a type of collateralised debt obligation where the underlying asset portfolio includes tranches of other CDOs.

Collateralised loan obligations (CLOs) are asset-backed securities for which the underlying asset portfolios are loans, often leveraged loans.

Collectively assessed loan impairment provisions – impairment loss provisions in respect of impaired loans, such as credit cards or personal loans, that are below individual assessment thresholds. Such provisions are established on a portfolio basis, taking account the level of arrears, security, past loss experience, credit scores and defaults based on portfolio trends.

Commercial mortgage backed securities (CMBS) are asset-backed securities for which the underlying asset portfolios are loans secured on commercial real estate.

Commercial paper (CP) comprises unsecured obligations issued by a corporate or a bank directly or secured obligations (asset-backed CP), often issued through a commercial paper conduit, to fund working capital. Maturities typically range from two to 270 days. However, the depth and reliability of some CP markets means that issuers can repeatedly roll over CP issuance and effectively achieve longer term funding. Commercial paper is issued in a wide range of denominations and can be either discounted or interest-bearing.

Commercial paper conduit is a special purpose entity that issues commercial paper and uses the proceeds to purchase or fund a pool of assets. The commercial paper is secured on the assets and is redeemed either by further commercial paper issuance, repayment of assets or liquidity drawings.

Commercial real estate – freehold and leasehold properties used for business activities. Commercial real estate includes office buildings, industrial property, medical centres, hotels, retail stores, shopping centres, agricultural land and buildings, warehouses, garages etc.

Constant proportion portfolio insurance notes (CPPI notes) – CPPI is the name given to a trading strategy that is designed to ensure that a fixed minimum return is achieved either at all times or more typically, at a set date in the future. Essentially the strategy involves continuously re-balancing the portfolio of investments during the term of the product between performance assets and safe assets using a pre-set formula. CPPI notes provide investors with a return linked to a CPPI portfolio.

Contractual maturity is the date in the terms of a financial instrument on which the last payment or receipt under the contract is due for settlement.

Core Tier 1 capital – called-up share capital and eligible reserves plus equity non-controlling interests, less intangible assets and other regulatory deductions.

Core Tier 1 capital ratio – core Tier 1 capital as a percentage of risk-weighted assets.

Cost:income ratio – operating expenses as a percentage of total income.

Covered mortgage bonds are debt securities backed by a portfolio of mortgages that is segregated from the issuer's other assets solely for the benefit of the holders of the covered bonds.

Credit default swap (CDS) is a contract where the protection seller receives premium or interest-related payments in return for contracting to make payments to the protection buyer upon a defined credit event in relation to a reference financial asset or portfolio of financial assets. Credit events usually include bankruptcy, payment default and rating downgrades.

Credit derivative product company (CDPC) is a special purpose entity that sells credit protection under credit default swaps or certain approved forms of insurance policies. Sometimes they can also buy credit protection. CDPCs are similar to monoline insurers. However, unlike monoline insurers, they are not regulated as insurers.

Glossary of terms continued

Credit derivatives are contractual agreements that provide protection against a credit event on one or more reference entities or financial assets. The nature of a credit event is established by the protection buyer and protection seller at the inception of a transaction, and such events include bankruptcy, insolvency or failure to meet payment obligations when due. The buyer of the credit derivative pays a periodic fee in return for a payment by the protection seller upon the occurrence, if any, of a credit event. Credit derivatives include credit default swaps, total return swaps and credit swap options.

Credit enhancements are techniques that improve the credit standing of financial obligations; generally those issued by an SPE in a securitisation. External credit enhancements include financial guarantees and letters of credit from third-party providers. Internal enhancements include excess spread – the difference between the interest rate received on the underlying portfolio and the coupon on the issued securities; and over-collateralisation – on securitisation, the value of the underlying portfolio is greater than the securities issued.

Credit risk assets – loans and advances (including overdraft facilities), instalment credit, finance lease receivables and other traded instruments across all customer types.

Credit risk spread is the difference between the coupon on a debt instrument and the benchmark or the risk-free interest rate for the instrument's maturity structure. It is the premium over the risk-free rate required by the market for the credit quality of an individual debt instrument.

Credit valuation adjustments are adjustments to the fair values of derivative assets to reflect the creditworthiness of the counterparty.

Currency swap – an arrangement in which two parties exchange specific principal amounts of different currencies at inception and subsequently interest payments on the principal amounts. Often, one party will pay a fixed interest rate, while the other will pay a floating exchange rate (though there are also fixed-fixed and floating-floating arrangements). At the maturity of the swap, the principal amounts are usually re-exchanged.

Customer accounts comprise money deposited with the Group by counterparties other than banks and classified as liabilities. They include demand, savings and time deposits; securities sold under repurchase agreements; and other short term deposits. Deposits received from banks are classified as deposits by banks.

Debt restructuring – see renegotiated loans.

Debt securities are transferable instruments creating or acknowledging indebtedness. They include debentures, bonds, certificates of deposit, notes and commercial paper. The holder of a debt security is typically entitled to the payment of principal and interest, together with other contractual rights under the terms of the issue, such as the right to receive certain information. Debt securities are generally issued for a fixed term and redeemable by the issuer at the end of that term. Debt securities can be secured or unsecured.

Debt securities in issue comprise unsubordinated debt securities issued by the Group. They include commercial paper, certificates of deposit, bonds and medium-term notes.

Deferred tax asset – income taxes recoverable in future periods as a result of deductible temporary differences – temporary differences between the accounting and tax base of an asset or liability that will result in tax deductible amounts in future periods – and the carry-forward of tax losses and unused tax credits.

Deferred tax liability – income taxes payable in future periods as a result of taxable temporary differences (temporary differences between the accounting and tax base of an asset or liability that will result in taxable amounts in future periods).

Defined benefit obligation – the present value of expected future payments required to settle the obligations of a defined benefit plan resulting from employee service.

Defined benefit plan – pension or other post-retirement benefit plan other than a defined contribution plan.

Defined contribution plan – pension or other post-retirement benefit plan where the employer's obligation is limited to its contributions to the fund.

Delinquency - a debt or other financial obligation is considered delinquent when one or more contractual payments are overdue. Delinquency is usually defined in terms of days past due. Delinquent and in arrears are synonymous.

Deposits by banks comprise money deposited with the Group by banks and recorded as liabilities. They include money-market deposits, securities sold under repurchase agreements, federal funds purchased and other short term deposits. Deposits received from customers are recorded as customer accounts.

Derivative – a contract or agreement whose value changes with changes in an underlying index such as interest rates, foreign exchange rates, share prices or indices and which requires no initial investment or an initial investment that is smaller than would be required for other types of contracts with a similar response to market factors. The principal types of derivatives are: swaps, forwards, futures and options.

Discontinued operation is a component of the Group that either has been disposed of or is classified as held for sale. A discontinued operation is either: a separate major line of business or geographical area of operations or part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations; or a subsidiary acquired exclusively with a view to resale.

Exposure at default (EAD) – an estimate of the expected level of utilisation of a credit facility at the time of a borrower's default. The EAD may be higher than the current utilisation (e.g. in the case where further drawings may be made under a revolving credit facility prior to default) but will not typically exceed the total facility limit.

Fannie Mae (Federal National Mortgage Association) is a US Government Sponsored Enterprise. It buys mortgages, principally issued by banks, on the secondary market, pools them, and sells them as residential mortgage-backed securities to investors on the open market. Its obligations are not explicitly guaranteed by the full faith and credit of the US Government.

Federal Home Loan Mortgage Corporation see Freddie Mac.

Federal National Mortgage Association see Fannie Mae.

FICO score – a FICO score is calculated using proprietary software developed by the Fair Isaac Corporation in the US from a consumer's credit profile. The scores range between 300 and 850 and are used in credit decisions made by banks and other providers of credit.

First/second lien – a lien is a charge such as a mortgage held by one party, over property owned by a second party, as security for payment of some debt, obligation, or duty owed by that second party. The holder of a first lien takes precedence over all other encumbrances on that property i.e. second and subsequent liens.

Forward contract – a contract to buy (or sell) a specified amount of a physical or financial commodity, at an agreed price, at an agreed future date.

Freddie Mac (Federal Home Loan Mortgage Corporation) is a US Government Sponsored Enterprise. It buys mortgages, principally issued by thrifts, on the secondary market, pools them, and sells them as residential mortgage-backed securities to investors on the open market. Its obligations are not explicitly guaranteed by the full faith and credit of the US Government.

Futures contract is a contract which provides for the future delivery (or acceptance of delivery) of some type of financial instrument or commodity under terms established at the outset. Futures differ from forward contracts in that they are traded on recognised exchanges and rarely result in actual delivery; most contracts are closed out prior to maturity by acquisition of an offsetting position.

G10 - the Group of Ten comprises the eleven industrial countries (Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States) that have agreed to participate in the IMF's General Arrangements to Borrow.

Ginnie Mae (Government National Mortgage Association) is a US Government Agency that guarantees investors the timely payment of principal and interest on mortgage-backed securities for which the underlying asset portfolios comprise federally insured or guaranteed loans – mainly loans insured by the Federal Housing Administration or guaranteed by the Department of Veterans Affairs. Ginnie Mae obligations are fully and explicitly guaranteed as to the timely payment of principal and interest by the full faith and credit of the US Government.

Government Sponsored Enterprises (GSEs) are a group of financial services corporations created by the US Congress. Their function is to improve the efficiency of capital markets and to overcome statutory and other market imperfections which otherwise prevent funds from moving easily from suppliers of funds to areas of high loan demand. They include Fannie Mae and Freddie Mac.

Gross yield is the interest rate earned on average interest-earning assets i.e. interest income divided by average interest-earning assets.

Guaranteed mortgages are mortgages that are guaranteed by a government or government agency. In the US, government loan guarantee programmes are offered by the Federal Housing Administration, the Department of Veterans Affairs, and the Department of Agriculture's Rural Housing Service. In the Netherlands, the Gemeentegarantie programme is run partly by the central government and partly by the municipalities.

Home equity loan is a type of loan in which the borrower uses the equity in their home as collateral. A home equity loan creates a charge against the borrower's house.

Impaired loans – a loan or other financial asset or portfolio of financial assets classified as held-to-maturity, available-for-sale or loans and receivables is impaired if there is objective evidence that an event or events since initial recognition of the asset have adversely affected the amount or timing of future cash flows from the asset.

Impairment allowance – see loan impairment provisions.

Impairment losses – for impaired financial assets measured at amortised cost, impairment losses – the difference between carrying value and the present value of estimated future cash flows discounted at the asset's original effective interest rate – are recognised in profit or loss and the carrying amount of the financial asset reduced by establishing a provision (allowance). For impaired available-for-sale financial assets, the cumulative loss that had been recognised directly in equity is removed from equity and recognised in profit or loss as an impairment loss.

Individually assessed loan impairment provisions – impairment loss provisions for individually significant impaired loans assessed on a case-by-case basis, taking into account the financial condition of the counterparty and any guarantor and the realisable value of any collateral held.

International Accounting Standards Board (IASB) is the independent standard-setting body of the IASC Foundation. Its members are responsible for the development and publication of International Financial Reporting Standards (IFRS) and for approving Interpretations of IFRS as developed by the International Financial Reporting Interpretations Committee (IFRIC).

Interest rate swap – a contract under which two counterparties agree to exchange periodic interest payments on a predetermined monetary principal, the notional amount.

Interest spread is the difference between the gross yield and the interest rate paid on average interest-bearing liabilities.

Investment grade generally represents a risk profile similar to a rating of a "BBB-"/"Baa3" or better, as defined by independent rating agencies.

Latent loss provisions – loan impairment provisions held against impairments in the performing loan portfolio that have been incurred as a result of events occurring before the balance sheet date but which have not been identified as impaired at the balance sheet. The Group has developed methodologies to estimate latent loss provisions that reflect historical loss experience (adjusted for current economic and credit conditions) and the period between an impairment occurring and a loan being identified and reported as impaired.

Leveraged loans – funding (leveraged finance) provided to a business resulting in an overall level of debt that exceeds that which would be considered usual for the business or for the industry in which it operates. Leveraged finance is commonly employed to achieve a specific, often temporary, objective: to make an acquisition, to effect a buy-out or to repurchase shares.

Glossary of terms continued

Liquidity enhancements make funds available to ensure that the issuer of securities, usually a commercial paper conduit, can redeem the securities at maturity. They typically take the form of a committed facility from a third-party bank.

Loan impairment provisions – are established to recognise incurred impairment losses on a portfolio of loans classified as loans and receivables and carried at amortised cost. It has three components: individually assessed loan impairment provisions, collectively assessed loan impairment provisions and latent loss provisions.

Loan-to-value ratio – the amount of a secured loan as a percentage of the appraised value of the security e.g. the outstanding amount of a mortgage loan as a percentage of the property's value.

Loss given default (LGD) – the economic loss that may occur in the event of default i.e. the actual loss – that part of the exposure that is not expected to be recovered – plus any costs of recovery.

Master netting agreement is an agreement between two counterparties that have multiple derivative contracts with each other that provides for the net settlement of all contracts through a single payment, in a single currency, in the event of default on, or termination of, any one contract.

Medium term notes (MTNs) are debt securities usually with a maturity of five to ten years, but the term may be less than one year or as long as 50 years. They can be issued on a fixed or floating coupon basis or with an exotic coupon; with a fixed maturity date (non-callable) or with embedded call or put options or early repayment triggers. MTNs are most generally issued as senior, unsecured debt.

Monoline insurers are entities that specialise in providing credit protection against the notional and interest cash flows due to the holders of debt instruments in the event of default. This protection is typically in the form of derivatives such as credit default swaps.

Mortgage-backed securities – are asset-backed securities for which the underlying asset portfolios are loans secured on property. See residential mortgage backed securities and commercial mortgage backed securities.

Mortgage servicing rights are the rights of a mortgage servicer to collect mortgage payments and forward them, after deducting a fee, to the mortgage lender.

Mortgage vintage – the year in which a mortgage loan was made to the customer.

Negative equity mortgages – mortgages where the value of the property mortgaged is less than the outstanding balance on the loan.

Net interest income is the difference between interest receivable on financial assets classified as loans and receivables or available-for-sale and interest payable on financial liabilities carried at amortised cost.

Net interest margin is net interest income as a percentage of average interest-earning assets.

Net principal exposure is the carrying value of a financial asset after taking account of credit protection purchased but excluding the effect of any counterparty credit valuation adjustment to that protection.

Non-accrual loans comprise all 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 non-accrual loans.

Non-conforming mortgages – mortgage loans that do not meet the requirements for sale to US Government agencies or US Government sponsored enterprises. These requirements include limits on loan-to-value ratios, loan terms, loan amounts, borrower creditworthiness and other requirements.

Option - an option is a contract that gives the holder the right but not the obligation to buy (or sell) a specified amount of the underlying physical or financial commodity, at a specific price, at an agreed date or over an agreed period. Options can be exchange-traded or traded over-the-counter.

Past due – a financial asset such as a loan is past due when the counterparty has failed to make a payment when contractually due.

Potential problem loans – are loans other than non-accrual loans, accruing loans which are contractually overdue 90 days or more as to principal or interest and troubled debt restructurings where known information about possible credit problems of the borrower causes management to have serious doubts about the borrower's ability to meet the loan's repayment terms.

Prime - prime mortgage loans generally have low default risk and are made to borrowers with good credit records and a monthly income that is at least three to four times greater than their monthly housing expense (mortgage payments plus taxes and other debt payments). These borrowers provide full documentation and generally have reliable payment histories.

Private equity investments are equity investments in operating companies not quoted on a public exchange. Capital for private equity investment is raised from retail or institutional investors and used to fund investment strategies such as leveraged buyouts, venture capital, growth capital, distressed investments and mezzanine capital.

Probability of default (PD) – the likelihood that a customer will fail to make full and timely repayment of credit obligations over a one year time horizon.

Regular way purchase or sale is a purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned.

Renegotiated loans – loans are generally renegotiated ('restructured') either as part of the ongoing banking relationship with a creditworthy customer or in response to a borrower's financial difficulties. In the latter case renegotiation may result in an extension of the due date of payment, a concessionary rate of interest or other changes in the terms of the loan; the loan continues to be overdue and will be individually impaired if the renegotiated payments of interest and principal are insufficient to recover the loan's original carrying amount.

Repurchase agreement (Repo) see Sale and repurchase agreements.

Residential mortgage backed securities (RMBS) are asset-backed securities for which the underlying asset portfolios are residential mortgages.

Retail loans are loans made to individuals rather than institutions. The loans may be for car purchases, home purchases, medical care, home repair, holidays and other consumer uses.

Reverse repurchase agreement (Reverse repo) – see Sale and repurchase agreements.

Risk asset ratio (RAR) – total regulatory capital as a percentage of risk-weighted assets.

Risk elements in lending (REIL) comprise non-accrual loans, accruing loans which are contractually overdue 90 days or more as to principal or interest and troubled debt restructurings.

Risk-weighted assets – assets adjusted for their associated risks using weightings established in accordance with the Basel Capital Accord as implemented by the FSA. Certain assets are not weighted but deducted from capital.

Sale and repurchase agreements – in a sale and repurchase agreement one party, the seller, sells a financial asset to another party, the buyer, at the same time the seller agrees to reacquire, and the buyer to resell, the asset at a later date. From the seller's perspective such agreements are repurchase agreements (repos) and from the buyer's reverse repurchase agreements (reverse repos).

Securitisation is a process by which assets or cash flows are transformed into transferable securities. The underlying assets or cash flows are transferred by the originator or an intermediary, typically an investment bank, to a special purpose entity which issues securities to investors. Asset securitisations involve issuing debt securities (asset-backed securities) that are backed by the cash flows of income-generating assets (ranging from credit card receivables to residential mortgage loans). Liability securitisations typically involve issuing bonds that assume the risk of a potential insurance liability (ranging from a catastrophic natural event to an unexpected claims level on a certain product type).

Special purpose entity (SPE) is an entity created by a sponsor, typically a major bank, finance company, investment bank or insurance company. An SPE can take the form of a corporation, trust, partnership, corporation or a limited liability company. Its operations are typically limited for example in a securitisation to the acquisition and financing of specific assets or liabilities.

Structured Investment Vehicle (SIV) is a limited-purpose operating company that undertakes arbitrage activities by purchasing highly rated medium and long-term, fixed-income assets and funding itself with short-term, highly rated commercial paper and medium-term notes.

Structured notes are securities that pay a return linked to the value or level of a specified asset or index. Structured notes can be linked to equities, interest rates, funds, commodities and foreign currency.

Student loan related assets are assets that are referenced to underlying student loans.

Subordinated liabilities are liabilities which, in the event of insolvency or liquidation of the issuer, are subordinated to the claims of depositors and other creditors of the issuer.

Sub-prime – sub-prime mortgage loans are designed for customers with one or more high risk characteristics, such as: unreliable or poor payment histories; loan-to-value ratio of greater than 80%; high debt-to-income ratio; the loan is not secured on the borrower's primary residence; or a history of delinquencies or late payments on the loan.

Super senior CDO is the most senior class of instrument issued by a CDO vehicle. They benefit from the subordination of all other instruments, including AAA-rated securities, issued by the CDO vehicle.

Tier 1 capital – core Tier 1 capital plus other Tier 1 securities in issue, less material holdings in financial companies.

Tier 1 capital ratio – Tier 1 capital as a percentage of risk-weighted assets.

Tier 2 capital – qualifying subordinated debt and other Tier 2 securities in issue, eligible collective impairment allowances, unrealised available for sale equity gains and revaluation reserves less certain regulatory deductions.

Troubled debt restructurings – comprise those loans that are troubled debt restructurings but that are not included in either non-accrual loans or in accruing loans which are contractually overdue 90 days or more as to principal or interest. A restructuring of a loan is a troubled debt restructuring if the lender, for economic or legal reasons related to the borrower's financial difficulties, grants a concession to the borrower that it would not otherwise consider.

US Government National Mortgage Association see Ginnie Mae.

Unaudited – unaudited financial information is information that has not been subjected to the audit procedures undertaken by the Group's auditors to enable them to express an opinion on the Group's financial statements.

VaR is a technique that produces estimates of the potential change in the market value of a portfolio over a specified time horizon at given confidence levels.

Wrapped security – a wrapped security is a debt security where the holder benefits from credit protection provided by a third party, typically a financial guarantor or monoline insurer.

Write down – a reduction in the carrying value of an asset to record a decline in its fair value or value in use.

Five year summary

Summary consolidated income statement	2009 £m	Restated 2008 £m	2007 £m	2006 £m	2005 £m
Net interest income	11,543	13,509	11,116	10,392	9,711
Non-interest income (1, 2)	13,000	2,348	11,191	11,176	9,963
Total income	24,543	15,857	22,307	21,568	19,674
Operating expenses (3, 4, 5, 6)	(12,372)	(20,367)	(11,287)	(11,341)	(10,672)
Profit/(loss) before impairment losses	12,171	(4,510)	11,020	10,227	9,002
Impairment losses	(12,174)	(4,706)	(1,865)	(1,873)	(1,709)
Operating (loss)/profit before tax	(3)	(9,216)	9,155	8,354	7,293
Tax credit/(charge)	523	505	(1,903)	(2,433)	(2,267)
Profit/(loss) for the year	520	(8,711)	7,252	5,921	5,026
Profit/(loss) attributable to:					
Minority interests	235	208	53	45	27
Preference shareholders	523	638	331	252	154
Ordinary shareholders	(238)	(9,557)	6,868	5,624	4,845

Notes:

(1) Includes gains on strategic disposals of £442 million in 2008 (2007 and 2006 – nil; 2005 – £242 million).

(2) Includes gain on redemption of own debt of £2,694 million in 2009.

(3) Includes integration and restructuring costs of £859 million (2008 – £647 million, 2007 – £92 million, 2006 – £120 million, 2005 – £349 million).

(4) Includes purchased intangibles amortisation of £81 million in 2009 (2008 – £100 million; 2007 – £124 million; 2006 – £94 million; 2005 – £97 million).

(5) Includes write-down of goodwill and other intangible assets of £118 million in 2009 (2008 – £8,144 million).

(6) Includes gains on pensions curtailment of £2,148 million in 2009.

Summary consolidated balance sheet	2009 £m	2008 £m	2007 £m	2006 £m	2005 £m
Loans and advances	604,610	698,890	647,795	547,042	485,488
Debt securities and equity shares	187,586	180,457	169,941	126,621	120,351
Derivatives and settlement balances	455,506	948,328	211,301	109,548	89,479
Other assets	85,279	50,255	42,701	50,416	49,806
Total assets	1,332,981	1,877,930	1,071,738	833,627	745,124
Owners' equity	55,051	45,958	47,683	37,936	34,510
Minority interests	1,146	1,292	152	396	104
Subordinated liabilities	34,717	39,951	27,796	27,786	28,422
Deposits	569,440	635,111	594,490	516,462	452,729
Derivatives, settlement balances and short positions	468,938	955,062	256,921	152,989	128,295
Other liabilities	203,689	200,556	144,696	98,058	101,064
Total liabilities and equity	1,332,981	1,877,930	1,071,738	833,627	745,124

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Published by The Royal Bank of Scotland Group plc
Printed at St Ives Westerham Press Ltd, ISO14001, FSC certified and CarbonNeutral®

FSC Mixed Sources
Product group from well-managed forests, controlled sources and recycled wood or fiber
www.fsc.org Cert no. SGS-COC-1732
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